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THE ELUSIVE COVENANT NOT TO COMPETE

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Finding an enforceable covenant not to compete is not as easy as it looks. This article explores the battle in one state — Texas — between the state's legislature and courts. The author explains that conflicting case law has left banks and other Texas employers guessing on how to create the elusive, enforceable covenant not to compete. This article discusses how to locate the elusive, enforceable covenant not to compete.

The Texas legislature has provided banks and other businesses in Texas with straightforward protections against unlawful competition from former employees. Section 15.50(a) of the Texas Business and Commerce Code states:

> [A] covenant not to compete is enforceable [(1)] if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made [and (2)] 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.

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Seems pretty simple, right? Wrong. The history of covenants not to compete in Texas has been a continuous battle between the legislature and the courts. On the one hand, the legislature seeks to provide banks and businesses protection against unlawful competition; on the other hand, the courts go to great lengths to declare covenants not to compete void by finding that they are unlawful restraints on trade. In fact, the Texas Supreme Court has considered covenants not to compete and has never found one to be enforceable. Consequently, the Texas legislature has amended the covenant not to compete statute several times to provide certain protections to citizens, banks, and other businesses in Texas and to counter the courts' interpretations of the covenant not to compete statute.

"AT-WILL"?

One of the primary issues when considering the enforceability of a covenant not to compete is whether the employee is employed in an "at-will" relationship or is employed for a specific period, which period is terminable only for cause. Although many high-level employees in the banking industry have employment agreements for a specific or stated term, it is likely that many of these bank employees are still at-will employees despite these agreements under the law. This conclusion is premised on the particular language of Section 24 of the National Bank Act. Section 24 gives the board of directors of a national bank the authority to appoint a president, vice president, cashier and other officers; however, it also requires that the board of directors must retain the power to dismiss such officers at the board's pleasure. This requirement provides a good argument, which may be accepted by Texas courts, that all such employees are at-will employees, at least for covenant not to compete purposes because "at the board's pleasure" is very similar to how Texas courts define at-will employment — employment that may be terminated by either party at any time and for any reason or no reason at all.

Although Section 24 only applies to national banks, a similar statute exists in the Texas Finance Code, so Texas state chartered banks are in the same position. The remainder of this article reviews the current state of Texas law as it relates to covenants not to compete entered into with at-will

employees and what steps should be taken to draft and enter into a covenant not to compete in Texas.

SEEKING STANDARDS

The Texas Supreme Court's most recent interpretation of the non-compete statute was in 1994 in *Light v. Cental Cellular Co. of Texas*.[1] There, the Texas Supreme Court reviewed the enforceability of a covenant not to compete in an at-will employment relationship. In so doing, the Texas Supreme Court complained that the legislature had failed to "provide any standards for assessing whether or not a covenant not to compete is ancillary to or a part of an otherwise enforceable agreement." Instead of relying on the plain meaning of the words of the statute and contract law 101, the Texas Supreme Court created its own standard. The Texas Supreme Court held that for a covenant not to compete to be "ancillary to an otherwise enforceable agreement" between an employer and an employee: (i) there must be an enforceable agreement; and (ii) the consideration for the agreement must be designed to enforce the employee's promise not to compete. The Texas Supreme Court provided an example of what it meant, stating that if an employer promised to give confidential information to an employee and the employee promised not to disclose or use such information after the termination of the employee's employment, then the employer and employee would have an agreement and the covenant not to compete would be designed to protect these promises. Again, this seems pretty simple. Not so fast.

Based on the *Light* Court's analysis, the language in covenants not to compete changed across Texas to include expressed and implied promises by employers to provide confidential information to their employees in consideration of their employees' promises not to use or disclose such information after the termination of their employment relationships. Language of the implied and expressed promises commonly found in covenants not to compete after *Light* typically was, "during your employment with the company, you will have access to the company's confidential information," or "from time to time, you will have access to the company's confidential information consistent with your job duties."

Despite these drafting efforts, the Texas appellate courts found that such promises by employers were still not sufficient because the courts found there was no enforceable promise by the employer to actually give the confidential information, and to the extent such an enforceable promise existed, the promise was dependant upon an additional period of time, i.e. "during your employment" or "consistent with your duties from time to time." Thus, the appellate courts uniformly voided covenants not to compete containing such promises.

AFFIRMATIVE PROMISES ADDED

Once again, employers and their lawyers went back to their covenants not to compete and added affirmative promises to provide and disclose confidential information to their employees that were not dependent on any additional period of time such as: "the Company will disclose its confidential information to employee."

The Texas appellate courts have had a harder time avoiding these affirmatively stated promises because on their face they place actual obligations on the employer to provide its confidential information to the employee, and the obligations are not contingent on a specific period of employment or continued employment. Currently, the Texas appellate courts are split regarding this issue. One of the Houston appellate courts and the Beaumont and San Antonio appellate courts hold that an affirmative promise to provide confidential information is sufficient to create a contract to which a covenant not to compete may be ancillary, rendering the covenant enforceable under the Texas statute. In contrast, the other Houston appellate court and the Dallas, Fort Worth, and Austin appellate courts hold that the employer must not only affirmatively promise to provide the confidential information but must also act upon this promise at the time or, more accurately, at the moment the agreement is executed. Yes, that seems an extreme result. But read on!

