

RESTRICTIVE COVENANT AGREEMENTS IN TEXAS AND PRACTICAL ADVICE FOR CORPORATE COUNSEL

What is a Restrictive Covenant and why should they be important to me and my employer (client)? A restrictive covenant is defined as a formal and serious agreement or promise to refrain from doing something which otherwise one would have a right to do. We are most familiar with restrictive covenants from real property law and the covenants that ran with deeds. However, it could be argued that more prevalent today for our clients are the restrictive covenants employers make their employees sign as a condition of employment to protect the employer's confidential information, trade secrets, and the investment the employer makes in training the employee.

A. Common Restrictive Covenants

Common types of restrictive covenants include non-competition agreements, non-solicitation agreements, and confidentiality or non-disclosure agreements. Covenants not to compete are most commonly found in employment contracts/sales contracts and are authorized by statute.¹ Typically a covenant not to compete offers the greatest protection of the restrictive covenants but as such they are also subject to the greatest scrutiny. Non-solicitation agreements are usually directed towards protecting relationships, i.e. customer, employee, vendor, or the like, and consequently as they are often easier to enforce than non-compete agreements. Confidentiality or non-disclosure agreements are usually easily enforceable, however are considered less effective at protecting trade secrets/confidential information because once the information is out or used, it is out,

i.e., it is impossible to put the genie back in the bottle.

B. Practical Issues Requiring the Use of Restrictive Covenants

Due to the evolving job market in the State of Texas and throughout the country, we are witnessing hard times that directly affect employee retention. First, companies, especially in the energy sector are shedding jobs by lay-off and buy-out. Two, because employers are always searching for the top talent we are witnessing increased employee movement at the top and with employees with certain skill sets. Likely because of the times, new employees are less willing to sign non-competes or other restrictive covenants. Therefore, it is increasingly more important for corporate counsel to implement policies to protect employer information including:

- Customer lists and information;
- Engineering designs, processes, techniques;
- Prices, costs, margins, mark-ups, "metrics";
- Internal weaknesses;
- Marketing and strategic plans;
- Vendor lists and information;
- Supplier lists and information;
- Employees; and,
- Consultant/contractors.

But how does one obtain an employee's cooperation in today's environment? I would propose that the consideration should begin with a "Team" approach, indicating to the employees or prospective employee that "We all sign them" and that they are designed to "Protect all of us." Second, I would suggest that the actual restrictive covenants be drafted as narrowly as possible to only protect those interests that truly need to be protected, such that:

1. any restrictions should be for a limited duration, i.e., what is the minimum time needed to protect my employer's information?
2. if a limitation by geography is needed, what is the minimum limitation that will protect my employer's information, i.e., limit restrictions to customers and/or areas that person is responsible for and/or exposed?
3. if a limitation by scope of activity is needed, what is the narrowest definition of the activity that will protect my employer's information?

Creating and keeping an open line of communication regarding these restriction will also assist and encourage participation by signing. If management agrees, and especially if these restrictive covenants are being entered into after employment has begun, additional consideration in the form of a bonus or the like should be considered.

The remainder of this article will discuss drafting techniques and related law for each of non-disclosure agreements, non-solicitation agreements and covenants not to compete.

C. Practical Advice for Drafting Confidentiality Agreements

A confidentiality agreement or non-disclosure agreement is nothing more than a contract in which an employee makes a covenant not to disclose, e.g., a promise not to disclose, certain information acquired during employment.ⁱⁱ Non-disclosure covenants are not a restraint on trade and therefore not against public policy and not subject to the reasonable time, geographic, and scope-of-activity limitations that apply to

covenants not to compete.ⁱⁱⁱ As such, non-disclosure agreements are easier to enforce.

