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2015 Covenants Not to Compete Update

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A May 2012 update of this paper was co-authored by Ian Scharfman of The Scharfman Law Firm, PLLC in Houston. Ian is two of the following three things: (a) a very knowledgeable non-compete lawyer; (b) breeder of world class circus donkeys; and (c) all-around decent human being. If you want to report how grossly inferior this 2015 update is to the 2012 update, please contact Ian at (713) 25-LABOR or ian@scharfmanlawfirm.com or even www.scharfmanlawfirm.com.

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	As mentioned above, the employee must also evaluate their options, preferably by speaking with counsel, as to whether they believe the restrictive covenant is enforceable, and the limitations, if any, are reasonable. If a determination is made that there are legitimate legal challenges that can be made to the restrictive covenants, the employee should be prepared for either initiating legal action or responding to legal action should they engage in activity that is in violation of the terms of the covenant, as written. It goes without saying that the employee can also assess their options for other employment that is not in violation of such terms regardless as to their belief of the enforceability of reasonableness of the covenant.....	29
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	Employers should first obtain good legal advice in the drafting of a covenant not to compete. How the agreement is structured affects not only whether the agreement is enforceable, but may also affect such issues as (a) who bears the burden of proof regarding enforceability; (b) whether attorneys’ fees are recoverable in a case for breach of the agreement; (c) whether the agreement will be reformed and therefore whether damages are recoverable in a case of breach of the agreement; (d) venue for the suit; (e) construction of the agreement; and many other critical aspects. Employers should also consider a range of factors in determining whether and how to enforce a covenant. The following outline is offered as a starting point for employer considerations:	29
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	Codified as Chapter 134A of the TEXAS CIVIL PRACTICE & REMEDIES CODE, the Texas Uniform Trade Secrets Act (“TUTSA”) became effective September 1, 2013. Section 3 of Senate Bill 953 states that TUTSA applies to the misappropriation of a trade secret made on or after September 1, 2013.....	31
	TUTSA should clarify the substantive law and certain procedures employed in litigating trade secret disputes. The purpose of this section of the paper is to identify the key components of TUTSA.....	31
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	TUTSA contains a new, not altogether foreign, definition of a “trade secret.” “Trade secret means information... that (A) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and (B) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.” TEX. CIV. PRAC. & REM. CODE §34A.002(6).	31
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	TUTSA expressly provides that “actual or threatened misappropriation may be enjoined.” TEX. CIV. PRAC. & REM. CODE §34A.003(a). This is not a radical departure from existing Texas common law, though courts have been reluctant to impose wholesale bans on employee competition under a theory that the employee will inevitably disclose trade secrets by working for a competitor. Commentators are already questioning what this provision means for the “inevitable disclosure” doctrine in Texas. <i>See</i> Alex Harrell, “Is Anything Inevitable?” Texas Bar Journal Vol. 76 No. 8, p. 757 (September 2013).	31
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	The definition of “misappropriation” includes “acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means.” TEX. CIV. PRAC. & REM. CODE §34A.002(A).	31
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	TUTSA provides that an injunction shall be terminated once the trade secret ceases to exist (such as through a secret’s becoming public or losing economic value), “but the injunction may be continued for an additional reasonable period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.” TEX. CIV. PRAC. & REM. CODE §34A.003(a).	31
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	TUTSA also recognizes that it may be inequitable to outright ban one party from using information, even if the information is the trade secret of another. TUTSA permits a court “in exceptional circumstances” to issue an injunction that allows future use of a trade secret but conditioned on the payment of a reasonable royalty. TEX. CIV. PRAC. & REM. CODE §34A.003(b). “Exceptional circumstances include a material and prejudicial change of position before acquiring knowledge or reason to know of misappropriation that renders a prohibitive injunction inequitable.” <i>Id.</i>	31
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	The TUTSA damages section largely just codifies what was already Texas Common law, which affords broad remedies for misappropriation. TUTSA expressly allows a plaintiff to recover damages that can include (1) actual loss caused by misappropriation, (2) the unjust enrichment caused by misappropriation, and (3) a reasonable royalty for a misappropriator’s unauthorized disclosure or use. TEX. CIV. PRAC. & REM. CODE §34A.004(a). Punitive damages are available if “willful and malicious misappropriation is proven by clear and convincing evidence.” TEX. CIV. PRAC. & REM. CODE §34A.004(b). Punitive damages are capped at two times the amount awarded under subsections (1), (2), and (3) above.	32

G.	Attorneys' Fees	32
	TUTSA provides that the court may award reasonable attorneys fees to the prevailing party if: (1) a claim of misappropriation is made in bad faith; (2) a motion to terminate an injunction is made or resisted in bad faith; or (3) willful and malicious misappropriation exists. TEX. CIV. PRAC. & REM. CODE §34A.005.....	32
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	TUTSA displaces “conflicting tort, restitutionary, and other law of this state providing civil remedies for misappropriation of a trade secret.” TEX. CIV. PRAC. & REM. CODE §34A.007. But TUTSA does not, for example, affect remedies available under contract, whether or not based upon misappropriation of a trade secret. <i>Id.</i> It also does not displace criminal remedies. <i>Id.</i>	32
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I. OVERVIEW OF COVENANTS NOT TO COMPETE

A. The Statute.

Covenants not to compete are governed in Texas by statute. Section 15.05 of the TEXAS BUSINESS & COMMERCE CODE generally declares restraints on competition unlawful. However, the Covenants Not to Compete Act, enacted in 1989, carves out an exception for non-compete agreements and provides the framework for litigating the enforceability of non-competes. *See* TEX. BUS. & COM. CODE ANN. § 15.50 – 15.52.

