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NONCOMPETE AS CONDITION FOR OPTION EXERCISE IN TEXAS

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Distancing itself from earlier precedent, the Supreme Court of Texas recently concluded that an employer could require an employee to give a covenant not to compete in exchange for allowing the employee to exercise stock options, if the noncompete were reasonable as to time, scope of activity, and geographical area. Earlier decisions of the Texas court could have been read to suggest that stock option compensation was not, by itself, adequate to support an employer's ability to require a covenant not to compete. The decision is *Marsh USA Inc. v. Cook*, 2011 Tex. LEXIS 465 (Tex. 2011).

The point of controversy was whether, in order to justify requiring an employee to give a noncompete, an employer must provide an employee not just with stock options or other compensation, but must also (or instead) give the employee access to confidential information. The Texas court had earlier indicated that to justify a noncompete under Texas law the consideration given by the employer (whether stock options or access to confidential information) must itself give rise to the employer's interest in restraining the employee from competing. This prior standard might be met where, for example, an employer provides an employee with access to trade secrets, confidential information, or special training. Those things would be given to an employee only to allow the employee to perform his or her job better, and this would make the employee more valuable to the company and therefore more valuable to other companies, which could justify a covenant not to compete. That is, the very thing given to the employee – the confidential information or special training – would itself give rise to the employer's legitimate interest in preventing the employee from competing. Providing an employee with confidential information or special training, or something else giving rise to a need for a noncompete, was at least arguably required under earlier Texas decisions.

But the court had little good to say about its earlier interpretation of Texas law. In *Marsh*, the court instead effectively concluded that where stock options are granted as a means of aligning the interest of key employees with a company's long term business interests, and thereby furthering the stockholders' interest in fostering goodwill between the company and its clients, a company may require a covenant not to compete, so long as that covenant is reasonable as to time, scope of activity, and geographical area.

Marsh involved options granted to a managing director of Marsh USA Inc. The option plan provided time vesting of options in 25 percent increments each year, with full vesting and exercise ability after four years. Under the plan, an employee could exercise options only if he or she were to agree for a period of time not to solicit or accept business of the type offered by the Marsh's parent company and in which the employee had been involved. This restriction applied if the employee left Marsh within three years after exercising his or her options,

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and applied for a period of two years following the employee's termination. Under these circumstances, the employee could not solicit or accept business from companies that were clients, prospective clients, or former clients of the parent company or its affiliates within the two years prior to the employee's termination, and with which the employee had worked. In fact, the plaintiff resigned less than three years after signing the noncompete that was part of his notice of exercise of option and immediately began working for a competitor.

The court looked first to the language of the Texas statute, which provided, in part, that "a covenant not compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made," to the extent the noncompete's limitations as the time, geographical area, and scope of activities to be restrained are reasonable and are not more than is necessary to protect the goodwill or other business interests of the employer. As to the requirement that the covenant be "ancillary to or part of an otherwise enforceable agreement," the court said there was no dispute that there was an "otherwise enforceable agreement." Specifically, the employee had entered into an agreement that he would not solicit Marsh's clients, recruit Marsh's employees, or disclose confidential information, in exchange for the stock option exercise. The court said this offer, acceptance, and consideration, and the nonsolicitation and nondisclosure agreements, constituted "otherwise" enforceable agreements.

The question was whether the noncompete was "ancillary to or part of" the otherwise enforceable agreement. This is where the confusion from the earlier court cases arose. Those cases required that the consideration given by the employer (in this case, the stock options) "give rise to" the employer's interest in restraining the employee from competing. The court effectively disowned this analysis, saying instead that consideration (such as stock options given to an employee) that is "reasonably related" to goodwill, or reasonably related to other interests worthy of protection such as trade secrets or confidential information, will provide the required connection between the noncompete and the goodwill (or other business interest worthy of protection). It is not necessary that the stock options themselves give rise to the employer's need for a noncompete.

The court said awarding the stock options aligned the interests of the plaintiff, a key employee, with the company's long term business interests, and therefore awarding the options furthered the shareholders' interests in fostering goodwill between the employer and its clients. The court found that the stock options were reasonably related to the protection of this business goodwill, and therefore the covenant not to compete was "ancillary" to an otherwise enforceable agreement, as required under Texas law. The court did not decide whether the agreement was reasonable as to time, scope of activity, or geographical area. It left that for the trial court to consider.

In summary, the Supreme Court of Texas concluded that the covenant not to compete was "ancillary to or part of" an otherwise enforceable agreement, as required under the Texas statute, because the business interest being protected (goodwill) was "reasonably related" to the consideration given by the employer (the stock options). The court said the Texas law requires that there be a "nexus" between the covenant not to compete and the interest being protected, and there was such a connection in the matter at hand.

Lesson. Although the decision of the Supreme Court of Texas in *Marsh* was not unanimous (three of the nine justices dissented), the court went far toward eliminating the earlier concern that an employer could not require a covenant not to compete as a condition of a stock option grant (or, more precisely, as a condition of an employee exercising his or her options). For Texas employers, and other companies with employees in Texas, there may be some value in reciting in their stock option plans and grants that (a) the options are being granted to link the interests of employees with the company's long term

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business interests, in an effort to increase the employer's goodwill with its clients, and (b) in order to protect the employer's goodwill, the employer finds it appropriate to require a noncompete as a condition to an employee exercising his or her options.

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