Did They Turn Out the *Light*?

The Supreme Court Rules on Covenants Not to Compete

By W. Gary Fowler and M. Scott McDonald

Earlier this year, the Texas Supreme Court handed down its long-awaited covenant-not-to-compete decision, *Alex Sheshunoff Management Services, L.P. v. Johnson*, 2006 WL 2997287 (Tex. 2006). In *Sheshunoff*, the court overturned part, but not all, of the previous landmark covenant-not-to-compete decision, *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642 (Tex. 1994).

Sheshunoff affects the most confusing and artificial part of *Light*: the part that did not allow for a unilateral contract. Footnote 6 in *Light* required proof of an otherwise enforceable ancillary agreement at the time the noncompete agreement is made that was not contingent on continued at-will employment. Many courts construed this part of the *Light* opinion to require that a contemporaneous or instantaneous exchange of confidential information occur at the time of the execution of the covenant not to compete. Now it is clear that, as long as the employer promises to give the employee confidential information, the covenant not to compete will constitute an "otherwise enforceable agreement," even if it is contingent on continued at-will employment, so long as the employer performs its side of the bargain by providing confidential information during the employment relationship. It is no longer necessary for the employer to give confidential information contemporaneously with the employee's signing the non-compete.

However, drafting non-competition covenants still requires an understanding of the *Light* decision, as *Sheshunoff* only disturbed one part of *Light*. The part of *Light* that appears to have been retained is the requirement that "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."[1] As such, an understanding of *Light* is still necessary to draft an effective non-competition agreement.

Requirements Under Section 15.50

It is imperative, in the first instance, to meet the minimum statutory criteria for a covenant not to compete, because, without meeting such requirements, the court cannot enforce the covenant and may not be able to reform it.

Under Section 15.50 of the Texas Business & Commerce Code, there are two basic requirements for a covenant not to compete to be valid and enforceable:

(1) The covenant must be "ancillary to or part of an otherwise enforceable agreement at the time the agreement is made"; and

(2) The covenant must contain "limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee."[2]

In *Light* and *Sheshunoff*, the court focused on this first requirement ("ancillary to an otherwise enforceable agreement at the time the agreement is made"). Due to some confusion caused by *Light*, the court clarified its position in *Sheshunoff*.

Requirements Under *Light* and *Sheshunoff*

In *Light*, the Supreme Court examined what constitutes "an otherwise enforceable agreement at the time the agreement is made."[3] The court held that the agreement at issue failed to meet the statutory requirement because there was no promise by Debbie Light concerning confidential information that would meet the ancillary agreement requirements of the statute as it was interpreted by the court.

Most employees, including Light, are "at will" — either the employer or the employee may terminate the employment relationship at any time for any for no reason. The Supreme Court indicated in *Light* that a non-competition covenant may be enforceable in an at-will context (despite earlier opinions that appeared to hold to the contrary). However, the court also stated that the at-will relationship is not, in and of itself, sufficient to support a non-competition covenant. Moreover, some of the reasoning in *Light* (primarily in Footnote 6) indicated that a promise that is dependent on continued employment is "illusory" and therefore not an "otherwise enforceable agreement" at the time the agreement is made.

The statutory phrase "at the time the agreement is made" was construed differently by different courts of appeals. One group of decisions appeared to focus on whether the employee received confidential information or other consideration giving rise to the noncompete contract "at or near" the time the noncompete contract was formed. Another group of opinions construed the test more strictly. This string of appellate court decisions found that even an unequivocal promise from the employer to provide confidential information to an at-will employee is insufficient to create an "otherwise enforceable agreement." In *Strickland v. Medtronic, Inc.*, the Dallas Court of Appeals found that a promise to provide confidential information to an at-will employee is still illusory "because it necessarily depends on a period of employment."[4] Under this reasoning, the exchange of consideration had to be contemporaneous.

While *Sheshunoff* purports not to overturn the decision in *Light*, it does depart from the *Light* opinion. The court focused on Footnote 6 of *Light*, which had caused most of the confusion. The court held that it is no longer required that the employer hand over confidential information contemporaneously with the employee's signing the covenant not to compete: "[W]e disagree with footnote six [of *Light*] insofar as it precludes a unilateral contract made enforceable by performance from ever complying with the Act because it was not enforceable at the time it was made."[5] In other words, unilateral contracts that involve covenants not to compete in an at-will situation are now enforceable. Once the employer gives the employee the confidential information or trade secrets, the covenant not to compete becomes enforceable. However, prior to the employer giving trade secrets, the employer's promise is still illusory, as in *Light*.

To illustrate the change *Sheshunoff* brings, consider the following example:

> If you work for the Cola Company (Cola) on an at-will basis, Cola will pay you upon completion of your work and, during the course of employment, you will receive trade secrets, including the Ultra Charge secret formula, Cola's distributor lists, its relationships with its suppliers, and its marketing plans; in return, you will not disclose said trade secrets nor will you work for Popsi or other competitors in the soft drink industry.

