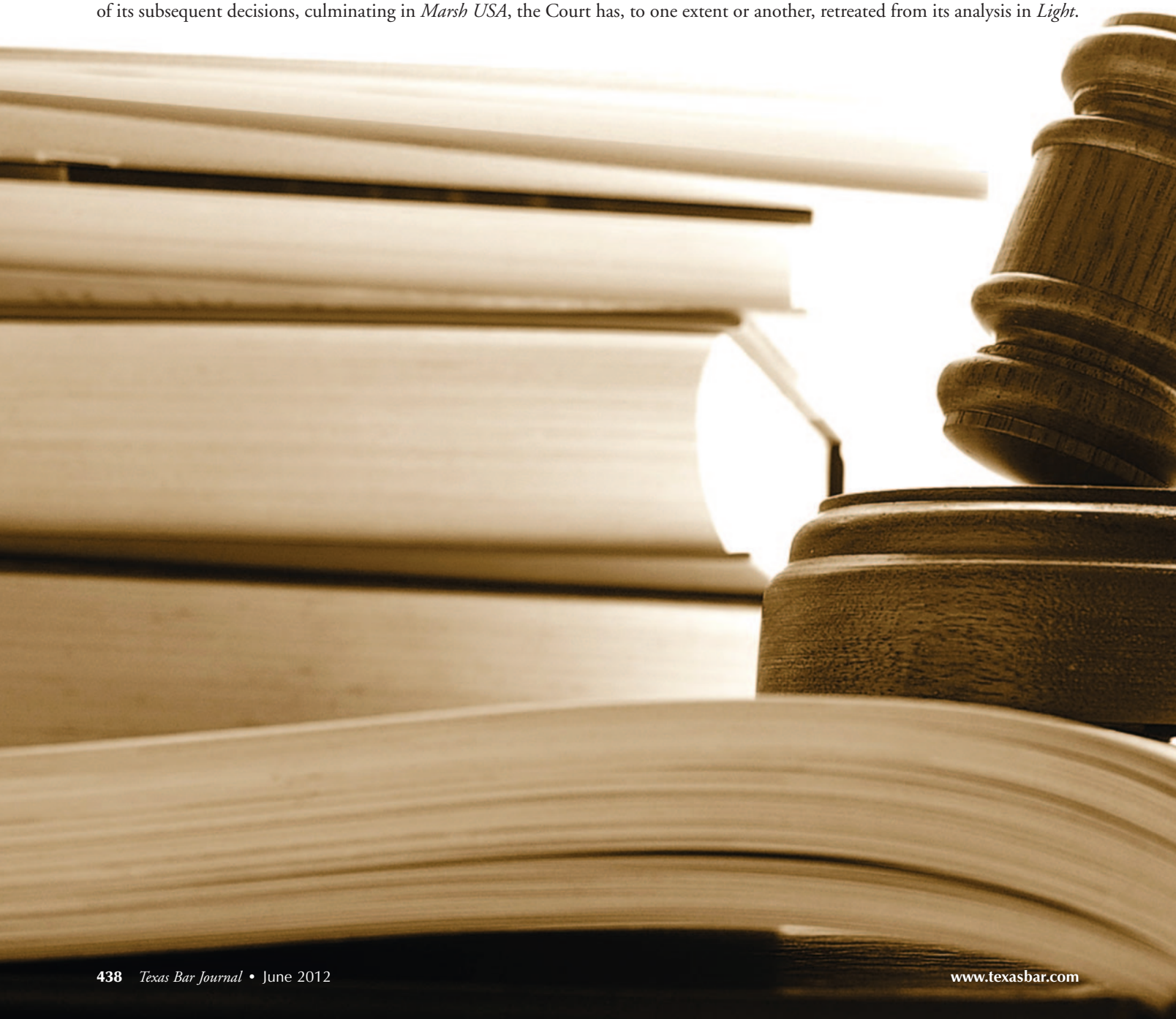
Light Fades Further

The Texas Supreme Court Changes Direction on Covenants Not to Compete

By Alex Harrell

With its decision in *Marsh USA, Inc. v. Cook*, 354 S.W.3d 764 (Tex. 2011), the Texas Supreme Court for the third time revisited its analysis of the Covenants Not to Compete Act (Tex. Bus. & Com. Code §§15.50–.52) and again moved away from the interpretation of the Act it espoused in *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642 (Tex. 1994). The 1989 Act creates an exception to the general proposition that "[e]very contract, combination, or conspiracy in restraint of trade or commerce is unlawful"[1] and legitimizes covenants not to compete, provided the covenants satisfy certain conditions. Specifically, a covenant not to compete is only enforceable under the Act if it is "part of or ancillary to" an "otherwise enforceable agreement."[2] The Act further provides that any limitations in a covenant as to time, geographical area, and scope of activity restrained must be (1) reasonable and (2) no greater than is necessary to protect the goodwill or other business interest sought to be protected by the agreement.[3] Decided 17 years before *Marsh USA*, *Light* was the Court's first crack at interpreting the Act. But with each of its subsequent decisions, culminating in *Marsh USA*, the Court has, to one extent or another, retreated from its analysis in *Light*.



LIGHT V. CENTEL CELLULAR CO. OF TEXAS

In *Light*, an at-will employee was forced to sign a covenant not to compete two years after her employment began.[4] The employee eventually resigned and her employer refused to voluntarily release her from the covenant.[5] The employee sued, seeking a declaration that the covenant was unenforceable.[6] The trial court determined that the covenant was unenforceable but the Twelfth Court of Appeals reversed.[7]

On appeal, the Texas Supreme Court noted that "[a]lthough Light was an employee-at-will, and by definition, she and her employer could not have an 'otherwise enforceable agreement' between them pertaining to, for example, the duration of her employment, at-will employment does *not* preclude the formation of other contracts between employer and employee."[8] Thus, the Court concluded that otherwise enforceable agreements "can emanate from at-will employment so long as the consideration for any promise is not illusory."[9] The court found three non-illusory promises in Light's "agreement" with her employer: (1) the employer's promise to provide specialized training; (2) Light's promise to provide 14 days' notice if she terminated her employment; and (3) Light's promise to provide an inventory of all the employer's property on termination.[10]

