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### "Understanding Restrictions on Competition"

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As business owners know, Texas courts have become reluctant to enforce non-competition agreements—perhaps even in instances related to the sale of businesses. The Texas Legislature attempted to establish the primary ground rules by passing, and later amending, the Covenants Not to Compete Act. In an attempt to provide protection to employers and to successfully negotiate this minefield of the law, employers have responded by shifting the nature of non-competition agreements to confidentiality and non-disclosure obligations that courts appear more willing to enforce because they purport to protect ownership rights in intangible business assets. To understand the interests in conflict requires a brief discussion of the political struggle between the legislature and the Texas Supreme Court over the enforcement of covenants not to compete.

#### **A Brief History[i] of Texas Law**

Prior to 1987, the enforceability of non-competition covenants in employment contracts in Texas was relatively settled under “common law”, that is non-statutory law, pronounced by Texas courts.[ii] Beginning in 1987, however, the Texas Supreme Court (which had undergone a political shift, Texas judges being elective officials) began to dramatically revise the common law, making it virtually impossible to enforce such covenants.[iii] In one of its more extreme opinions, later withdrawn, the court found the employer liable for a violation of the Texas Free Enterprise and Antitrust Act for its attempts to enforce a signed covenant.[iv] This abrupt revisionism was countered by the passage in 1989 of the Covenants Not to Compete Act by the Texas Legislature.[v] This Act sought to return the law of non-competition covenants in Texas to the common law as it existed prior to 1987.

While in cases after the Act the Supreme Court retreated in finding employer liability under the state anti-trust statute, the court continued its campaign to invalidate these agreements.[vi] Remarkably, the court did so claiming that its decisions were based on the common law as it existed prior to the statute, almost ignoring the clear language of the statute itself.[vii]

#### **Current Statute**

In light of the second series of Supreme Court decisions, the legislature addressed non-competition agreements again in an attempt “to clarify the applicability of the Chapter and....[to] insure that at-will employment contracts are covered.”[viii] As amended, the Texas Business and Commerce Code now provides as follows:[ix]

##### “§15.50 Criteria for Enforceability of Covenants Not to Compete

Notwithstanding Section 15.05 of this code [the basic state anti-trust and anti-monopoly provisions], a covenant not to 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 that it 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.”

##### “§15.51 Procedures and Remedies in Actions to Enforce Covenants not to Compete

(a) Except as provided in Subsection (c) of this section, a court may award the promisee under a covenant not to compete damages, injunctive relief, or both damages and injunctive relief for a breach by the promisor of the covenant. (Ed.: This basically restates the law)

(b) If the primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, for a term or at will, the promisee has the burden of establishing that the covenant meets the criteria specified by Section 15.50 of this code. If the agreement has a different primary purpose, the promisor has the burden of establishing that the covenant does not meet those criteria. For the purposes of this subsection, the “burden of establishing” a fact

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means the burden of persuading the triers of fact that the existence of the fact is more probable than its nonexistence. (Ed: This appears to state that an employer has the burden of proof; if the non-competition agreement relates to the sale of a business, the burden is on the person making the promise.)

(c) If the covenant is found to be ancillary to or part of an otherwise enforceable agreement but contains limitations as to time, geographical area, or scope of activity to be restrained that are not reasonable and impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee, the court shall reform the covenant to the extent necessary to cause the limitations contained in the covenant as to time, geographical area, and scope of activity to be restrained to be reasonable and to impose a restraint that is not greater than necessary to protect the goodwill or other business interest of the promisee and enforce the covenant as reformed, except that the court may not award the promisee damages for a breach of the covenant before its reformation and the relief granted to the promisee shall be limited to injunctive relief. If the primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, the promisor establishes that the promisee knew at the time of the execution of the agreement that the covenant did not contain limitations as to time, geographical area, and scope of activity to be restrained that were reasonable and the limitations imposed a greater restraint than necessary to protect the goodwill or other business interest of the promisee, and the promisee sought to enforce the covenant to a greater extent than was necessary to protect the goodwill or other business interest of the promisee, the court may award the promisor the costs, including reasonable attorney's fees, actually and reasonably incurred by the promisor in defending the action to enforce the covenant." (Ed: This provision is a unique compromise of interests. The first sentence restates existing law concerning non-competes related to the sale of a business. The penalty is not severe for overly broad provisions. The second sentence presents itself as granting the promisor a remedy for overly broad provisions, but to do so the promisor must prove that the person receiving the promise knew that the limitations were not reasonable and that the limitations were in excess of those necessary to protect the business, a most difficult task in the courtroom since actual knowledge appears to be a requisite)

### "§15.52 Preemption of Other Law

The criteria for enforceability of a covenant not to compete provided by Section 15.50 of this code and the procedures and remedies in an action to enforce a covenant not to compete provided by Section 15.51 of this code are exclusive and preempt any other criteria for enforceability of a covenant not to compete or procedures and remedies in an action to enforce a covenant not to compete under common law or to otherwise." (Ed: This appears to tell the Supreme Court not to try an end run creating another line of legal rulings)

Well where does the squabbling between the Court and the legislature leave the business owner? Can we seek some ground rules that we know are enforceable and identify the key areas of debate? Of course! Not surprisingly, contracts enforceable under the statute must pass the fundamental test of reasonableness. As discussed below, we will argue that ultimately the test of reasonableness involves some test of fairness and necessity.

