ADVISING THE DEPARTING EMPLOYEE

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ADVISING THE DEPARTING EMPLOYEE

This paper will cover the topics that normally arise when advising an employee who is about to leave his or her employer. Typically, this involves negotiating the terms of a severance agreement. On some occasions, however, it involves advising an employee regarding his or her rights concerning a covenant not to compete. Accordingly, this paper shall cover issues concerning the potential severance agreement for a departing employee as well as issues concerning covenants not to compete.

I. POTENTIAL CLAIMS

First, before any severance can be negotiated, it must be determined which, if any, possible claims the employee has against the company. Of course, the first place to start is by interviewing the departing employee. In addition, however, witnesses that can be ethically contacted should also be interviewed.[1] Of course, in a layoff, the employer often provides, pursuant to the Older Workers Benefit Protection Act, 29 U.S.C. 621, *et. seq*., a list of the ages of those laid off and those retained.

The employee should retain and store all documents that might be relevant to any potential claim that are not the exclusive property of the employer. For example, all evaluations of the employee should be retained.

A. Internal Appeals

Once all potential claims have been analyzed, all potential internal options should also be considered. Normally, if an employer has any real internal appeal opportunities, such processes are not prerequisites to bringing suit against the employer. That does not always mean that they should be ignored.

For example, in a potential discrimination case, it is important to put the employer's human resources department on notice, as soon as possible, that the employee believes that they are the victim of discrimination. If the employer then ignores the employee's complaint, the employer may risk a finding of punitive damages against them.

Also, where the employee believes that they are being fired for refusing to commit an illegal act, I believe it is important to notify the employer of this action as

[1] State Bar 4.02 places limitations on persons who can be ethically contacted by lawyers. The scope of Rule 4.02 is outside the scope of this paper, but should be consulted, particularly, Rule 4.02(c) dealing with who cannot ethically be contacted at an organization such as corporation.

soon as possible. *See Sabine Pilot v. Hauck*, 687 S.W. 2d, 733 (Tex. 1985). Here, again, the employer's reaction to such notification can be important evidence in the case. Moreover, there is always the chance that the employer will correct the illegality and rescind the termination.

Finally, where the employee is leaving because of a hostile work environment, and intends to claim a constructive discharge, it is critical to make sure that the employer has had prior notice of the hostile work environment and an opportunity to remedy it. Legally, lack of such notice may help provide a defense against any such hostile work environment claim. *See Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742, 765 (1998). Factually, it is important to the jury to know that the employee tried to remedy the work environment and that the employer refused to take any action. Without such notice, a jury is often prone to hold the employee in part responsible.

B. Administrative Prerequisites

If there are administrative prerequisites, such as filing a charge with the Equal Employment Opportunity Commission for an age, race, sex, pregnancy, national origin, disability, or religious discrimination matter, it is best to have such filing as soon as possible, and before settlement negotiations are entered into. Since under recent Supreme Court law, each discrete employment action, such as firing, refusal to promote, demotion, etc., begins a new limitations period, it is imperative to have the employee file such a charge within the deadline, 300 days from the date the employee learned of the discrete discriminatory action. *See National Railroad Passenger Corp. v. Morgan*, 122 S.Ct. 2061 (2002). To preserve remedies under State discrimination laws, the deadline is shorter – 180 days from the date the employee learned of the discriminatory action.

C. The Texas Workforce Commission

The employee should also file for unemployment compensation with the Texas Workforce Commission as soon as possible after being fired. Apart from the monetary benefits it provides to the employee, in the event that the employer contests the unemployment compensation claim, and there is an appeal by either side, the Texas Workforce Commission will typically hold a telephonic hearing where evidence is presented. This can be an invaluable opportunity for the employee's attorney to conduct some free discovery regarding the employer's defenses.

Furthermore, if the employee is leaving involuntarily, the employee should be paid within six days of leaving the employer. Texas Labor Code 61.014(a). If leaving voluntarily, the employee should be paid no later than the next scheduled payday. Texas Labor Code 61.014(b). If the employee has not been paid timely, a claim should

be filed with the Texas Workforce Commission within 180 days. Texas Labor Code 61.051.

Also, if the employer has a ***written*** bonus, severance, vacation, sick time, or any other policy providing benefits or compensation, the employee should be paid for any such remaining pay, and if not so paid, a claim should be filed with the Texas Workforce Commission.