The Court next considered whether the covenant was "ancillary to" this agreement between Light and her employer.[11] Citing U.S. Supreme Court Justice John Paul Stevens' dissenting opinion in *Bus. Elecs. v. Sharp Elecs.*, 485 U.S. 717 (1988), the Court held a covenant is "ancillary to" an employment agreement if two conditions are met:

(1) the consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in restraining the employee from competing; and

(2) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.[12]

The Court concluded that because the covenant forced on Light was not "designed to enforce any of Light's return promises in the otherwise enforceable agreement … [,]" it was not ancillary to that agreement and therefore was not enforceable.[13]

ALEX SHESHUNOFF MGMT. SERVS., L.P. V. JOHNSON

Light remained untouched until the Texas Supreme Court issued its decision in *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644 (Tex. 2006). The at-will employee in *Sheshunoff* was forced to sign an employment agreement containing a covenant not to compete five years after he began working and shortly after being promoted to a position focused on maintaining relationships with clients and prospective clients.[14] The agreement included a provision under which the employer promised to give the employee special training and access to certain confidential and proprietary information.[15] Four years later, the employee quit and accepted a position with a direct competitor.[16]

The employer sued, alleging breach of contract and seeking injunctive relief.[17] After granting temporary injunctive relief, the trial court entered summary judgment in favor of the employee.[18] The trial court interpreted a footnote from *Light* as requiring the employer's promise to the employee

in the employment agreement to be non-illusory at the time the promise was made.[19] Since the employer was free to terminate the employee before providing the promised confidential information and specialized training, those promises were illusory at the time the agreement was made and the court therefore decided the covenant was unenforceable.[20] The Third Court of Appeals agreed with the trial court's interpretation of *Light* and affirmed.[21]