### **The Court's Interpretation of the Statute**

In 1994, the Texas Supreme Court considered the only non-competition covenant case it has heard since the statute's amendment and—finally—decided the case based on the statute.<sup>[x]</sup> The court acknowledged that "the Legislature has generally sought to occupy the field with this statute"<sup>[xi]</sup> in *Light v. Centel Cellular Co. of Texas*, following the language of §15.50 to say that, to be enforceable, (1) there must be an otherwise enforceable agreement, to which (2) the covenant not to compete is ancillary to or a part of at the time the agreement is made.<sup>[xii]</sup>

### **Otherwise Enforceable Agreement**

Under its discussion of the statutory language "otherwise enforceable agreement," the Court in *Light* made clear that an independently enforceable agreement is required. The Court reaffirmed, for instance, that previous decisions of the Court holding at-will employment agreements were not "otherwise enforceable" agreements because they were terminable at the will of either party.<sup>[xiii]</sup> The *Light* court, however, found that an at-will employment agreement can be an otherwise

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enforceable agreement (the obvious intention of the legislature) to the extent it contains other binding, non-illusory promises at the time of execution. To be non-illusory in the case of an at-will employment contract, this promise must not be dependent on future employment that can be terminated at any time. On the facts of the case before it, the *Light* court found that there were binding, non-illusory promises at the time the agreement was executed in addition to the illusory promise of employment, and, thus, an otherwise enforceable agreement.<sup>[xiv]</sup> Thus employers have developed various “non-illusory” promises that will sustain non-competes. Examples are stipulated term agreements, sign-up bonuses (the amount of which is obviously an issue), stock options or other equity incentive plan participation, or severance benefits of one sort or another. Essentially the statutory amendment made it much easier to create an agreement that is colorably enforceable. The great problem of enforceability lies in the language of the statute that requires that the covenant not “impose a restraint that is ... greater than necessary to protect the goodwill or other business interest of the promisee.”

Some types of “otherwise enforceable agreements” seem indisputable. An employment contract for a guaranteed period of time (a term contract) is an otherwise enforceable agreement as required by the statute. The security granted the employee in having a guaranteed term of employment should be recognized by the courts as giving rise to an interest of the employer in a period of security from competition by this employee. Where additional benefits are given to the employee, such as introductions to customers or clients, special training provided by the employer, access to confidential information or trade secrets, the consideration paid for by the employer gives rise to an even larger employer interest in preventing competition. Similarly, the “termination for dissatisfaction only” contract has been recognized by Texas courts as an “otherwise enforceable contract.”<sup>[xv]</sup> In this type of agreement, the employer agrees not to terminate the employee unless the employer is dissatisfied with the employee’s performance. From this type of agreement, the courts infer that the employer has agreed to use good faith in assessing its own satisfaction and find that this is enough to form an enforceable contract.<sup>[xvi]</sup>

### **Ancillary to the Otherwise Enforceable Agreement**

Under this alternative prong of the test of enforceability, the *Light* court next considered whether the covenant not to compete is ancillary to the “otherwise enforceable agreement.” Using its interpretive powers, the Supreme Court fashioned an awkward two-part test to determine whether a non-competition covenant is ancillary to the underlying agreement. The Court and most practitioners, however, don’t seem to know what this language means or is for. In fact, this language appears in many previous non-competition cases involving the sale of a business. The language was probably added to simply mean that the covenant is a part of or “executed in conjunction with but is in a separate document or agreement related to” an otherwise binding agreement.<sup>[xvii]</sup>

### **“Gives Rise To”**

On the facts of *Light*, the court found that the consideration given by the employer (special training) did give rise to its interest in restraining the employee from competing, thus satisfying the statutory test. We know from the *Light* footnotes and subsequent appeals court decisions, that in the case of at-will employment, the court will also accept the disclosure of confidential proprietary information or trade secrets as consideration that gives rise to the employer’s protectable interest in non-disclosure.<sup>[xviii]</sup> Because these are the only types of consideration expressly sanctioned by the Court to date, these are the only types of agreements that can be confidently presumed that the Court will enforce.

In creating the “give rise to” test, the Court leaves no doubt that, although consideration is not specifically required by the statute, consideration must be paid or given by the employer as part of the otherwise enforceable agreement requirement. Simply paying wages to an at-will employee is not adequate consideration. The promises discussed above for term employment or termination only for unsatisfactory job performance are two other types of consideration that can be given by the employer and which should “give rise” to a protected interest of the employer. The question then becomes what type of interest and how great an interest do these and other promises or other types of employer consideration give rise to? In one court of appeals decision involving a *term* employment contract under which the employee could not be fired except for cause, the court found that an experienced travel agent who received no special training and no special entrée into the travel business, but who did receive access to a confidential customer list, could be restrained from competing with her

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former employer. On the facts of this case, the employee did not even take the customer list with her when she left the company.<sup>[xix]</sup>

The courts will look closely to the equities of the factual situation. In its consideration of an at-will employment agreement in which the only non-illusory promise of the employer was to give thirty day's notice of termination, the Dallas Court of Appeals found that this consideration did not "give rise to" the employer's stated interest in restraining its former employee from competing.<sup>[xx]</sup>

Another employment issue is what payments by the employer constitute "consideration" for the non-competition covenant. Where the non-competition covenant is entered into at the beginning of the employment relationship and the relationship is not at will, wages and other employment benefits should be considered valid consideration.<sup>[xxi]</sup> The question of consideration becomes more difficult where the employment agreement is entered into, not at the beginning of the employment relationship, but after the employee has been employed for some period of time. At this point, access to confidential information, trade secrets and initial training has often been provided already, although from a technical standpoint the information belongs to the employer. Thus the issue arises whether continued employment can become "consideration" for a promise not to compete. Appropriate additional consideration might be required—a bonus, a raise in pay (for a non at-will employee), a promotion, special training, replacement of at-will employment with term employment or other additional benefits that would not be expected as a routine result of continued employment and that are not given to other employees not being asked to sign the agreement containing the non-competition covenant. This additional consideration and the interest it gives rise to should be highlighted in any agreement with current employees.

Where an employer requires an at-will employee to agree not to compete and there exists no training, confidential proprietary information or trade secrets, employers have not yet been successful enforcing a non-compete agreement under *Light*. One type of consideration that may be worth trying is an agreement to pay severance pay to a terminated employee in exchange for the employee's agreement not to compete.