This example is a unilateral contract because it is one in which a promise serves as an offer, which the promisee accepts by performing the requested act. In the example, please assume that, after signing the agreement, the employee goes to work for Cola and that, during the course of employment, the employee actually receives the secret formula and other confidential information from Cola.

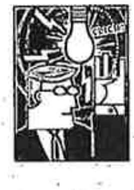
This contract flunks Footnote 6 of the *Light* opinion because, according to the Supreme Court, "it could only be accepted by future performance … [and therefore] could not support a covenant not to compete inasmuch as it was not an 'otherwise enforceable agreement at the time the agreement is made.'"[6] It does not matter that the employee actually received the trade secrets and is now working for the competitor because the employer was not obliged to do anything "at the time the agreement was made."[7]

Under *Sheshunoff*, on the other hand, this covenant would meet the "otherwise enforceable agreement" part of Section 15.50 once the employer accepted the employee's offer by performance (giving the employee the Ultra Charge formula). This example illustrates precisely where the court departed from *Light*. The court recognized that it is completely impractical to expect employers to hand over trade secrets at the moment the employee signs the agreement. While the court will not enforce the covenant not to compete until the employer performs, employers need not worry as much about exactly when they make their employees privy to their confidential information.[8]

Unfortunately, as under *Light*, *Sheshunoff* leaves some things unclear. Take, for example, the following covenant not to compete:

> You will be employed by the Cola Company (Cola) on an at-will basis. Upon your receipt of Cola's trade secrets, including the Ultra Charge secret formula, Cola's distributor lists, its relationships with its suppliers, and its marketing plans, you promise not to disclose those secrets nor work for Popsi or other competitors in the soft drink industry.

This is clearly unenforceable under *Light*, as it is an illusory promise at the time it is signed by the employee. However, under *Sheshunoff*, it is unclear whether this is enforceable. The key difference between this example and the previous one is that there is no firm promise by the employer to give the employee trade secrets during the course of employment. The court's opinion does not speak to whether it would extend the reasoning in *Sheshunoff* to apply to a covenant not to compete such as this. To avoid the risk of having their covenant not to compete declared unenforceable, practitioners should model covenants not to compete after the first example.



That being said, the court made clear that it wanted to end the era of *Light* to the extent that it promoted form over substance:

> We also take this opportunity to observe that section 15.50(a) does not ground the enforceability of a covenant not to compete on the overly technical disputes that our opinion in *Light* seems to have engendered over whether a covenant is ancillary to an otherwise enforceable agreement. Rather, the statute's core inquiry is whether the covenant "contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee."[9] Concerns that have driven disputes over whether a covenant is ancillary to an otherwise enforceable agreement — such as the amount of information an employee has received, its importance, its true degree of confidentiality, and the time period over which it is received — are better addressed in determining whether and to what extent a restraint on competition is justified. We did not intend in *Light* to divert attention from the central focus of section 15.50(a). To the extent our opinion caused such a diversion, we correct it today.

Moreover, a concurring opinion by Justice Dale Wainwright suggested extinguishing *Light* altogether and, particularly, its two-part test for what is "ancillary" to an otherwise enforceable agreement. We now turn to that test, albeit with the warning that the court ultimately may turn out the light on that part of *Light* as well.

"Ancillary to an Otherwise Enforceable Agreement"

The second part of *Light* and *Sheshunoff* concerns what is meant by the phrase "*ancillary* to the otherwise enforceable agreement." In regard to this test, the majority opinion in *Sheshunoff* did not alter the ruling in *Light*. By this phrase, the court stated in *Light* that the employer must meet two tests:

(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 competition; and
(2) The covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.

In a footnote, the court noted that this would occur when the employer gives an employee trade secrets in exchange for the employee's promise not to disclose them.[10] In *Light*, the Supreme Court held that the employer promised to give Light trade secrets, but that the "ancillary" test was not met because Light did not explicitly promise not to disclose trade secrets after she left her employer. In fact, it is because of this that the *Sheshunoff* court did not overturn the decision in *Light*. The court is clear that the employer's consideration must still give rise to the employer's interest in restraining competition.[11]

In other recent cases (*Medtronic* and *Dickey*), the courts have determined that a non-compete agreement can only be ancillary to a promise that gives rise to the interest protected by the covenant not to compete. A non-compete agreement will not be considered ancillary to other promises (even when non-illusory) that do not involve the exchange of consideration that gives rise to the employer's interest in restraining the employee from competition.

Therefore, a careful drafter for Cola might draft the covenant as follows:

(1) Cola promises to give you the Ultra Charge secret formula and other confidential information during the course of your employment;
(2) In return, you agree not to use or disclose Cola's trade secrets;
(3) Ancillary to the above agreements, you agree not to work for Cola's competitors.

