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**THE CHANGING LANDSCAPE OF
COVENANTS NOT TO COMPETE IN TEXAS**

Who Should Read This Newsletter?

- Businesses that have covenants not to compete with their executives or employees.
- Businesses that encounter potential executives and employees with existing covenants not to compete from prior employers.
- Executives and employees who have covenants not to compete.

On April 9, 2010, the Texas Supreme Court granted review in the case of *Marsh USA Inc. v. Cook* (discussed below). The *Marsh* case involves a covenant not to compete and may once again alter the legal landscape for Texas employers and employees for so-called "no-compete" covenants.

Much has changed recently and many existing and long-standing non-competition covenants or agreements, once thought to be unenforceable and/or vulnerable to attack, may (or may not) be valid and enforceable under these new Court cases.

This Newsletter will briefly review the current state of the law, how we got here and, what may be coming that will impact Texas employers and employees, with a focus on how to best protect your business and yourself through the proper use and deployment of covenants not to compete.



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1. What is a *Covenant Not to Compete*?

A covenant not to compete or non-competition agreement or provision, seeks to prevent an executive or employee from performing similar work for other companies and/or working for competitors after leaving their current employer. Covenants not to compete are usually found in formal agreements such as a business sales contract, an employment contract, or a stock option grant. Covenants not to compete are often coupled with language seeking to protect trade secrets, confidential and proprietary business information and/or with non-solicitation obligations seeking to prohibit or limit a departing employee from soliciting their current employer's customers, suppliers, vendor base and/or workforce. Some employers also include such provisions in employee handbooks and policies.

2. Texas Statutory Requirements for Covenants Not to Compete

A stand alone covenant not to compete is not enforceable in Texas. For a covenant not to compete be valid and enforceable in Texas, at a minimum (1) it must be connected to or part of another enforceable *contract* (i.e. employment contract, sales agreement, etc.); (2) it must have *limitations* as to time/duration, geographical area, and scope of activity to be restrained; and (3) the limitations must be *reasonable* and not impose a greater restraint than necessary to protect the employer's *goodwill* or other *business interest*, (Texas Covenant Not to Compete Act, Tex. Bus. & Com. Code Section 15.50 (the "Act")).

Non-competition agreements that meet the Act's requirements may be enforceable even in "at-will" employment situations. However, it is important that the non-competition agreement be properly targeted and limited and carefully and artfully drafted; otherwise the effectiveness and enforceability of the covenant not to compete may be lost. (If the covenant not to compete pertains to Texas-licensed physicians, additional requirements must be met.)

3. Recent Texas Supreme Court Case Provides Some Relief to Employers Regarding Covenants Not to Compete

To satisfy the Act's first requirement that a non-competition clause or agreement be part of an enforceable contract, Texas courts have long held that there must be "consideration" (i.e., an exchange of something of *value* between the parties) that gives rise to the employer's interest in restraining competition. Prior to the 2009 Texas Supreme Court case of *Mann Frankfort v. Fielding*, the "consideration" requirement was met if, in exchange for the employee's *express* promise not to compete or not to disclose the employer's confidential information, the employer made an *express* (or explicit) promise (in return) to provide the employee with something of value, such as the promise to disclose the employer's *confidential information* (i.e., trade secrets on products, marketing, strategic plans, sales data and forecasts, customer lists, etc.) or the

promise to provide specialized training.

In April 2009, the Texas Supreme Court in the *Mann* case upheld a covenant not to compete where the employee expressly promised not to disclose the employer's confidential information but the employer made no *express* promise in return to disclose its confidential information to the employee. The Court reasoned that "if the nature of the employment for which the employee is hired will reasonably require the employer to provide confidential information to the employee to accomplish the contemplated job duties, then the employer *impliedly* promises to provide confidential information."

In the *Mann* case, the employee was a CPA originally hired as a staff accountant, and later re-hired as a senior manager, in the employer's tax department. The Court found evidence that the employee was required to use tax and financial information of the employer's clients in order to complete their tax returns.

Before the Texas Supreme Court's decision in the *Mann* case, it appeared that an employer's promise to the employee must be "express." After the *Mann* case, it appears that an employer's "implied" promise may be sufficient consideration.

4. A New Development in the Texas Supreme Court -- the *Marsh* case

On April 9, 2010, the Texas Supreme Court announced that it would review the *Marsh* case (referenced above). It is expected that the Texas Supreme Court will focus on deciding the issue of whether a financial benefit, in the form of stock options given to the employee, is sufficient "consideration" to validly support a non-competition agreement.

Texas courts have long held that the *nature* of the consideration given to the employee in return for a covenant not to compete must *give rise to* the employer's legitimate and reasonable business interest in restraining competition. This has been held by some Texas courts to mean that an employer's confidential information and specialized training given to an employee satisfies the "consideration" requirement, while a financial benefit (i.e., discounted sale of stock, stock options, term of employment, payment of money, promise to compensate employee in economic hardship, etc.) does not. The *Marsh* case may be a game changer for covenants not to compete in Texas with regards to the essential requirement of adequate "consideration."

5. What Should You Do Given the *Mann* Decision and the Pending *Marsh* Case?

If an employer has non-compete agreements or provisions that fail to include an *express* promise by the employer in an otherwise enforceable contract, such

agreements may be found to be enforceable under the *Mann* case. However, even if the Texas courts are becoming more tolerant of inartfully drafted covenants not to compete, the recommended, most prudent and best management practice for drafting, redrafting and/or revising non-competition agreements and provisions to protect an employer's business interests is to:

(i) Use written non-compete agreements signed by both employee and employer.

Even without a covenant not to compete, an employee has a duty not to use a former employer's confidential information to compete with that employer. However, as a practical matter, a signed non-compete agreement, defining the limitations on time/duration, geographical area, and scope of activity to be restrained, provides notice to and formalizes the obligations of the employee, and serves as a better deterrent to employees from violating the terms of the covenant not to compete, from using confidential and proprietary information and/or from soliciting the employer's customer, suppliers, vendors or workforce.

(ii) Continue to include an *express* promise by employer.

An express or explicit promise or statement of consideration by the employer will avoid or minimize an employer's burden of proving that an "implied" promise was made by the employer based on the "nature" of the employee's employment.

(iii) Include reasonable limits on the time/duration, geographical area, and scope of activity to be restrained that do not impose greater restraints than needed to protect the employer's goodwill or reasonable business interest.

In the *Mann* case, the Texas Supreme Court held that the Texas Covenant Not to Compete Act's remaining requirements must be satisfied, including that the restraints on competition be *reasonable*.

(iv) Potential impact of the *Marsh* case.

If the Texas Supreme Court decides that financial benefits, such as stock options, are sufficient "consideration" to validly support covenants not to non-compete, such should serve to increase the use, effectiveness and enforceability of non-competition agreements.

6. Conclusion

Regardless of the outcome in the *Marsh* case, it will remain prudent and should be easier to enforce non-competition obligations, if the restrictions and consideration are clearly provided in writing and signed by the employee and the employer. This recommended practice should also raise a red-flag to any company that considers hiring an employee who is subject to a well-written covenant not to compete.

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