### **Employee's Consideration Enforces Covenant**

The covenant in *Light* was ultimately held not to be ancillary to the underlying agreement of the employee because it failed to meet the second part of the "ancillary" test—it was not designed to enforce the employee's return promises.<sup>[xxii]</sup> The only promises by the employee in *Light* which the court found not dependent on continued employment were a promise to give 14-days' notice prior to leaving her employment and a promise to inventory and return the employer's property upon termination. The court found these promises not functionally enforced by the covenant that prohibited her from competing for one year after termination.<sup>[xxiii]</sup> The court in a footnote pointed out that "The covenant would have enforced an agreement by *Light*, for example, not to disclose confidential proprietary information after her termination."<sup>[xxiv]</sup> Ms. *Light* did not, however, have a non-disclosure agreement with the employer, and thus the employer was left without an ancillary covenant that it could enforce. In future employment agreements, this relationship between the employee's promise and the covenant must be clearly highlighted in the agreement. The authors have thus noted an explosion of language in restrictive covenants reciting the particular relationship of the promisor to the business and the nature of the knowledge known, the information to be revealed, the training to be acquired, the damage to be done by violation of the covenant, and the state of awareness of the promisor when the promises were made.

The court in a footnote in *Light* gives an example of another agreement that would meet its *Light* tests. The text of the footnote is as follows:

"Thus if an employer gives an employee confidential and proprietary information or trade secrets in exchange for the employee's promise not to disclose them, and the parties enter into a covenant not to compete, the covenant is ancillary to an otherwise enforceable agreement because:

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- 1) the consideration given by the employer [the trade secrets] in the otherwise enforceable agreement [exchange of trade secrets for promise not to disclose] must give rise to the employer's interest in restraining the employee from competing [employer has interest in restraining employee with knowledge of employer's trade secrets from competing] and
- 2) the covenant must be designed to enforce the employee's consideration or return promise [the promise not to disclose the trade secrets] in the otherwise enforceable agreement."<sup>[xxv]</sup>

What types of covenants that the courts intend to enforce is a matter of some speculation. Not unexpectedly practitioners have fashioned language in non-competes that seeks to invoke the *Light* sanctioned agreements.

### **Enforceable at the Time the Agreement is Made**

Under *Light*, the otherwise enforceable agreement must be enforceable from the time of execution. Under the common law of contracts, it is possible to have an agreement executed that is not enforceable until the happening of a subsequent event. The court discussed this in *Light*, saying "If only one promise is illusory, a unilateral contract can still be formed; the non-illusory promise can serve as an offer which the promisor who made the illusory promise can accept by performance."<sup>[xxvi]</sup> The court continues to say "But such unilateral contract, since it could be accepted only by future performance could not support a covenant not to compete in as much as it was not an "otherwise enforceable agreement at the time the agreement is made" as required by §15.50.<sup>[xxvii]</sup> Thus, if the employment is at-will, other binding, non-illusory promises not dependent upon future employment must be binding from the execution for the agreement to be enforceable "at the time the agreement is made."<sup>[xxviii]</sup> The timing of the enforceability of the underlying agreement should not be at issue in a term or satisfaction agreement because the promises of the employer are binding from its execution. And agreements effective in the near future or upon termination of an employee's prior employment should be "enforceable at the time of agreement."

### **Reasonableness Requirements**

The criteria discussed above and in *Light* are not the only requirements to be satisfied to form a valid non-competition covenant. The statute and the common law also require that, once a valid covenant is found to exist, additional standards must be met for the covenant to be enforced as written.<sup>[xxix]</sup> These criteria determine the reasonableness of the covenant and are today's battleground of enforceability. If the covenant is found unreasonable the covenants can be reformed by the courts under §15.51(c) and enforced by injunction as modified.<sup>[xxx]</sup> The specific factors required to obtain a reasonable covenant are reasonable restrictions on the (1) time, (2) geographic area and (3) scope of activity of the employee's post-employment activities.<sup>[xxxi]</sup> Critically important is the additional requirement that none of the restrictions can be greater than necessary to protect the goodwill or other business interest of the employer.<sup>[xxxii]</sup> This provision can cause great pain to business owners. For instance, if a business closes or abandons a location, any associated non-competes become unenforceable because almost definitionally no value exists in protecting the closed location and no damage can occur. Explaining that result to a client who has paid good money to buy a business, only to see the business operators "run the business into the ground", causing its failure, and then to have those same operators form phoenix-like a new and competitive business involving the same suppliers, customers, and business methods, is a hard task!

If one of these four standards is found by the court to be unreasonable, the court is charged with reforming the covenant and enforcing it as modified.<sup>[xxxiii]</sup> However, the only relief available under a covenant reformed by the court is an injunction after reformation.<sup>[xxxiv]</sup> Unfortunately, by the time the covenant is reformed, it is possible that the covenant will have expired, and no injunctive relief or damages may be available.<sup>[xxxv]</sup> Damages from the date of termination of employment to the date of reformation are not available under the statute.<sup>[xxxvi]</sup> In addition, an unreasonable covenant in an employment agreement that the employer knew to be unreasonable at the time it was executed, can result in employer liability for court costs and attorneys fees incurred by its former employee.<sup>[xxxvii]</sup> The "bottom line" is simple: it is in the employer's best interest to draw the covenant narrowly as to the three factors listed above, and in establishing the covenant, the employer should clearly consider the nature and extent of any damage that the promisee could wreak if the covenant was violated. Not only will an overbroad covenant provide no protection for the employer, it could create liability!