In one case, the employer affirmatively promised to disclose its confidential information and provide specialized training to the employee and the employee agreed not to use such information and training after the termination of his employment.[2] A few hours after the agreement was executed,

the employer satisfied its obligation to provide the confidential information to the employee and the specialized training. Still, the Austin Court of Appeals found that the few hour delay was too long and that at the time the agreement was executed it was not enforceable since the employer could have terminated the agreement and without being bound to perform, even though in this case it actually did perform. The view held by one of the Houston courts and the Austin, Dallas, and Fort Worth courts is impractical and likely renders almost all current covenants not to compete entered into with at-will employees unenforceable in these courts. This is particularly troubling in the banking context since the banking laws discussed above, arguably create an at-will relationship even under employment agreements with a stated term.

Although the Texas Supreme Court has refused to review the above-described case, the Texas Supreme Court elected to review another Austin Court of Appeals' decision supporting this impractical result.[3] The Texas Supreme Court has an opportunity to follow the intent of the Texas legislature and provide needed guidance on the proper interpretation of the covenants not to compete statute in Texas. But, based upon the Texas Supreme Court's past holdings (remember, the Texas Supreme Court has never found a covenant not to compete enforceable) and the general disfavor Texas courts hold for covenants not to compete, it is possible that the Texas Supreme Court will agree with the Austin, Dallas, and Fort Worth appellate courts even though such a rule could invalidate most of the existing covenants not to compete between Texas banks and their employees, and between other Texas employers and their at-will employees.

STEPS TO TAKE

What are Texas employers to do in the meantime?

First, all contracts that contain covenants not to compete or covenants not to solicit customers should include, among other items, (i) an affirmative obligation by the employer to disclose at least a portion of its confidential and proprietary information to the employee, and (ii) a statement memorializing that contemporaneously with the execution of the agreement the employer is providing its confidential information to the employee.

Such an agreement on its face should comply with the most restrictive interpretations of Texas law. Additionally, the employer must actually provide the employee at least a portion of its confidential information at the table when the contract is executed.

The next best choice is for the agreement to be drafted consistent with precedent set by the Houston, Beaumont, and San Antonio appellate courts by including an affirmative obligation on the employer (i) to disclose its confidential information to the employee before termination or (ii) to disclose its confidential information to the employee, without such disclosure being contingent upon continued employment or a specific term of employment.

A third less attractive alternative is not to rely on a covenant not to compete or a covenant not to solicit customers and, instead, to rely on a traditional nondisclosure or confidentiality agreement. Texas courts have uniformly recognized that an agreement not to disclose or use an employer's confidential information is valid and enforceable and, most importantly, is not considered a restraint on trade. Consequently, such a covenant need not satisfy the Texas courts' interpretations of the Texas non-compete statute nor must it have limitations as to the duration of its effectiveness, geographic area, and scope of activity. At least one Texas court has addressed the enforceability of covenants not to solicit an employer's employees and has held that, like nondisclosure agreements, these covenants are not restraints on trade. With the proper drafting of nondisclosure and nonsolicitation of employee agreements, banks and other employers, therefore, are able to prohibit their former employees' use of their confidential information and solicitation of their current employees, without the unpredictability of trying to enforce covenants not to compete in Texas.

Finally, if an employer does choose to rely upon a covenant not to compete, it is important to be mindful of the reasonableness of the particular limitations or restrictions imposed by the covenant. The reasonableness requirement calls for an individualized review of the employer's legitimate business interests in insisting upon the non-competition covenant compared to the restrictions placed on the employee and how those restrictions relate to the confidential information disclosed to the employee and the degree to which the employee is involved with customers. Texas courts are skeptical of blanket restrictions against competition. Instead, Texas courts favor

restrictions that are specifically tailored to the employee and relate to the activities the employee performed or to the customers with whom the employee had confidential information, or special contact or business relationships. By creating individualized and tailored restrictions, a bank or other employer will have a much better chance of demonstrating that the restrictions in the covenant not to compete or not to solicit customers are related to, and designed to protect, the bank's or company's legitimate business interests and are not simply restraints on trade.

CONCLUSION

The Texas Supreme Court has not decided a covenant not to compete case and interpreted the noncompete statute in over ten years. The Texas Supreme Court's last pronouncement on this topic created additional elements and standards not created by Texas lawmakers. In the continuous struggle between the legislature's efforts to provide banks and other businesses necessary protections and the Texas courts' strong disfavor of covenants not to compete, some Texas appellate courts have interpreted the Texas noncompete statute so that almost every current noncompete agreement with an at-will employee is in danger of being technically void. These courts' strained interpretations of the non-compete statute have left businesses, particularly banks, and lawyers with a continuous burden of trying to predict what the courts may do next in an effort to find the elusive, enforceable covenant not to compete.

Given the continuously changing nature of the law as it relates to covenants not to compete, and the need to have precise language to satisfy the technical nature of covenant not to compete statute, it is essential that banks have their agreements reviewed by legal counsel.

NOTES

[1] 883 S.W.2d 642 (Tex. 1992).

[2] *See Trilogy Software, Inc. v. Callidus Software, Inc.,* 143 S.W.3d 452 (Tex. App. – Austin 2004, pet. denied).

[3] *See Alex Sheshunoff Mgmt. Serv. L.P. v. Johnson,* 124 S.W.3d 678 (Tex. App. – Austin 2003, pet. granted).