It is critical that the second line be included in any covenant not to compete to have a chance at being enforceable. Again, the reason the decision in *Light* stands is because Light did not agree not to disclose trade secrets. Correlatively, one of the reasons the agreement in *Sheshunoff* is enforceable is because Johnson, in exchange for receiving trade secrets, promised not to disclose those secrets.

The Fifth Circuit, on the other hand, has refused to adopt this construction of the "ancillary to or part of" test. In *Guy Carpenter & Co. v. Provenzale*, 334 F.3d 459 (5th Cir. 2003), the Fifth Circuit found that, so long as the employer has made *some* enforceable promise, the employer need not make an enforceable promise to provide the employee access to confidential information. This appears much closer to the position Justice Wainwright took in his concurrence in *Sheshunoff*. But, Justice Wainwright's position was not in the majority, so it is now uncertain whether the Fifth Circuit will continue to interpret the law as it has.

Complying with *Light* and *Sheshunoff*

Here are some practical ideas for complying with the ancillary agreement element of *Light* and *Sheshunoff*:

(1) Ensure that there are mutually enforceable agreements on the face of the agreement that give rise to a protectable interest (promises around confidential information, training, or goodwill) and make sure these promises can be (and are) fulfilled in a reasonable time frame.
(2) Describe the training or trade secrets with as much specificity as possible; otherwise the court may hold the covenant too indefinite to be enforceable.

(3) Do not depend upon past consideration; the *Light* court indicated this would fail to meet the criteria for an "otherwise enforceable agreement" and would be illusory. *Sheshunoff* does not address this, although it does allow enforcement where the employee receives additional confidential information and training.

(4) If the basis for the covenant rests on the employer's goodwill, describe such goodwill as a valuable asset of the employer and note what steps the employer has done, or will do, to build such goodwill (paying for time spent developing customers).

(5) Identify exactly what a competitor could use to compete *unfairly* against the employer so that the employer can show that the non-competition provision is more than a "naked restraint of trade."

(6) Don't rely solely on pecuniary interests like cash or publicly traded stock as consideration. Build in a full range of other, mutual obligations between the parties in the agreement that are more likely to give rise to (or justify) the noncompete.

NOTES

1. *Light*, 883 S.W.2d at 647.
2. Tex. Bus. & Com. Code §15.50.
3. *Id.*
4. 97 S.W.3d 835, 839 (Tex. App. — Dallas 2003, pet. dism'd w.o.j.); *See 31-W Insulation Co., Inc. v. Dickey*, 144 S.W.3d 153 (Tex. App. — Fort Worth 2004, no pet.) The facts and analyses in Dickey are essentially identical to those in *Medtronic.*; *Trilogy Software, Inc. v. Callidus Software, Inc.*, 143 S.W.3d 452 (Tex. App. — Austin 2004, pet. denied). The court in *Medtronic* went on to find that several non-illusory promises had been made, satisfying the "otherwise enforceable agreement" standard. However, these promises did not give rise to an interest protected by the covenant not to compete, so the court found that the covenant was not ancillary to an "otherwise enforceable agreement." S.W.3d at 839.
5. *Sheshunoff*, 2006 WL 2997287*5.
6. *Id.* (quoting Tex. Bus. & Com. Code §15.50).
7. For example, several cases had found that the "illusory promise," even if actually performed later, failed to meet the *Light* test. *Anderson Chemical Co. v. Green*, 66 S.W.3d 434, 438 (Tex. App. — Amarillo 2001, no pet.); *Terminex International Co. v. Denton*, 2000 WL 84888 (Tex. App. — San Antonio, Jan. 26, 2000)(unpublished); *Ad Com, Inc. v. Helms*, 2000 WL 45880 (Tex. App. — Dallas, Jan. 21, 2000)(unpublished); *Houston Solvents and Chemicals Co. v. Montealegre*, 1999 WL 219366, at *3 (Tex. App. — Houston [14th Dist.], April 15, 1999) (unpublished) ("[w]hether any training was actually provided after the agreements were entered is not material to this determination because a binding obligation to provide it was not part of the otherwise enforceable agreement at the time the agreement was made").
8. However, in his concurring opinion, Chief Justice Wallace Jefferson takes a more narrow view of this than the court generally. While he agrees with the court that the exchange of consideration does not have to be contemporaneous, he believes that it must occur within a "reasonable time." *Sheshunoff*, concurring opinion Part C. The Chief Justice believed Sheshunoff's time of acceptance was reasonable; however, he does not believe that the employer may make the covenant not to compete enforceable at *any* time simply by performing their side of the bargain.
9. Tex. Bus. & Com. Code §15.50(a).
10. *Id.* at 647 n.14.
11. *Sheshunoff*, 2006 WL 2997287*4.

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