The Texas Supreme Court granted review to consider the question of "whether an at-will employee who signs a non-compete covenant is bound by that agreement if, at the time the agreement is made, the employer has no corresponding enforceable obligation."[22] The answer under *Light* had always been "no."[23] In footnote 6 of *Light*, the Court had decided that a unilateral contract that could be accepted only by an employer's future performance "could not support a covenant not to compete inasmuch as it was not an 'otherwise enforceable agreement at the time the agreement is made' as required by §15.50."[24] In its first departure from *Light*, the *Sheshunoff* court held that "[t]here is no sound reason why a unilateral contract made enforceable by performance should fail under the Act."[25] The Court therefore concluded that "if … the employer's consideration is provided by performance and becomes non-illusory at that point, and the agreement in issue is otherwise enforceable under the Act, … " then the covenant is enforceable.[26]

MANN FRANKFORT STEIN & LIPP ADVISORS, INC. V. FIELDING

The Texas Supreme Court waited only three years before again revisiting its interpretation of the Act. In *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844 (Tex. 2009), the Court considered "whether a covenant not to compete in an at-will employment agreement is enforceable when the employee expressly promises not to disclose confidential information, but the employer makes no express return promise to provide confidential information."[27] The employee in *Mann Frankfort* was an accountant who resigned from an accounting firm but was rehired two years later.[28] As a condition of his reemployment, he was forced to sign an at-will employment agreement that included a covenant not to compete.[29] The covenant bound the employee not to disclose or use any confidential information or knowledge he obtained while employed.[30] There was no provision in the agreement by which the accounting firm promised to provide the employee access to any such confidential information.[31] The trial court found the covenant unenforceable and the First Court of Appeals affirmed.[32]

On appeal, the Texas Supreme Court held that the accounting firm did not need to expressly promise to provide the employee access to confidential information. According to the Court, "[w]hen the nature of the work the employee is hired to perform requires confidential information to be provided for the work to be performed by the employee, the employer impliedly promises confidential information will be provided."[33] The Court noted that "if one party makes an express promise that cannot reasonably be performed absent some type of performance by the other party, courts may imply a return promise so the dealings of the parties can be construed to mean something rather than nothing at all."[34] Because the circumstances of the employee's duties to the accounting firm "indicate[d] that his employment necessarily involved the provision of confidential information by Mann Frankfort before [he] could perform the work he was hired to do[,]" and because this implied promise gave rise to the employer's interest in having the covenant not to compete, the Court held that both prongs of *Light*'s "ancillary to" test were met and therefore found the covenant enforceable.[35]

MARSH USA, INC. V. COOK

After retreating from *Light* to one extent or another in *Sheshunoff* and *Mann Frankfort*, the Court, in a 5-3 decision,[36] opted to dramatically shift the landscape of its covenants not to compete jurisprudence when it handed down its *Marsh USA* decision in 2011. Following 13 years of service, the *Marsh USA* plaintiff, Cook, was rewarded by his employer with stock options as part of an employee incentive plan.[37] The plan "was developed to provide 'valuable,' 'select' employees with the opportunity to become part owners of the company with the incentive to contribute to and benefit from the long-term growth and profitability of [the company]."[38] Nine years later, Cook exercised the options.[39] Pursuant to the plan, at that time he was required to execute a non-solicitation agreement, which included a covenant not to compete.[40] Less than three years after exercising the options, Cook resigned and went to work for a direct competitor.[41]

Cook's employer sued, claiming breach of contract and breach of fiduciary duty.[42] Cook filed a motion for partial summary judgment alleging the agreement was unenforceable because it was not ancillary to or part of an otherwise enforceable agreement and citing *Light*.[43] The trial court determined the agreement was unenforceable and, relying on *Light*, the Fifth Court of Appeals affirmed.[44]