D. Demand Letter

If your client has plenty of time, no administrative prerequisites, and does not have a limitations problem, I think it is better to send a demand letter to the employer rather than filing a lawsuit first. Of course, there are some employers who do not take any matter seriously unless they have a lawsuit filed against them; however, that can be accomplished after settlement negotiations break down. In any event, the lawyers should not let negotiations drag on for too long without the filing of a lawsuit lest the employer figure that the employee is not serious about their case. If an administrative action has been filed, I think it is important to enclose that in the detailed demand letter made to the employer.

In the demand letter, in many cases it is better not to make a specific monetary demand. It is often difficult to assess the proper amount of damages because the employee's job prospects for future are uncertain. Rather, it would be better in most instances to outline the type of damages that would be sought. In the meantime, the employee should immediately start testing the job market to assess how long it will take to find a job, and how much that job will pay relative to how much the employee made before.

II. THE SEVERANCE AGREEMENT

The typical severance agreement is somewhat employer oriented, and not without good reason. The employer is buying peace, and therefore has to cover all possible bases for any potential future lawsuit. In doing so, however, the employer occasionally overreaches. But in most of those instances, if the employee's counsel catches such overreaching, the employer will typically agree to modify the severance agreement. I have attempted to outline below some of the typical provisions that arise in a severance agreement and the issues that arise therein.

A. Payroll taxes.

There is ongoing debate about whether, and how much, an employer can deduct in taxes for payments pursuant to a severance agreement. At the present time, all

such payments except for those in settlement or payment of "physical injury", are includable as income and therefore taxable by the IRS. In rare instances, for example, settlement of a sexual harassment claim resulting from a serious physical assault, damages may be at least in part non-taxable. In the vast majority of cases, however, since damages in employment lawsuits do not result from "physical injury" those damages are taxable by the Internal Revenue Service. *See* 26 U.S.C. §104(a)(2). Therefore, the employer often insists on deducting for federal income taxes.

Far more controversial, however, is the employer's deduction of payroll taxes, such as unemployment compensation (FUTA), social security (FICA), medicare, etc. These deductions should only be made for damages that can be fairly classified as wages. It should be noted, of course, that some Courts have held that such payments to a former employee are not wages because the person being paid is not an employee any longer. *See Churchill v. Star Enterprises*, 3 F.Supp. 2d 622 (E.D.Pa. 1998). In any event, many employers insist on withholding lest they risk trouble with state and federal taxing authorities.

However, since many employees, to the extent that they would have a case against their employer, have damages in excess of lost wages, some allocation between wages (which are subject to payroll taxes) and non-wage losses is appropriate. For example, in a typical employment discrimination case, the plaintiff will claim compensatory (mental anguish) and punitive damages in addition to lost wages and attorneys' fees. Depending upon the case, I have always believed it is appropriate to, after issuing a separate check for attorneys' fees (discussed later) divide the employee's damages in half between lost wages and non-wage compensatory and punitive damages. For example, in a settlement to an employee of $150,000.00, if the attorneys' fees are $50,000.00, and the net portion to the employee is $100,000.00, it would be appropriate to allocate the remaining $100,000.00 in proceeds to the employee as $50,000.00 in payment for wages, and $50,000.00 in payment for compensatory and punitive damages. That way, the employee is not subject to payroll taxes for the entire amount.

B. <u>Tax Indemnification Provision</u>

In light of any requested allocation by the employee, the employer frequently requests a provision indemnifying the employer for any tax liability that occurs because of the payment to the employee. As long as the indemnification is because of specific allocation or deduction request by the employee, such request is reasonable. If, on the other hand, it is the employer alone that determines the such allocations or deductions, the indemnification may be unfair since the employee has no control over the potential liability they are being asked to indemnify.

C. Separate Checks.

With respect to the portion that is for attorneys' fees, I have always believed that it is important to have a separate check issued to the attorney. Otherwise, the Internal Revenue Service often takes the position that the entire amount, inclusive of attorneys' fees, is taxable to the employee. Of course, consistent with the separate checks, separate 1099's should be issued as well.

D. Release of Claims.

Typically, as one might imagine, the release of claims is extraordinarily broad. The only provision which is typically objectionable is any release of claims for future acts by the employer. In other words, the employee should release claims for those actions which occur up to the date of the release, but not thereafter. An employee should never release claims based upon events that happen in the future.