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### Reasonable Length of Time

Because the reasonableness of post-employment restrictions is very dependent on the facts of the individual case, it is difficult to suggest standards of reasonableness that will apply in most cases. In the context of employment agreements, courts are very concerned about enforcing restrictions that allow the employee to sign away his ability to earn a living, especially where it appears that the bargaining power of the employee is extremely limited. Both case law and practice norms indicate that the length of time the employee may be barred from competing has shortened over the past few years. Prior to the enactment of the statute, restrictions of two to five years were enforced.<sup>[xxxviii]</sup> There is even a case involving a lifetime covenant (involving the sale of a business)! The time period that can be enforced is, of course, longer in the cases involving the sale of a business (where there is greater consideration paid to the seller and more equality between the parties).<sup>[xxxix]</sup>

In cases involving one year limitations, the courts have ruled the one-year limitation “not unreasonable as a matter of law,”<sup>[x]</sup> “plainly reasonable under Texas law”<sup>[xli]</sup> and “certainly reasonable.”<sup>[xlii]</sup> The Texas Courts have also upheld two-year restrictions in employment agreements as “not unreasonable.”<sup>[xliii]</sup> When the restrictive covenant in an employment context reaches three years, the cases become less consistent and more fact intensive. One court considering a three-year limit upheld it<sup>[xliv]</sup> and one court has reformed it to six months.<sup>[xlv]</sup> Texas courts have also been reluctant to enforce restrictive covenants for a period longer than the employee was employed.<sup>[xlv]</sup> Also, covenants with no limit<sup>[xlvii]</sup> or an indefinite time limit (such as thirty days after the employer ceases to do business with the customer)<sup>[xlviii]</sup> have been struck down by Texas courts. In most cases, therefore, the authors advise that an employee’s covenant be limited to the shorter of two years from termination of employment or the time worked for this particular employer.

### Reasonable Geographic Scope

The covenant not to compete must contain reasonable limitations on the territory in which the employee is restrained.<sup>[xlix]</sup> In general, the area in which the employee may be restrained from competing depends upon the nature and geographic reach of the employer’s business and the employee’s activities within that business.<sup>[i]</sup> A common mistake in drafting the territorial limitations appears to be defining the geographic area in which this particular employee can not compete based on the whole area of the employer’s business.<sup>[ii]</sup> Such restrictions have been held to be too indefinite where the area was defined as the “existing marketing area” and the “future marketing area” and such areas were not otherwise delineated in the agreement or proved up in court.<sup>[iii]</sup> A territorial limitation based on an employer’s area of operation may also be overbroad where the employee did not work in the entire area.<sup>[iiii]</sup> Again the lesson is that the author of non-competes should conduct a careful factual analysis of where exactly the employee’s competition would be in direct competition with the successor in the promisee’s job.

The geographic scope of a non-competition agreement may be defined based on the employee’s territory; Texas courts have noted that “what constitutes a reasonable area generally is considered to be the territory in which the employee worked while in the employment of his employer.”<sup>[liv]</sup> Care must be taken, however, either to carefully define this territory in the employment agreement or to keep an on-going log for the purposes of proving what area comprises such employee’s territory in the event of a lawsuit. The area must be defined clearly and unambiguously as “indefinite descriptions of the area covered by a non-competition covenant render them unenforceable as written.”<sup>[lv]</sup> One court held “metropolitan area” to be too vague for enforcement.<sup>[lvi]</sup>

The area encompassed by the restriction must be reasonably restricted. An industry-wide covenant applicable to a former employee will probably not be upheld.<sup>[lvii]</sup> A nationwide restriction will also probably not be upheld.<sup>[lviii]</sup> The enforceability of smaller specific geographic delineations depends on whether the employee actually worked in the area in question and whether the geographic area was too broad or not.<sup>[lix]</sup>

The statute and the cited cases are problematic to lawyers whose clients have businesses that are non-geographically bound. To consider geographic limitations on most Internet related clients, for instance, is fairly useless since an Internet employee can become an effective competitor literally anywhere on the globe, much less anywhere in the United States.

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Presumably courts will acknowledge the changing scope of e-commerce, but until the courts acknowledge the fundamental changes going on in telecommunications, practitioners should recite in non-competition agreements some geographic limitation and recite why narrower restrictions do not apply to the particular industry.

A common method of defining a territory is by a radius in miles from the employee's workplace. Courts have upheld a radius of fifteen miles.<sup>[ix]</sup> A restriction of sixty miles from any newspaper owned by the employer has been reformed to ten miles from the single newspaper where the employee worked.<sup>[xi]</sup> The particular facts of each case will define the acceptable distance that the court will accept. For example, where the record showed that pet owners travel only a few miles for pet care, a twelve mile radius from a veterinarian's office was held overbroad.<sup>[xii]</sup> Thus, it would appear advisable to ascertain from the operation of a particular business what may be a reasonable territory to restrict and to recite any relevant industry statistics in the agreement.

### **Reasonable Scope of Activity**

The particular impermissible activity of the employee being restricted must be described in the covenant and should be reasonably limited and narrowly drawn,<sup>[xiii]</sup> and the activities restricted must have some relationship to the activities performed by the employee while employed.<sup>[xiv]</sup> For example, if the employee is employed by an employment agency placing data processing workers, a limitation that restricts the employee from working in the employment agency business generally is overly broad.<sup>[xv]</sup>

### **No Greater Than Necessary to Protect Employer's Interest.**

As discussed above, in a suit to enforce a non-competition covenant against an employee, the employer must be able to show both that the consideration paid the employee in the underlying agreement gave rise to a legitimate business interest in preventing competition by its former employee<sup>[xvi]</sup> and that the covenant is limited to restrictions necessary to protect its goodwill or other business interest.<sup>[xvii]</sup> The concept of tying the consideration with the interest is confusing both to lawyers and their clients. What constitutes this justifiable interest and the extent to which this interest justifies restraining the activities of the employee are not always clear.

Business goodwill has been defined by Texas courts as the relationship a business entity enjoys with its customers.<sup>[xviii]</sup> The Texas courts will thus enforce an agreement not to solicit customers of the former employer and not to use or disclose information about the customers such as their preferences and past buying practices.<sup>[xix]</sup> Other protectable business interests include trade secrets<sup>[xx]</sup> and other confidential or proprietary information (including customer information).<sup>[xxi]</sup> For a discussion of trade secrets and confidential information, see below.