The Texas Supreme Court reversed.[45] The Court focused in large part on the legislative history of the Act and stated that the legislature "crafted the Act to prohibit naked restrictions on employee mobility that impede competition while allowing employers and employees to agree to reasonable restrictions on mobility that are ancillary to or part of a valid contract having a primary purpose that is unrelated to restraining competition between the parties."[46] The Court reaffirmed the two-step threshold inquiry it has long applied to determine if a covenant is enforceable.[47] First, the Court determined whether there was an "otherwise enforceable agreement.[48] Since that issue was not in dispute, the Court proceeded to the second step: deciding whether the covenant was "ancillary to or part of" the otherwise enforceable agreement.[49]

The Court then considered the two-pronged "ancillary to" inquiry it first announced in *Light*. Noting that "the Act itself

does not include a 'give rise' requirement, nor does it define 'ancillary[,]' " the Court concluded that "*Light*'s 'give rise' condition on the enforceability of noncompetes was more restrictive than the common law rule the Legislature intended to resurrect [with its passage of the Act]."[50] The Court therefore found that the Legislature did not intend to include a "give rise" requirement in the Act.[51] According to the majority, "there is no compelling logic in *Light*'s conclusion that consideration for the otherwise enforceable agreement gives rise to the interest in restraining the employee from competing."[52]

Instead, the Court found that by requiring a covenant to be "part of" or "ancillary to" an otherwise enforceable employment agreement, the Legislature intended only that there be "a nexus" between the covenant and the agreement.[53] The Court determined the common definition of "ancillary" is " 'supplementary' " and that "part means 'one of several units … of which something is composed.' "[54] Accordingly, the Court held that "[c]onsideration for a noncompete that is reasonably related to an interest worthy of protection, such as trade secrets, confidential information or goodwill, satisfies the statutory nexus; and there is no textual basis for excluding the protection of much of goodwill from the business interests that a noncompete may protect."[55]

Applying its new "reasonably related" standard to the covenant before it, the Court noted that "[b]y awarding Cook stock options, Marsh linked the interests of a key employee with the company's long-term business interests."[56] Stockholders, the Court observed, "are 'owners' who, beyond employees, benefit from the growth and development of the company" and their "interests are furthered by fostering the goodwill between the employer and its clients."[57] The Court therefore concluded that "stock options are reasonably related to the protection of this business goodwill."[58] Thus, the Court held that the covenant was ancillary to an otherwise enforceable agreement.[59]

CONCLUSION

So what changed in 17 years since a seven-justice majority[60] decided *Light*?[61] Certainly the economic climate today is more precarious than it was in 1994, when the nation was beginning its embrace of dot coms and faced a burgeoning period of financial prosperity. Perhaps the uncertainty in the market over the last several years has left the judiciary more acutely sympathetic to employers' concerns.[62] Undoubtedly, the composition of the Court is different today. Justice Nathan Hecht, who sided with the majority in both *Light* and *Marsh USA*,[63] is the only justice who remains from the *Light* court. Clearly, there is much room for debate as to what brought us from *Light* to *Marsh USA*. One thing is certain: Section 15.50(a) of the Covenants Not to Compete Act remains textually identical to the statute interpreted in *Light*. In fact, it was last substantively amended in 1993 — the year before *Light* was decided.[64]

A more immediate and practical question is, after *Marsh USA*, what is the applicable test for deciding the enforceability of covenants not to compete? The two-part threshold inquiry is clearly still the law.[65] First, the court must determine whether there is an "otherwise enforceable agreement." The agreement may emanate from an at-will employment arrangement so long as there are mutual, non-illusory promises from employee and employer.[66] And the agreement may be enforceable and thus support a covenant not to compete even if the employer's consideration is in the nature of future performance, provided, of course, that the consideration is actually conveyed.[67] The court also may imply a promise by the employer to provide the employee access to confidential information if the nature of the work the employee is hired to perform requires him or her to have access to confidential information.[68] On the basis of that implied promise, the court may find an otherwise enforceable agreement sufficient to support a covenant not to compete.[69] With regard to current employees, a "covenant cannot be a stand-alone promise from the employee lacking any new consideration from the employer."[70] The courts will "not allow an employer to spring a non-compete covenant on an existing employee and enforce such a covenant absent new consideration from the employer."[71]