However, some case law suggests that confidentiality agreements are only enforceable to the extent they prohibit the disclosure of trade secrets. In *CRC-Evans Pipeline International, Inc. v. Myers*, two employees signed employment agreements in which they promised not to disclose "trade secrets or confidential information" that they had learned in a previous stint of employment, in exchange for the employer's promise of renewed employment.^{iv} In this case, the Court found the agreement unenforceable because what the employees promised not to disclose were not trade secrets because the employer had not taken sufficient steps to protect the trade secrets.^v The Court adopted this holding even though the non-disclosure agreement called for the non-disclosure of both trade secrets and confidential information.^{vi}

Generally, however, the mere exchange of confidential information, i.e. information you would not want your competitor to know, with an employee who has signed a non-disclosure agreement will create a unilateral contract.

In drafting a non-disclosure agreement, here are some important tips to consider:

1. **Nature of the Obligation.** What is the non-disclosure agreement attempting to accomplish? What is being restricted? Many agreements have language to the effect of "recipient of the information is required to exercise the same degree of care that it would use to protect its own confidential information, but, at a minimum, the recipient of the

information should be required to exercise a reasonable degree of care.”

2. **Protected Information or Material.** What is the information sought to be protected? A concise description should be provided.
3. **Marking Requirement.** The non-disclosure agreement should include a procedure for identifying protected information or material.
4. **Permitted Use.** Are there any allowed uses by the other side? Those should be provided in a list if possible.
5. **Permitted Disclosure.** Are any disclosures permitted? The non-disclosure agreement should define the class or classes of people who can receive and use the Protected Information or Material.
6. **Mutual v. Unilateral.** Are there considerations that each side may be disclosing confidential information? Do you want your employer subject to a non-disclosure agreement?
7. **Duration of Obligation.** The non-disclosure agreement should state a term for the entire agreement.
8. **Remedy for Breach.** The non-disclosure agreement should state that, in the event of a breach, monetary damages would not be sufficient and that the parties agree injunctive relief is proper.
9. **Enforcement.** The agreement should choose a choice of law, forum and a venue for any lawsuit to enforce the covenants. If desired, an alternative to court adjudication can be added such as arbitration or mediation.
10. **Indemnification.** The nondisclosure agreement should state that, in the event a breach is proven to have occurred, the breaching party agrees to indemnify the non-breaching party for any attorneys’ fees or expenses

that are necessary to enforce the terms of the non-disclosure agreement.

D. Practical Advice in Drafting Non-Solicitation Agreements

In the middle of the road between Non-disclosure agreements and non-compete agreements are non-solicitation agreements. Non-solicitation or anti-raiding agreements are important agreements most commonly used to prevent former employees or contractors from taking confidential company information such as clients, vendors or suppliers or from hiring away employees. It is important to note that non-solicitation agreements are considered restraints on trade, and thus most courts, including those in Texas, will enforce them only if they are “reasonable.”

Courts will traditionally assess the reasonableness of a non-solicitation agreement by evaluating the scope of the restriction as it relates to three factors:

- 1) the employer’s interest in protecting its business;
- 2) the employee’s right to work and earn a living; and,
- 3) the public’s interest in free trade and competition.

In drafting a non-solicitation agreement:

1. Be Clear About What You Are Trying to Protect in the Non-Solicitation Agreement

Courts are likely to protect anything that gives a company value and goodwill. Certainly, Texas Courts will protect against former employees from soliciting clients,

vendors or suppliers. In general, if the former employee or contractor uses information learned from the company that the company considers confidential and such information gives the former employee or contractor (and the new employer) and unfair competitive advantage in the marketplace then the courts will enforce the non-solicitation agreement. However, a caveat to this rule is that the confidential information would not include general knowledge or skills the employee acquired during his employment or information that is available to the public through other sources because such information would likely not be protected by a court.

2. The Time Period for Non-Solicitation Must Be Reasonable

In order to be enforced, non-solicitation agreements must have a reasonable time limit, i.e., no longer than needed. The determination of a reasonable restriction is determined on a case by case basis. Factors in assessing reasonability should include the time necessary to train a new employee, the time for the business needs to change, and the time that information sought to be protected remains valuable. In general, the shorter the time the more reasonable it will seem.