Special training or knowledge acquired by an employee during employment is also a protectable business interest of the employer.<sup>[xxii]</sup> General knowledge, skills and experience are not protectable business interests even if acquired during employment.<sup>[xxiii]</sup> The level at which an employee is employed within the business is also significant. One Texas court has pointed out that "[it] is evident that as an employee's job level rises and as that job becomes more specialized and unique, and as his job requires more personal contact with the customers he must serve, the likelihood that a restrictive covenant will be enforced against him increases greatly."<sup>[xxiv]</sup> Following this reasoning, an employer will probably not be able to prove a protectable business interest that will support a non-competition agreement with an unskilled laborer.<sup>[xxv]</sup>

The courts have held that the following do not constitute protectable interests. Bankruptcy courts have held that bankrupt employers cannot enforce covenants not to compete against their former employees absent an enforceable contract giving them a proprietary interest in their customers.<sup>[xxvi]</sup> The courts reason that a business that is not continuing can have no interest in preventing competition in the future. Similarly, Texas courts have held that an employer who has gone out of a certain line of business cannot enforce a non-competition covenant as to that aspect of its business.<sup>[xxvii]</sup> Because of prohibitions on restraint of trade, Texas courts have held that, by itself, the desire to prevent competition is not a protectable interest.<sup>[xxviii]</sup> In a well-argued case, the court found no protectable interest of the employer where a former employee who had worked in the line of business for twenty-five years prior to his beginning work for his employer, had built up his own

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goodwill, did not have an exclusive territory or exclusive customers and where evidence showed that sales in the industry were no longer primarily influenced by personal contact but by price and the company's reputation for performance.<sup>[lxxix]</sup>

### **Non-Competition Agreements, In Conclusion**

Because employers want to be able to enjoin a departed employee's competition before real damage is done and need the time granted by the non-compete to reinforce customer relations the clear message is to avoid overreaching, vague and overly broad non-compete agreements. Thought must be invested in every such agreement to insure appropriate application to the facts applicable to the particular employee and marketplace—and no more restrictive than absolutely necessary to protect the good will and business of the employer.

Pure non-competition agreements should be supplemented by other types of agreements, such as non-disclosure agreements and agreements not to solicit customers. Those types of agreements may be more enforceable. So we now address those.

### **Non-Solicitation Agreements**

Customers. A non-solicitation agreement is usually an agreement not to solicit customers of the former employer. While in the past these agreements have been enforced,<sup>[lxxx]</sup> in more recent cases, such clauses have been held to a strict standard of reasonableness comparable to those of non-competition covenants.<sup>[lxxxi]</sup> In *Peat, Marwick*, the Supreme Court states:

We hold that provisions clearly intended to restrict the right to render personal services [in this case, a non-solicitation of customers agreement] are in restraint of trade and must be analyzed for the same standards of reasonableness as covenants not to compete to be enforceable. We hold that the provision in question here is unreasonable because it applies to clients who first become clients after the accountant left the firm or with whom the departing partner had no contact while he was at the prior firm.<sup>[lxxxii]</sup>

In *Juliette Fowler Homes*, the Supreme Court stated that a prohibition against "entering into any form of contract for services or employment in any capacity or position, directly or indirectly, with any past or present clients of Welch wherever they may be located," is "absolute, unequivocal and unreasonable."<sup>[lxxxiii]</sup>

Thus, while customer lists are protectable as trade secrets (discussed below),<sup>[lxxxiv]</sup> an agreement not to solicit business from the customers contained on the list is subject to the *Light* analysis as a restrictive covenant.<sup>[lxxxv]</sup> Thus, a non-solicitation of customers clause should be limited to those customers with which the employee had actual contact during employment and should allow employees who have left to perform services for customers of the former employer which are not of a type performed while employed.<sup>[lxxxvi]</sup>

Employees. Another type of non-solicitation agreement is the agreement not to solicit fellow employees to leave the employer and go to a competing business. This type of non-solicitation agreement has been upheld.<sup>[lxxxvii]</sup> It is not clear, however, on what basis the courts have founded their decisions. In *Justin Belt* the Supreme Court does not discuss the non-solicitation of employees clause as distinct from the non-competition covenant.<sup>[lxxxviii]</sup> The court in *Electronic Data Systems Corporation* upheld an injunction prohibiting the former employee from soliciting fellow employees but also without a specific discussion of its reasoning on this issue.

Because the analysis of the courts involving non-solicitation of customer agreements could be applied equally to solicitation of employees, it would be advisable to assume that agreements not to solicit fellow employees should be narrowly drafted as well. Such agreements should probably be limited to non-solicitation of those fellow employees with whom the employee who is leaving has actually worked, and what non-solicitation is prohibited should be carefully defined.

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The law of other jurisdictions, while not consistent, generally finds that inducement of an employee to move to a competitor is not actionable except where the party offering the inducement “has an unlawful or improper purpose or uses unlawful or improper means.”<sup>[xxxix]</sup> Courts of other jurisdictions have considered misuse of secret information, a malicious attempt to ruin another’s business and spreading false and derogatory statements to be improper purposes or means<sup>[xc]</sup>. Also, the attempts of an employee to solicit his fellow employees to leave while still employed and without the knowledge of the employer has been held to be a breach of the employee’s fiduciary duty to his employer.<sup>[xci]</sup>

### **Non-Disclosure Agreements**

Non-disclosure or confidentiality agreements refer to agreements that certain information possessed by an employee will not be disclosed outside the limits established in the agreement. Such information is generally confidential information, whether or not such information constitutes trade secrets. Even without a non-disclosure or confidentiality agreement, trade secrets and confidential information may be protected under the common law of unfair competition. However, such agreements are very useful to establish and define trade secrets and to provide an additional, contractual basis for protection.

