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Keys to Drafting an Effective Non-Compete And other Protective Covenants

Moderator:
Stephen E. Fox

Panelists:
Gary L. Ingram
Monica W. Latin
M. Scott McDonald

Contract Solutions for Unfair Competition: A Drafting Guide[1]

This paper is an outline covering a variety of different considerations that a drafting attorney will want to keep in mind when a client requests assistance with a contractual solution to unfair competition – primarily by employees moving to a competitor. The suggestions provided here are general guidance only and are not provided as definitive statements of the law. The individual facts of a particular employer's business area, employee contingent, states of operation and functional goals may generate very different results from those identified here. Our goal with this paper and the presentation accompanying it is simply to provide some options and ideas that a careful drafting attorney will want to keep in mind.

This paper is derived in large part from the analytical approach and case materials compiled in M. Scott McDonald & Jacqueline C. Johnson, Unfair Competition and Intellectual Property Protection in Employment Law: Contract Solutions and Litigation Guide (Bloomberg BNA 2014). Rather than provide the full citation everywhere where material in this paper is pulled from or derived from sections of the book, a short form cite to the book (e.g., *Unfair Competition*, p. __, or Chpt __) is used at the end of paragraphs that draw heavily from the book.

Appendix A to this paper is a reprint of one approach illustrated in the book.[2] It uses seven (7) steps and a layered approach that applies different contracts to different categories of employees. The employees are broken down into six layers. The top layer is the high level executives for whom the broadest restrictions are used. The next layer contains mid-management employees that have more regional or business sector oriented restrictions. Another layer involves the sales and customer facing employees for whom nonsolicitation restrictions are the primary focus. Research and development employees for whom intellectual property hold-over restrictions are important are a fourth layer. And finally there is a layer of agreement for lower level employees who handle confidential information and have important internal contacts for whom the only necessary restrictions are confidentiality and employee nonsolicitation provisions. The layer structure used in the Appendix is only provided as an example and will not be an applicable stratification for every employer.

The discussion below is organized in a series of steps for the drafting attorney to consider in counseling with the client, and determining how and when to use various contract options.

1. Help the client do a cost v. benefit analysis of contract options in advance.

The best designed contract programs start off with practical considerations in mind. Setting the client's expectations on what can be achieved through a contract and making sure the client has considered the practical implications of implementing the contract being drafted can be a critical step in reducing client frustration. Starting the client with a simple cost v. benefit review is a helpful way to get perspective on the practical issues.

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[1] **M. Scott McDonald**, Shareholder, Littler Mendelson P.C., 2001 Ross Ave. Suite 1500, Dallas, TX 75201, Phone: 214.880.8107; Email: smcdonald@littler.com.

[2] Mr. McDonald thanks BNA for its gracious permission to use the reprint in Appendix A.

A noncompete contract program will often have a number of costs that need to be considered such as: (1) a negative effect on recruiting and employee morale, (2) the need for the conveyance of extra "consideration" to the employee, (3) an administrative burden on managers and staff responsible for securing them, (4) consistency challenges in enforcement, (5) a reduced ability to hire aggressively from competitors, (6) legal cost of creation and maintenance of the contracts, (7) the cost of enforcement actions, and (8) the potential difficulties of dealing with a highly valued employee who refuses to sign the agreement. *Unfair Competition*, p. 68 – 88 ("Practical Risk and Benefit Considerations")

On the benefit side, the noncompete contract can have a number of practical and legal benefits like: (1) a deterrent effect on employees attempting to move to competitors, (2) a deterrent effect on competitors attempting to hire away employees, (3) acting as a legal foundation for a tortious interference claim, (4) creating a legal hurdle to "lift out" moves by a competitor, (5) reinforcing the seriousness of confidential information protection, (6) enhancing customer stability, and (7) helping to retain the value of the business in the event of a sale. *Id.*

2. Educate the client on the need for a legitimate business interest.

In counseling the client, it will be important to help the client understand that contracts in restraint of trade are generally disfavored. See Tex. Bus. & Com. Code §15.05, et. seq. The law protects free and fair competition. Consequently, a contractual restriction that limits free competition with no justification or purpose other than to prevent competition is likely to be found unenforceable. Most courts recognize that "[a] covenant not to compete is invalid unless it protects some legitimate interest beyond the employer's desire to protect itself from competition." *Valley Med. Specialists v. Farber*, 194 Ariz. 363, 982 P.2d 1277, 1281 (1999); *see, e.g., Dawson v. Temps Plus, Inc*., 987 S.W.2d 722, 726 (Ark. 1999) (there is no protectable interest in avoiding "ordinary competition"). This is also sometimes referred to as the "justification" for the restraint at issue. The justification must be present for the contract to work. If this foundational point is understood from the outset, then there will be better "buy in" from the client on the critical need to identify a protectable interest and be able to support it with testimony when the time comes for enforcement.

The protectable interest that can be used to justify a restriction will vary by state, profession, and industry sector, but the most commonly recognized justifications are:

1. Sale of a Business
2. Trade Secrets and Confidential Information
3. Goodwill (Generally Customer Goodwill)
4. Specialized Training
5. Unique Talent or Promotional Investment
6. Workforce Stability
7. Dispute Resolution / Settlement

See, Unfair Competition, Chp. 4("Protectable Interests").

Sale of business. The noncompete agreement that is being used to protect the value of goodwill purchased in the sale of a business is one of the most widely recognized and accepted justifications. *See Williams v. Powell Elec. Mfg. Co.,* 508 S.W.2d 665, 667 (Tex. Civ. App. 1974, no writ); *Dicen v. New Sesco, Inc.*, 839 N.E.2d 684, 687 (Ind. 2005). If the buyer could

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