E. Practical Advice for Covenants not to Compete

Texas law remains that naked restraints on trade are unlawful.^{vii} The courts have long stated that “[w]here the object of both parties in making such a contract ‘is merely to restrain competition, and enhance or maintain prices,’ there is no primary and lawful purpose of the relationship ‘to justify or excuse the restraint.’”^{viii} However, the Texas Legislature recognizes that a valid covenant not to compete facilitates economic

competition and is not a naked restraint on trade.^{ix} Covenants not to compete (also known as non-competition agreements) are most commonly found in business sale contracts and employment contracts. However, for too long, Texas courts construed the Act in an overly pro-employee manner thereby making most covenants not to compete unenforceable.^x

Prior to 2006, the courts required that non-compete agreements be ancillary to an agreement that was enforceable at the time the agreement was made. With such a requirement, the enforceability of non-compete agreements was nearly impossible because most employment relationships in Texas are "at-will," and in an "at-will" relationship the employer can avoid its obligations by simply terminating employment. The courts reasoned, the employer failed the first prong of the "ancillary" test because it was not really giving anything in exchange for the employee's promise not to compete, i.e., the promise by the employer was illusory.

However, in 2006 the case of *Alex Sheshunoff Management Services, L.P. v. Kenneth Johnson and Strunk & Associates*.^{xi} There, the Texas Supreme Court held that an employer's future promise could form an "otherwise enforceable agreement" so long as the employer actually makes good on the promise.^{xii} Just three years later, the Texas Supreme Court expanded the law again in *Mann Frankfort v. Fielding*,^{xiii} holding that the consideration need not even be explicitly promised, so long as it could be inferred given the nature of the employment.^{xiv}

In 2011, in *Marsh United States, Inc. v. Cook*^{xv} the Texas Supreme Court further relaxed its view on the enforceability of covenants not to compete at least with regards to the form of consideration that

would support a covenant not to compete. The Texas Supreme Court started its analysis of the enforceability of covenants not to compete by referring to the Texas House Business and Commerce Committee and its comments on the Covenants Not to Compete Act (“Act”).

It is generally held that these covenants, in appropriate circumstances, encourage greater investment in the development of trade secrets and goodwill employee training, providing contracting parties with a means to effectively and efficiently allocate various risks, allow the freer transfer of property interests, and in certain circumstances, provide the only effective remedy for the protection of trade secrets and good will [sic].^{xvi}

The Legislature, presumably recognizing these interests could conflict, crafted the Act to prohibit naked restrictions on employee mobility that impede competition while allowing employers and employees to agree to reasonable restrictions on mobility that are ancillary to or part of a valid contract having a primary purpose that is unrelated to restraining competition between the parties.^{xvii}

Under the Act, a covenant not to compete may be enforceable if it is:

1. "Ancillary" to another enforceable agreement; and
2. Reasonable.^{xviii}

1. What does it mean to be an Ancillary Agreement?

The phrase simply means that covenants not to compete on their own are not enforceable in Texas. To be enforceable, the covenants not to compete must be "ancillary to or part of an otherwise enforceable agreement at the time the agreement is made." Case law holds that in order for the covenant to be "ancillary:"

1. The consideration given must give rise to the Promisee's interest in restraining the Promisor; and
2. The covenant must be designed to enforce the Promisor's obligations in the otherwise enforceable agreement.^{xix}

Covenants in agreements for the sale of a business usually satisfy the ancillary requirement, but covenants arising in an employment arena were, prior to *Marsh*, considered to be more difficult when the only consideration given was financial consideration.^{xx}

2. The Act further requires that any restraint be reasonable

In addition to the "ancillary" requirement, the Act requires any restriction must contain reasonable "limitations as to time, geographical area, and scope of activity to be restrained" and "do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the Promisee." The court guidance in this area is somewhat lacking but basically the restrictions imposed should be no greater than needed.