Second, the court must determine whether the covenant is "part of or ancillary to" the otherwise enforceable agreement.[72] Under *Light*, this determination required another two-pronged analysis.[73] *Marsh USA* replaced the first *Light* prong, under which the court must now decide whether the consideration given by the employer is "reasonably related" to its interest in having the covenant.[74] The Act specifically mentions "goodwill" as a legitimate interest that may be protected by a covenant not to compete.[75] *Marsh USA* instructs that stock options are "reasonably related" to the protection of business goodwill,[76] and, therefore, an agreement tying a noncompete to the issuance of stock options satisfies the first prong of the new "part of or ancillary to" inquiry.[77]

At this point, it is unclear what other forms of consideration might satisfy the new "reasonably related" standard. But the range of different forms of consideration that will support a covenant not to compete is unquestionably more expansive under *Marsh USA* than was the case under the *Light* "give rise" inquiry. For its part, the dissent in *Marsh USA* postulated that "any financial incentive" including "a raise, a bonus, or even a salary could support an enforceable covenant" under the majority's reasoning.[78] Under the second *Light* prong — ostensibly left untouched by the Court in *Marsh USA*[79] — the covenant may only be found enforceable if it is designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.[80]

Lastly, in an area not extensively analyzed by the Court in any of the foregoing decisions,[81] any restrictions in the covenant as to time, geographic area, or scope of activity restrained must be (1) reasonable and (2) no greater than is necessary to protect the goodwill or other business interest the agreement is intended to protect.[82] Not unlike the "ancillary to" inquiry, this requires a fact-intensive analysis and what is "reasonable" will almost always depend on the unique circumstances of a given case.

Generally, restraints lasting up to five years have been found reasonable.[83] Under the *Light* paradigm, the simplest approach to analyzing the reasonableness of the time restraint was to determine at what point in time the consideration given by the employer could no longer be used to secure a competitive advantage. The analysis is not so clear under *Marsh USA*, which permits covenants supported by consideration such as stock options — something not susceptible to later use by the employee in competition against his former employer. As to geographic scope, covenants that restrain the former employee beyond the geographic area in which he or she worked while employed are more likely to be found unreasonable.[84] Similarly, a court will likely look with disfavor on a covenant that restrains a former employee from performing activities that are outside the scope of those he performed while working for the employer protected by the covenant.[85] Of course, even if a restriction as to time, geographic area, or scope of activity restrained is found unreasonable, the Act is clear that "the court *shall* reform the covenant to the extent necessary to cause the limitations contained in the covenant … to be reasonable … ."[86]

The Texas Supreme Court has instructed that "[t]he hallmark of enforcement is whether or not the covenant is reasonable."[87] There is minimal guidance in *Marsh USA* as to what is "reasonable" under the Court's new interpretation of the Act. It is evident, however, that a covenant that might not have passed muster under *Light*'s "give rise" test may now be found enforceable under the less stringent "reasonably related" standard announced in *Marsh USA*. It may be that a standard that rises or falls on a "reasonableness" inquiry will to some extent always suffer from "a certain eye-of-the-beholder flavor — a vagueness that inexorably produces the case-by-case unpredictability that haunts this area of employment law."[88] Only time will tell.

