

Authors

Gina E. Betts
214-740-8515
gbetts@lockelord.com

Kirsten M. Castañeda
214-740-8533
kcastaneda@lockelord.com

Texas Supreme Court to Address Employee Stock Options as Consideration for Covenants Not to Compete

On April 9, 2010, the Texas Supreme Court granted the petition for review in *Marsh USA, Inc. v. Cook*, No. 09-0558, which involves a recent split in the Texas courts of appeals as to whether and when employee stock options provide the requisite consideration under Texas law to support a covenant not to compete. The Houston First Court of Appeals held in 1998 that employee stock options could support a covenant not to compete. In 2009, the Dallas Court of Appeals rejected that conclusion, holding instead that employee stock options cannot support such a covenant. Compare *Marsh USA, Inc. v. Cook*, 287 S.W.3d 378, 381 (Tex. App.—Dallas 2009, pet. granted), with *Totino v. Alexander & Assocs., Inc.*, 1998 WL 552818, 1998 Tex. App. LEXIS 5295 (Tex. App.—Houston [1st Dist.] Aug. 20, 1998, no pet.). Having granted review in *Marsh*, the Texas Supreme Court is expected to resolve this uncertainty.

Under Texas law, a covenant not to compete (which encompasses both non-competition and non-solicitation covenants) is enforceable only if it is “ancillary to or part of an otherwise enforceable agreement at the time the agreement is made” See TEX. BUS. & COMM. CODE § 15.50(a). To create the “ancillary to or part of” relationship, the otherwise enforceable agreement (which we’ll refer to as the “other agreement”) must meet two conditions. First, the consideration given to the employee in the other agreement must “give rise” to the employer’s interest in restraining competition. Second, the covenant must be designed to enforce the employee’s return promise in the other agreement. See *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644, 648-49 (Tex. 2006); *Light v. Centel Cellular Co.*, 883 S.W.2d 642, 647 (Tex. 1994).

An “other agreement” that regularly satisfies the “ancillary” requirement is an employer’s giving trade secrets or other confidential information to the employee, in return for the employee’s promise to maintain the materials’ confidentiality. On the other hand, an employer’s payment of money routinely has been found *not* to “give rise” to an interest in restraining competition. Courts reason that a company’s goodwill is dependent, in part, on keeping trade secrets confidential, and that customer goodwill is an interest protectable through a competitive restraint. However, a financial payment does not directly invoke goodwill or any other interest in restricting the employee’s ability to compete. See *Marsh*, 287 S.W.3d at 381.

Somewhere in between these two extremes lie stock options. On first glance, a stock option may appear

analogous to financial compensation. On further examination, the Houston First Court of Appeals in *Totino* found that stock options involved an interest worthy of a competitive restraint. In that case, the evidence showed that the stock options awards were offered in recognition of the employee’s contributions to the employer’s business, were one part of a long-term employee incentive plan, and were meant to reaffirm management’s commitment to linking employee interests to those of the company’s shareholders. In other words, the options were offered to encourage the employee’s loyalty and continued employment. It appears that this interest may be protectable through a competitive restraint, and indeed, the court of appeals upheld the non-competition covenant as “ancillary to” the stock option agreement. See *Totino*, 1998 WL 552818, at *7, 1998 Tex. App. LEXIS 5295, at *24-25.

The Dallas Court of Appeals reached the opposite conclusion in *Marsh*. *Marsh* granted Cook stock options, with the requirement that he sign a non-solicitation agreement in order to exercise the options. Cook signed the non-solicitation agreement and exercised his stock options. When Cook left *Marsh*’s employment in 2007 and began working for a competitor within the restricted period, *Marsh* sued to enforce the covenant. *Marsh*, 287 S.W.3d at 379-80.

Consistent with the *Totino* opinion, *Marsh* argued that offering a stock option to a valuable employee gives rise to an interest in protecting the employer’s goodwill. However, the Dallas Court of Appeals rejected the conclusion in *Totino* that a stock option agreement can provide the “ancillary” relationship necessary to support a covenant not to compete. The Court found that the sole authority cited in *Totino* for that conclusion (an Indiana Court of Appeals case) used a different definition of “ancillary” and was not instructive as to Texas requirements. In applying the Texas requirement that the employer’s consideration “give rise” to the interest in restraining competition, the Dallas Court of Appeals used a strict construction. The Court distinguished between an employee incentive that *benefits* a company’s business goodwill and one that *gives rise* to that interest in restraining the employee from competing. The Court held that an incentive will meet the “gives rise” requirement only “if the consideration given by the company *creates* the interest in restraining competition.” *Marsh*, 287 S.W.3d at 382-83 (emphasis added).

www.lockelord.com

This *Client Alert* is provided solely for educational and informational purposes. It is not intended to constitute legal advice or to create an attorney-client relationship. Readers should obtain legal advice specific to their enterprise and circumstances in connection with each of the topics addressed.