Non-disclosure or confidentiality agreements are not considered in restraint of trade, as are non-competition agreements protecting the same information, and are more readily enforced by the courts.<sup>[xcii]</sup> The courts consider non-competition agreements narrow exceptions to the public policy prohibiting agreements restraining free competition. Non-disclosure covenants, however, do not run against the grain of public policy.<sup>[xciii]</sup> In an employment agreement, non-disclosure and confidentiality provisions are separable and may be enforced even if the non-competition covenant in the same contract is not enforceable.<sup>[xciv]</sup> Non-disclosure agreements are not subject to the statutory requirements of enforceability including the reasonableness of the time, territory and scope of activity covered.<sup>[xcv]</sup> As a result, businesses that rely heavily on trade secrets or confidential information look upon non-disclosure and confidentiality agreements as a preferable protective device.

### **What Constitutes a Trade Secret**

Texas has not adopted the Uniform Trade Secrets Act, as have most other states.<sup>[xcvi]</sup> Texas instead follows the Restatement of Torts definition of trade secrets:

“A trade secret may consist of any formula, pattern, device, or compilation of information which is used in one’s business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers. A trade secret is a process or device for continuous use in the operation of the business. Generally it relates to the production of goods (i.e., a machine or formula for the production of an article”.<sup>[xcvii]</sup>

Following this definition, the following types of information have been held to be “trade secrets by Texas courts based on the facts of the cases before them.

- customer and client lists
- customer order information
- buyer contacts
- vendor information
- blue prints, design manuals, and drawings
- product sketches
- bidding systems

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- combinations of software modules
- computer programs
- computer clustering technology
- manufacturing processes
- business forms
- marketing plans and strategies
- design specifications
- testing data
- training and service manuals
- pricing information
- “lead books” containing potential licensees
- and even fudge recipes”[\[xcviii\]](#)

To constitute confidential information or trade secrets, sufficient secrecy is required to confer an actual or potential competitive advantage.[\[xcix\]](#) An employer must make some effort to maintain the secrecy of the information.[\[c\]](#) Information widely known or easily ascertainable does not constitute a trade secret or confidential information.[\[ci\]](#) The Court in *Dannenbaum*,[\[cii\]](#) pointed out that while many Texas courts in determining whether information is protectable analyze the difficulty one might have in obtaining customer lists, whether such lists are in reality confidential information, and whether the information is readily accessible by industry inquiry,[\[ciii\]](#) other Texas courts have focussed on the method used to obtain the information. Even if the customer information is readily accessible in the industry, these latter courts find liability if the competitor actually gained the information in usable form while working for the former employer.[\[civ\]](#)

Odd results appear from this latter line of reasoning; some courts have held that if the former employee gained information while working for his former employer, he cannot use it even if it is now readily accessible.[\[cv\]](#) If secret information comes into the employee’s possession due to a confidential relationship with his employer, he may not breach the confidence by using the information to his employer’s disadvantage.[\[cvi\]](#) Period!

### **Misappropriation of a Trade Secret**

In addition to the contractual protections provided to employers through the use of a non-disclosure agreement, trade secrets are also protected under the common law from misappropriation. Trade secret misappropriation occurs when:

- 1) the employer’s “trade secret,” was disclosed to the employee in confidence;
- 2) the employee used the secret without authorization; and
- 3) the use caused the employer to sustain damages.[\[cvii\]](#)

Where a misappropriation is found, remedies include an injunction preventing disclosure, monetary damages or criminal sanctions against the employee. Compensatory and punitive damages may be obtained by the employer for misappropriation.[\[cviii\]](#) Punitive damages are appropriate where the employee’s actions were “fraudulent or malicious.”[\[cix\]](#)

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Under the Texas Penal Code, misappropriation of trade secrets is also a third-degree felony.<sup>[cx]</sup> In *Schalk v. State*,<sup>[cxi]</sup> the court found that where the employer had attempted to thoroughly protect its trade secrets (it had employee nondisclosure agreements and restricted access to sensitive areas and information), the employees who copied computer programs could be held criminally liable. In this case, the information was clearly protected, was clearly considered secret by the employer, this secrecy was clearly communicated to the employees and protective measures to guard access to the information were extensive.

### **Protection of Trade Secrets**

In the absence of a complete due diligence review of a business' trade secrets and confidential information by a qualified attorney, there are some simple steps that may be taken to improve protection of valuable information.<sup>[cxii]</sup> First, identify possible trade secrets. Second, label such information in writing "confidential information" and "property of....." and adopt corporate policies to the effect that all internal information is confidential whether labelled or not and should not be copied, disclosed or disseminated outside the company. Third, communicate with employees that such information is confidential information belonging to the employer and is not to be copied, disclosed to other employees or to anyone outside the company. Fourth, have all employees who have access to the information sign non-disclosure and confidentiality agreements as well as any third party who may have access such as consultants, independent contractors, licensees, joint venturers. Fifth, control access to information both within and without the company on a "need to know" basis. Sixth, inventory all confidential information as to its location and document the measures taken to protect against its disclosure including a list of persons with access to such information. If the value of the trade secrets or confidential information warrants the expense, additional protection may be obtained through maintenance of security measures and barriers to access such as "visitor badges, signs warning of restricted areas, escorts to sensitive areas, fences around facilities, surveillance cameras, passwords to access areas and databases, appropriate locking devices, etc."<sup>[cxiii]</sup> While not all of these measures will be justified for each business, such steps increase the likelihood that the business will prevail in a suit to protect trade secrets from misappropriation.