NOTES

1. Tex. Bus. & Com. Code §15.05(a).
2. *Id.* at §15.50(a).
3. *Id.*
4. 883 S.W.2d at 643.
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* at 644 (emphasis original).
9. *Id.*
10. *Id.* at 645–46.
11. The court did not consider whether the covenant was "a part of" the agreement.
12. *Id.* at 647.
13. *Id.* at 647–48.
14. 209 S.W.3d at 646.
15. *Id.* at 647.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* at 647–48.
22. *Id.* at 646.
23. *Id.*
24. 883 S.W.2d at 645 n. 6.
25. 209 S.W.3d at 651.
26. *Id.*
27. 289 S.W.3d at 845.
28. *Id.*
29. *Id.*
30. *Id.* at 846.
31. *Id.* at 847.
32. *Id.*
33. *Id.* at 850.
34. *Id.*
35. *Id.* at 852.
36. Justice Don Willett concurred in the judgment only. *Marsh USA*, 354 S.W.3d at 780 (Tex. 2011) (Willett, J., concurring in the judgment).
37. *Id.* at 766.
38. *Id.*
39. *Id.* at 767.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 768.
45. *Id.* at 780.
46. *Id.* at 770.
47. *Id.* at 773.
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.* at 775.
52. *Id.* The Court added to its criticism of *Light*, finding that "*Light*'s ['give rise'] requirement is contrary to the language of the Act; thwarts the purpose of the Act, which was to expand rather than restrict the enforceability of such covenants; and contradicts the Act's intent to return Texas law on the enforce-

ability of noncompete agreements to the common law prior to *Hill* [*v. Mobile Auto Trim, Inc.*, 725 S.W.2d 168 (Tex. 1987)]." *Id.*

53. *Id.*
54. *Id.* (citing *Sheshunoff*, 209 S.W.3d at 665 (Wainright, J., concurring) (quoting Webster's Ninth New Collegiate Dictionary 84, 857 (9th ed. 1990))).
55. *Id.*
56. *Id.* at 777.
57. *Id.*
58. *Id.*
59. *Id.*
60. There was no dissent in *Light*. Justice Lloyd Doggett joined in the judgment only and Justice Jack Hightower authored a concurring opinion in which he opined that an at-will employment arrangement could not constitute an "otherwise enforceable agreement." *Light*, 883 S.W.2d at 648 (Hightower, J., concurring).
61. The *Marsh USA* dissent would likely answer "nothing." The dissent was somewhat caustic in describing the majority's departure from *Light*, observing that "[t]he Court's main problem with the 'give rise' standard appears to be this: Stock options do not give rise to an interest in restraining trade, and therefore the give rise standard cannot accompany the enforcement of a covenant based on stock options." 354 S.W.3d at 789 (Green, J., dissenting).
62. The Court specifically observed that "valid covenants not to compete ensure that the costs incurred to develop human capital are protected against competitors who, having not made such expenditures, might appropriate the employer's investment." *Id.* at 769 (citing Greg T. Lembrick, *Garden Leave: A Possible Solution to the Uncertain Enforceability of Restrictive Employment Covenants*, 102 Colum. L. Rev. 2291, 2296 (2002)).
63. *Id.* at 766; *Light*, 883 S.W.2d at 643.
64. The dissent emphasized that "the Legislature has amended other portions of the Covenants Not to Compete Act three times in the 17 years since *Light* and has not changed the wording or meaning of the phrase 'ancillary to or part of' since [the Court's] application of the phrase in *Light*." at 792 (Green, J., dissenting) (citations omitted).
65. *Id.* at 773.
66. *Sheshunoff*, 209 S.W.3d at 651.
67. *Id.*
68. *Mann Frankfort*, 289 S.W.3d at 851–52.
69. *Id.* at 852.
70. *Sheshunoff*, 209 S.W.3d at 651.
71. *Id.*; *see also Powerhouse Productions, Inc. v. Scott*, 260 S.W.3d 693, 696–97 (Tex. App. — Dallas 2008, no pet.)
72. *Marsh USA*, 354 S.W.3d at 775–76.
73. *Light*, 883 S.W.2d at 647.
74. *Marsh USA*, 354 S.W.3d at 775–76.
75. Tex. Bus. & Com. Code § 15.50(a).
76. If the employee never exercises the options, however, the agreement may not be enforceable. The *Marsh USA* majority held that stock options "provided the required statutory nexus between the noncompete and the company's interest in protecting its goodwill" but also noted that the employee's exercise of the options "triggered the restraints in the noncompete." 354 S.W.3d at 777.