If you would like to be removed from our mailing list, please contact us at either unsubscribe@lockelord.com or Locke Lord Bissell & Liddell LLP, 111 South Wacker Drive, Chicago, Illinois 60606, Attention: Marketing. If we are not so advised, you will continue to receive *Client Alerts*.

Attorney Advertising

© 2010 Locke Lord Bissell & Liddell LLP

Offices

Atlanta

Austin

Chicago

Dallas

Houston

London

Los Angeles

New Orleans

New York

Sacramento

San Francisco

Washington, DC

Texas Supreme Court to Address Employee Stock Options as Consideration for Covenants Not to Compete (cont'd.)

In addition, the Dallas Court of Appeals held that the consideration in the other agreement can create a protectable interest “only where the interest in restraining competition *did not exist before* the consideration was given.” *Id.* at 383 (emphasis added). The court indicated that the interest in restraining the employee from competing must either “change or arise at the time” the consideration (in this case, the stock) was provided to the employee. *Id.* Although discussed in the context of the “gives rise” requirement, this holding effectively imposes an additional timing requirement not mentioned in previous Texas case law, including the *Sheshunoff* and *Light* opinions from the Texas Supreme Court.

The strict construction and timing requirements imposed in *Marsh* appear at odds with the trend in the Texas Supreme Court toward less strict application of the statutory requirements. For example, in *Sheshunoff*, the Court departed from its historical strict construction of the covenant not to compete statute in applying the requirement that the “other agreement” be “enforceable . . . at the time the agreement is made.” 209 S.W.3d at 650-51. And last year, the Court followed a less strict approach in interpreting the first prong of the “ancillary” requirement. *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844, 850-51 (Tex. 2009). The Court held that the consideration subject to the “ancillary” analysis may be provided by an implied, rather than express, promise. *Id.* Thus, in recent years, the Court’s interpretation of the statutory requirements indicates a departure from the strict construction approach used by the court of appeals in *Marsh*. Yet, the Texas Supreme Court’s less strict approach must be balanced against the continued vitality of the “ancillary” requirement. On balance, it is unclear whether the Court will move beyond trade secrets and embrace stock options – which do not share trade secrets’ immediately apparent link to an interest in restricting competition, and which do exhibit characteristics in common with financial compensation – as “ancillary” consideration capable of supporting a non-competition covenant.

Certainly, by granting the petition for review, the Texas Supreme Court has indicated its intent to address whether, and perhaps when, a stock option agreement may be used to support a covenant not to compete. On the other hand, it is unlikely that the Court will address the use of employee benefits other than stock options to support a covenant not to compete. Stock options involve an ownership component in which the employee gains an interest in the employ-

er’s success and the continued value of its customer goodwill. Other types of employee benefits may or may not involve that component. Moreover, these other types of employee benefits are more common and apply to a broader swath of employees than stock options typically do. Thus, it is unlikely the Court will broaden the scope of its opinion to address types of employee benefits other than stock options.

The Court has not yet set a date and time for *Marsh*’s oral argument. The Court has concluded its regular oral argument calendar for this term; therefore, argument is not expected to take place until next term, which begins September 1, 2010. To sign up for e-mail notices regarding docket activity on the *Marsh* case, go to the [Marsh Online Docket](#) and, in the list of links above the “Case Information,” click on “Add to CaseMail.” If you have not registered for CaseMail, you will be given the opportunity to do so, and then can add *Marsh* (No. 09-0558) to your account. You do not have to be a participant in a case in order to sign up for case alerts through CaseMail. For more information on CaseMail generally, you also can read the “[CaseMail Basics](#).”

About the Authors

Gina E. Betts is a partner at Locke Lord. As Chairman of the firm’s Private Equity Practice Group, Ms. Betts has extensive experience in corporate and securities law including representing issuers and purchasers in debt and equity public and private transactions, as well as in LBOs and MBOs, portfolio company acquisitions and dispositions, fund formations, preparing SEC reports, and counseling on general SBIC and SEC compliance.

Kirsten M. Castañeda is senior counsel in Locke Lord’s Appellate Practice Group. She handles a wide variety of sophisticated state and federal appeals involving employment issues, class actions, arbitration, financial institutions, and other commercial disputes. She frequently works with trial lawyers on discovery disputes, error preservation, and jury charge preparation and objections. Ms. Castañeda also has significant experience in mandamus matters.