1. The covenant's duration should relate to the business needs. A two year restriction for a six month project would likely be unreasonable. However, a six-month restriction for

the same project would likely be enforceable.

2. The geographical limitations should be narrowly tailored to an area no greater than the area in which the Promisor worked.

With today's pre-employer court decisions, it is likely that if the restrictions are not overly broad they will be upheld.

3. Can I rely upon reformation of the covenant or restriction by the Court?

Section 15.51(c) specifically allows a court to rewrite or narrow the restriction imposed by the covenant.^{xxi} However, in practice one should not rely upon a court to reform your restriction. Aside from the expense you are creating for your client in

litigating the issue, a court may simply render the restriction invalid as courts are generally loathe to determine the business necessities of a litigant. If a court does rewrite the agreement there is no guarantee it will be what you want, as the Act requires that the restriction impose no greater restraint than necessary to protect the legitimate business interests of the Promisee.^{xxii}

F. Conclusion And Key Take-Aways

While this article has highlighted areas for concern in drafting agreements with restrictive covenants, one should remember that as a lawyer protecting your client's confidential information you need to take the steps you feel necessary. In today's pro-business Texas Courts almost all reasonable restrictions will apparently be enforced. Good luck in drafting!

ⁱ Tex. Bus. & Com. Code § 15.50.

ⁱⁱ *Zep Mfg. Co. v. Harthcock*, 824 S.W.2d 654, 660 (Tex. App.—Dallas, 1992, writ denied).

ⁱⁱⁱ *Zep Mfg. Co.*, 824 S.W.2d at 663; *see also CRC-Evans Pipeline International, Inc. v. Myers*, 927 S.W.2d 259, 265 (Tex. App.—Hous.[1st Dist.] 1996, n.w.h.).

^{iv} *CRC-Evans*, 927 S.W.2d at 265.

^v *CRC-Evans*, 927 S.W.2d at 265-66.

^{vi} It is important to note that this case is before the adoption of TUTSA. It is likely the outcome would be different now.

^{vii} *See, e.g., Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844, 849 (Tex. 2009); *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 685 (Tex. 1973); *Weatherford Oil Tool Co. v. Campbell*, 161 Tex. 310, 340 S.W.2d 950, 952 (Tex. 1960).

^{viii} *United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 282-83 (6th Cir. 1898), *aff'd* 175 U.S. 211, 20 S. Ct. 96, 44 L. Ed. 136 (1899), *cited in Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 738, 108 S. Ct. 1515, 99 L. Ed. 2d 808

(1988) (Stevens, J., dissenting); *see also Potomac Fire Ins. Co.*, 18 S.W.2d at 934.

^{ix} Tex. Bus. & Com. Code § 15.04.

^x *See Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642, 644-45 (Tex. 1994).

^{xi} 209 S.W.3d 644 (Tex. 2006).

^{xii} *Id.* at 649.

^{xiii} 289 S.W.3d 844, 849 (Tex. 2009).

^{xiv} *Id.* at 849.

^{xv} 354 S.W.3d 764 (Tex. 2011).

^{xvi} House Comm. on Bus. & Commerce, Bill Analysis, Tex. S.B. 946, 71st Leg., R.S. (1989).

^{xvii} *See* Tex. Bus. & Com. Code §§ 15.05(a), .50(a).

^{xviii} *See* Tex. Bus. & Com. Code § 15.50.

^{xix} *Marsh United States, Inc. v. Cook*, 354 S.W.3d 764, 773 (Tex. 2011).

^{xx} Most lawyers believed that financial consideration alone would not make a covenant not to compete valid.

^{xxi} *See* Tex. Bus. & Com. Code § 15.51(c).

^{xxii} *See id.*