77. *Id.* Justice Willett characterized the majority's reasoning on this point as "a curious and slippery proposition" and questioned whether "any workplace benefit — a bonus, a raise, a promotion, a better parking space" will "suffice to justify a noncompete because it theoretically motivates an employee to strengthen client relationships?" *Id.* at 784 (Willett, J., concurring in the judgment). The dissent offered its own answer: "The Act mentions nothing about stock options, and equating stock options with goodwill creates a rule by which any financial incentive given to an employee could justify a noncompete." *Id.* at 788 (Green, J., dissenting). According to the dissent, "[i]f any financial incentive that can encourage an employee to create more goodwill can satisfy the consideration prong of the Act, then we might as well ignore the consideration requirement all together." *Id.* at 790.
78. *Id.*
79. *Id.* at 773.
80. *Id.*
81. Indeed, in his concurring opinion in *Marsh USA*, Justice Willett observed that the reasonableness of the time, geographical area, and scope of activity restraints "received scant attention below, rendering the record before [the Court] underdeveloped." *Id.* at 780 (Willett, J., concurring in the judgment).
82. Tex. Bus. & Com. Code §15.50(a). Justice Willett also suggested that the Legislature may have intended to create separate inquiries by separating the "reasonable" and "necessary" elements in the statute and he noted that "[m]any courts implicitly subsume everything under an overarching banner of reasonableness, while others treat them as separate prongs." *Marsh USA*, 354 S.W.3d at 783 (Willett, J., concurring in the judgment).
83. *See, e.g., Gallagher Healthcare Ins. Servs. v. Vogelsang*, 312 S.W.3d 640, 654 (Tex. App. — Houston [1st Dist.] 2009, pet. denied) (two-year restraint held reasonable); *Stone v. Griffith Comm'ns. and Sec. Sys., Inc.*, 53 S.W.3d 687, 696 (Tex. App — Tyler 2001, no pet.) (five-year restraint held reasonable) (collecting cases).
84. *Cobb v. Caye Publishing Gp., Inc.*, 322 S.W.3d 780, 784 (Tex. App. — Fort Worth 2010, no pet.); *Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 793 (Tex. App — Houston [1st Dist.] 2001, no pet.) (holding that "[t]he breadth of enforcement of territorial restraints in covenants not to compete depends upon the nature and extent of the employer's business and the degree of the employee's involvement" but also noting that "[g]enerally, a reasonable area … is considered to be the territory in which the employee worked while in the employment of his employer"); *but see Vais Arms, Inc. v. Vais*, 383 F.3d 287, 295–96 n. 20 (5th Cir. 2004) (holding nationwide restraint reasonable where business sold by restrained party was national in character).
85. *See, e.g., APRM, Inc. v. Hartnett*, 2002 Tex. App. LEXIS 4779, *13 (Tex. App. — Houston [1st Dist.] 2002, no pet.) (not designated for publication) (restraint that was "not limited to the capacity in which [the employee] worked for [the employer]" held overbroad and unreasonable); *Wright v. Sport Supply Gp.*, 137 S.W.3d 289, 298 (Tex. App. — Beaumont 2004, no pet.) ("A restrictive covenant is unreasonable unless it bears some relation to the activities of the employee.").
86. Tex. Bus. & Com. Code §15.51(c) (emphasis added); *but see Goodin v. Jolliff*, 257 S.W.3d 341 (Tex. App. — Fort Worth 2008, no pet.) (holding that an agreement restricting a party from starting, directly or indirectly, a competing business "without any limitation as to geographic scope whatsoever" was unenforceable).
87. *Marsh USA*, 354 S.W.3d at 777. In his concurring opinion, Justice Willett echoed this sentiment, albeit with greater gusto: "This much is clear: Courts cannot countenance covenants too contemptuous of competition." *Id.* at 781 (Willett, J., concurring in the judgment). The dissent, on the other hand, asserted that "[u]nder the express language of the statute, only the first prong — the consideration prong — determines whether covenants are enforceable, while reasonableness defines only *the extent* to which they are enforceable." *Id.* at 791 (Green, J., dissenting) (emphasis original) (citations omitted).
88. *Id.* at 782 (Willett, J., concurring in the judgment).

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