### **Tortious Interference**

When cases are brought involving non-competition or non-solicitation provisions, they often include actions based on tortious interference as well. Two types of tortious interference are common in employment cases. Tortious interference with an existing contract is proven when the plaintiff shows the following elements:

1. a contract existed;
2. the defendant willfully and intentionally interfered with the contract;
3. which proximity caused the plaintiff harm; and
4. actual damage or loss occurred.<sup>[cxiv]</sup>

One can also tortiously interfere with a prospective business relationship. The elements of tortious interference with a prospective business relationships are:

1. reasonable probability that plaintiff would have entered into a business relationship;
2. defendant acted maliciously and intentionally to prevent the relationship from occurring with the purpose of harming plaintiff;
3. the defendant was not privileged or justified in his actions.<sup>[cxv]</sup>

An action for tortious interference may be based on the contract between an employer and an employee.<sup>[cxvi]</sup> An employment contract, even an at-will employment contract, may be tortiously interfered with.<sup>[cxvii]</sup> At least one Texas case has held that even a prospective at-will employment contract can be tortiously interfered with.<sup>[cxviii]</sup>

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In the situation where a former employer is suing a new employer for tortious interference based on a non-competition covenant with its former employee, the action will not succeed if the non-competition agreement is deemed unenforceable.<sup>[cxi]</sup> This inability to defend against tortious interference by a competing employer is one more reason to draft *reasonable* non-competition covenants.

An enforceable non-competition, non-solicitation or non-disclosure agreement may also be of value to an employer as an affirmative defense against a claim that it has tortiously interfered with its former employee's new employment. In one case, an employer wrote a letter to its former employee's new employer stating that the former employee was breaching its non-competition covenant by taking the new position.<sup>[cxx]</sup> The employee then sued her former employer for tortious interference with her new employment relationship.<sup>[cxxi]</sup> The former employer prevailed on a motion for a summary judgement because it had a legal privilege to interfere in the new contract because it had done so in a bona fide exercise of its own rights under the enforceable non-competition agreement.<sup>[cxxii]</sup> Once again, an *enforceable* non-competition agreement was crucial to this employer's avoidance of liability.

However, it should be noted that as between a new and former employer, for the former employer to prevail, the new employer must have taken active steps to induce the employee to leave and not simply hired the employee who was acting on his own initiative in seeking a change of jobs.<sup>[cxxiii]</sup> This would be true whether or not there was an agreement between the former employer and the leaving employee.

### **In Conclusion**

We hope that you have gotten this far; while this is a lengthy article, we did have a lot of material to summarize. The theme of the law is that protection against competition and protection against disclosure of confidential information can be fashioned quite effectively, but such restraints must pass the tests of necessity, reasonableness and fairness. Please contact us if you would like us to prepare materials for you or give you samples of such agreements.

[i] For a more complete discussion of the history of the enforcement of Texas non-competition agreements, see the following articles:

Jeffrey W. Tayon, *Covenants Not to Compete in Texas: Shifting Sands from Hill to Light*, 3 Tex. Intell. Prop. L.J. 143 (1995).

Richard L. Armstrong, *The Changing Face of Non-competition and Non-disclosure Covenants*, 57 Tex. B.J. 962 (October 1994).

Crystal L. Landes, *The Story of Covenants Not to Compete in Texas Continues.....*, 33 Hous. L. Rev. 913 (Fall 1997).

[ii] *Frankiewicz v. National Comp Associates*, 633 S.W. 2d 505 (Tex. 1983), *Weatherford Oil Tool Co. v. Campbell*, 161 Tex 310, 340 S.W. 2d 950 (1960); *Justin Belt Co. v. Yost*, 502 S.W. 2d 681 (Tex. 1973).

[iii] In *Hill v. Mobile Auto Trim, Inc.*, 725 S.W.2d 168 (Tex. 1987), the court established a four-part test for enforceability of non-competition covenants in which it adds consideration by the promisee (employer) as a new requirement. (at 171). Also, in dicta, the court quoting from the Utah Supreme Court's opinion in *Robbins v. Finlay*, 645 P. 2d 623, 627 (Utah 1982), says it is adopting the "common calling" standard which states that "covenants not to compete which are primarily designed to limit competition or restrain the right to engage in a common calling are not enforceable". *Id.* at 172.

See Also *Bergman v. Norris of Houston*, 734 S.W. 2d 673, 674 (Tex. 1987).

In a decision which was later withdrawn, the court established a three-part test for the enforceability of a covenant not to compete, relegated the "common calling" standard to a factor to be sometimes considered as to the reasonableness of the covenant and found the employer liable for damages for wrong. *DeSantis v. Wackenhut Corp.*, 31 Tex. Sup. Ct. J. 616 (July 13, 1998) (*opinion withdrawn*).

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In *Juliette Fowler Homes v. Welch Associates*, 793 S.W. 2d 660 (Tex. 1990) the court found a non-competition covenant unenforceable by the employer because it was overbroad, but sufficient for an action of tortious interference with a contractual relationship against the employer.

In *Martin v. Credit Protection Association, Inc.*, 793 S.W. 2d 667 (Tex. 1990) the court found continuation of employment for an at-will employee insufficient consideration to support a non-competition covenant.

[iv] *DeSantis v. Wackenhut Corp.*, 31 Tex. Sup. Ct. J. 616 (July 13, 1988) *superseded by* 793 S.W. 2d 670 (Tex. 1990).

[v] Tex. Bus. & Com. Ann. §15.50-51.

[vi] *In Travel Masters, Inc., v. Star Tours, Inc.*, 827 S.W. 2d 830 (Tex. 1991), the court held that “a covenant not to compete executed either at the inception of or during an employment at-will relationship cannot be ancillary to an otherwise enforceable agreement and is unenforceable as a matter of law.” *Id.* at 833.

[vii] *Martin, Id.*

[viii] See the Covenant Not to Compete Act: Hearings on S.B. 946 Before the Senate Committee on Economic Dev., 71st Legislature (April 3, 1989).

[ix] Tex. Bus. & Com. Code §15.50, .51 and .52.

[x] *Light v. Centel Cellular Co.*, 883 S.W. 2d 642 (Tex. 1994).

[xi] *Id.* at 647.

[xii] *Id.* at 644.

[xiii] *Martin, Id.* at 669 and *Travel Masters, Id.* at 832.