B. Basic Requirements

15.50(a) of the TEX. BUS. & COM. CODE states,

Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b) [dealing with non-competes for physicians], 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.

The statute boils down to two basic requirements:

- the covenant must be “ancillary to or part of an otherwise enforceable agreement at the time the agreement is made”; and
- 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.

C. Is the Covenant “Ancillary to an Otherwise Enforceable Agreement at the time the agreement is made?”

The first issue that must be addressed by the employer is whether or not a non-competition covenant is “ancillary to or part of an otherwise enforceable agreement at the time the agreement is made.” TEX. BUS. & COM. CODE ANN. § 15.50.

1. Non-competition Covenants Contained in an Agreement for the Sale of a Business.

Covenants not to compete set forth in an agreement for the sale of a business or a settlement agreement almost always satisfy the ancillary requirement. *See, e.g., Hill v. Mobile Auto Trim, Inc.*, 725 S.W.2d 168 (Tex. 1987) (sale of business); *Heritage Operating, L.P. v. Rhine Bros., LLC*, 2012 Tex. App. LEXIS 2065, *17 (Tex. App. -- Fort Worth Mar. 15, 2012, no pet. history); *Justin Belt Co. v. Yost*, 502 S.W.2d 681 (Tex. 1973) (settlement agreement). The focus of this

paper, however, is the enforceability of non-competes that arise out of the employment relationship.¹

2. Non-competition Covenants Arising out of an Employment Relationship.

Covenants not to compete that arise out of an employment relationship are more difficult to enforce than those arising out of a sale of a business. To determine whether a covenant not to compete is “ancillary to or part of an otherwise enforceable agreement at the time the agreement is made,” a court must make two inquiries: (i) is there an enforceable agreement; and, if so, (ii) is the covenant not to compete “ancillary to or part of” the agreement at the time the agreement is made? The answer to both questions must be “yes,” or the non-compete is unlawful. *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844, 849 (Tex. 2009); *Ray Mart, Inc. v. Stock Building Supply of Texas LP*, 2008 U.S. App. LEXIS 22882 [**6] (5th Cir. 2008).

At this point we pause to consider the evolution in the law over the last 18 years. In that time the Texas Supreme Court has changed meaning of the statutory term “ancillary” and the meaning of the statutory phrase “otherwise enforceable agreement at the time the agreement is made.” This has caused a significant shift in non-compete law that makes it difficult to rely on some prior caselaw for some purposes. By way of example, pre-2006 cases seeming to require a simultaneous signing and exchange of confidential information are now obsolete. Also by way of example, in many situations an employer may not even be required to provide confidential information at all.

II. The Evolution of the Phrase “Ancillary to or Part of an Otherwise Enforceable Agreement at the Time the Agreement is Made: *Light* (1994) to *Sheshunoff* (2006), to *Mann Frankfort* (2009) to *Marsh* (2011).

A. *Light v. Centel Cellular of Texas*, 883 S.W.2d 642 (Tex. 1994).

Before the *Sheshunoff* opinion in October 2006, the Texas Supreme Court and virtually every appeals court required that the non-compete be ancillary to an agreement that was enforceable at the time the agreement was made. Neither an at-will employment relationship, nor any other promise that was conditioned upon a continued period of at-will employment, was deemed to be enforceable when made, since the person making the promise could avoid having to perform by simply terminating employment, which it could do at-will. *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642, 644-45 (Tex. 1994).

For example, promising to give a raise to an at-will employee after thirty days is an illusory promise because its performance is conditioned upon some period of continued at-will employment; so such a promise would not have satisfied the requirement articulated in *Light v. Centel* that the underlying agreement be enforceable at the time the agreement is made. *Light v. Centel* at 645. An employer’s promise to give an at-will employee access to confidential information during the course of the employment is likewise illusory because the promise

¹ In *Traders International, Ltd. v. Scheuermann*, 2006 U.S. Dist. LEXIS 61995 *25 (S.D. Tex. 2006), the court found that the fact that the defendant was an independent contractor rather than an employee did not in that case impact the enforceability of the non-compete. In 2002, the Amarillo Court of Appeals held that §15.50 of the TEXAS BUSINESS & COMMERCE CODE does not govern the rights and liabilities of owners of real property who sell or buy land subject to restrictive covenants on the use of the land. *Ehler v. B.T. Suppenas Ltd.*, 74 S.W.3d 515, 520 (Tex.App.—Amarillo 2002, writ denied). In conducting its analysis, the court said, “Section 15.50 of the TEXAS BUSINESS & COMMERCE CODE specifies criteria for enforceability of covenants not to compete almost exclusively in the context of employment contracts.” *Id*

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