[xiv] *Light, Id.* at 645-646.

[xv] *Zep Manufacturing Company v. Harthcock*, 834 S.W. 2d 654 (Tex. App. – Dallas 1992, no writ).

[xvi] *Id.* at 659.

[xvii] *Light, Id.* at 647.

[xviii] *Light, Id.* at 647, *f.n.* 15.

[xix] *Evans World Travel, Inc. v. Adams*, 978 S.W. 2d 225 (Tex. App. – Texarkana 1998, no writ)

[xx] *Donahue v. Bowles, Troy, Donahue, Johnson, Inc.*, 949 S.W. 2d 746 (Tex. App.—Dallas 1997, writ denied).

[xxi] *Gill v. Guy Chapman Co.*, 681 S.W. 2d 264, 269 (Tex. App. – San Antonio, no writ). (“The employment itself and the numerous financial benefits flowing from the position” are adequate consideration to support a non-competition agreement).

[xxii] *Light, Id.* at 647-648.

[xxiii] *Id.* at 647.

[xxiv] *Id.* at fn. 14.

[xxv] *Id.*

[xxvi] *Light, Id.* at 645.

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[xxvii] *Id.*

[xxviii] *Id.* at 645.

[xxix] Tex. Bus. & Com. Code §15.50 (Vernon 1999).

[xxx] Tex. Bus. & Com. Code §15.51(c) (Vernon 1999).

[xxxi] Tex. Bus. & Com. Code §15.50 (Vernon 1999).

[xxxii] *Id.*

[xxxiii] Tex. Bus. & Com. Code §15.51(c) (Vernon 1999).

[xxxiv] *Id.*

[xxxv] *John J. Ray & Sons v. Stroman*, 923 S.W. 2d 80 at 85 (Tex. App. – Houston [14th Dist.] 1996, writ denied).

[xxxvi] Tex. Bus. & Com. Code §15.51© (Vernon 1999).

[xxxvii] *Id.*

[xxxviii] *Investors Diversified Services v. McElroy*, 345 S.W. 2d 338 (Tex. App. – Corpus Christi 1982, no writ); *AMF Tuboscope v. McBryde*, 618 S.W. 2d 105 (Tex. App. – Corpus Christi 1981, writ denied n.r.e.). See generally, *Property Tax Assoc. v. Staffeldt*, 800 S.W. 2d 349 (Tex. App. – El Paso 1990, writ denied) (“*The courts of this state have upheld restrictions ranging from two to five years as reasonable*”).

[xxxix] *Chandler v. Mastercraft Dental Corp. of Texas, Inc.*, 739 S.W. 2d 460, 464-465 (Tex. App. – Fort Worth 1987, writ denied) (*upholding 5 years restriction in sale of business.*)

[xl] *Meineke Discount Muffler v. Jaynes*, 999 F. 2d 120, 123 (5th Cir. 1993) (*Federal court considering a licensing agreement basing its decision on Texas Law.*)

[xli] *Ruscitto v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 777 F. Supp. 1349, 1354 (N.D. Tex. 1991) (*Federal courts considering employment agreement, based on Texas Law.*)

[xlii] *Investors Diversified Services, Inc. v. McElroy, Id.* at 339. See also, *Car Wash Systems of Texas, Inc. v. Brigance*, 856 S.W. 2d 853, 859 (Tex. App. – Forth Worth 1993, no writ) and *Isuani v. Manske-Sheffield Radiology Group P.A.*, S.W. 798 S.W. 2d 346, 606 (Tex. App. – Beaumont 1991) *rev'd on other grounds*, 802 S.W. 2d 235 (Tex. 1991).

[xliii] *Travel Masters, Inc. v. Star Tours, Inc., Id.* at 840. See also *Property Tax Associates, Inc. v. Staffeldt*, 800 S.W. 2d 349, 350-351 (Tex. App. – El Paso 1990, writ denied), *Safeguard Business Systems v. Schaffer*, 822 S.W. 2d 640, 644-45 (Tex. App. – Dallas 1991, no writ).

[xliv] *Webb v. Hartman Newspapers, Inc.*, 793 S.W. 2d 302, 305 (Tex. App. – Houston [14th Dist.] 1990, no writ); *Integrated Interiors, Inc. v. Snyder*, 565 S.W. 2d 350, 392 (Tex. App. – Fort Worth 1978, writ ref'd n.r.e.).

[xlv] *Bob Pagan Ford, Inc. v. Smith*, 638 S.W. 2d 176 (Tex. App. – Houston [1st Dist.] 1982, no writ).

[xlvi] *Lewis v. Kruger, Hutchison & Overton Clinic*, 269 S.W. 2d 798 (Tex. 1954); *T&T Drapery Services, Inc. v. Brown*, 534 S.W. 2d 373 (Tex. App. – Dallas, no writ).

[xlvii] *Juliette Fowler Homes, Id.* at 663.

[xlviii] *General Devices, Inc. v. Bacon*, 888 S.W. 2d 497, 504 (Tex. App. – Dallas, 1994, writ denied).

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[xlix] Tex. Bus. & Com. Code Ann. §15.50 (Vernon 1999).

[i] *Diversified Human Resources Group, Inc. v. Levinson-Polakoff*, 752 S.W. 2d 8 (Tex. App. – Dallas 1988, no writ), *Martin v. Linen Systems for Hospitals, Inc.*, 671 S.W. 2d 706, 709 (Tex. App. 1984, no writ).

[ii] *Emergicare Systems Corp. v. Bourdon*, 942 S.W. 2d 201 (Tex. App. – Eastland 1997, no writ), *Weatherford Oil Tool Company v. Campbell, Id.* at 952.

[lii] *Gomez v. Zamora*, 814 S.W. 2d 114 (Tex. App. – Corpus Christi 1991, no writ).

[liii] *Posey v. Manier Resources, Inc.*, 768 S.W. 2d 915, 918-919 (Tex. App. – San Antonio 198