Often times the employee is asked to indemnify the employer for any tax issues that result from any employee's request. As long as such indemnification occurs as a result of an employee's request, I do not believe such indemnification is inappropriate. However, if the employer determines the tax deductions at its sole discretion, such indemnification would be inappropriate. After all, the employee has no control over what the employer deducts, and therefore should not be responsible for any indemnification to the employer. If, however, the employee is insisting on a certain tax arrangement then it is entirely appropriate for the employee to indemnify the employer for accommodating the employee on such tax arrangement.

While the employee generally is required to give up all potential claims for which one would file a charge with the Equal Employment Opportunity Commission, such as race, sex, age, national origin, disability, and religious discrimination, the employer cannot validly ban an employee from filing an Equal Employment Opportunity Commission charge. In other words, they can require the employee to release such discrimination claims against the employer, but cannot disallow the employee from filing an Equal Employment Opportunity Commission charge. Obviously, once the employee releases his or her discrimination claims, filing an Equal Employment Opportunity Commission charge will do the employee little good. However, the Equal Employment Opportunity Commission insists that all employees be allowed access to it for the purpose of filing charges, even if they have waived their own rights against the employer. The Equal Employment Opportunity Commission will take the position that it can still investigate and obtain injunctive relief against the employer or perhaps relief for other parties.

E. Availability Clause.

Often times the former employee in a severance agreement agrees to make himself available at a reasonable time and place at no cost to the employer for his time for any investigation or proceeding arising from any act occurring during his employment. While it is not entirely clear what "reasonable time and place" means, the employee should be covered for reasonable travel expenses, and it should be explicitly mentioned in the severance agreement that if the travel expenses are necessary the employee will not have to bear any such travel expenses.

F. No Re-Employment or "Darken Door" Clause.

Often times the severance agreement includes a clause that the former employee will not seek, apply for or accept employment with the former employer. While seemingly harsh, the reason for such clause is entirely legitimate. After all, if an employee does not waive claims for acts that occur in the future, as he should not, the employee could simply get around any severance agreement by reapplying with the employer, and if he got rejected, then bring a new claim against the employer for failure to hire. This would provide a rather fruitful and potentially lucrative, and endless, basis for new claims against the employer by the employee. Obviously, since the employer wishes to buy peace, they need to obtain a release for any such claims, even though such claims are in the future. The only way of doing so is an agreement that the employee will not seek re-employment.

Of course, in the event that employer and employee truly wish to reunite in the future, such clause does not prevent such re-employment. After all, parties to a contract can always agree to waive or modify a previous agreement. What is important, from the employee's perspective, are two issues. First, the re-employment agreement must not be overly broad. For example, many employers insist that such agreement applies to anybody having the slightest thing to do with the employer. While it is typical for such a clause to involve not only the former employer, but subsidiaries, parent companies, and affiliates of the employer, it should not involve such companies as contractors, vendors, clients, and customers of the former employer. Secondly, the provision should also state that in the event that the employer acquires a company where the employee works, the employee should not be required to resign. In other words, if the employee signed such agreement, and later subsequently works for an employer which, at the time of the employee's employment with such employer is bought out by the former employer, the employee should not be required to resign. Every employer which I have ever dealt has been agreeable with such a provision.

G. Confidentiality.

Nowadays, with the potential exception of those severance agreements with public entities, every severance agreement I have been involved with involves an agreement of confidentiality of the severance agreement by the employee. What occasionally is an issue is a liquidated damages provision that the employer provides in the event that the employee breaches the confidentiality provision. Obviously, it is difficult, if not entirely speculative, for the employer to assess damages as a result of a breach of confidentiality. Accordingly, many employers attempt to insert a liquidated damage provision for such breach. Obviously, as long as the provision is reasonable, it should not cause any alarm to the employee's counsel. However, in no case should the liquidated damages provision be in excess of any severance payment pursuant to the severance agreement. In most cases, it should actually be far less.

H. Non Disparagement.

Most agreements provide that the employee shall not disparage the employer. Most employees wonder why such provision is not mutual. Shouldn't the employer be required not to disparage the employee as well? The difficulty with the provision from the employer's prospective is that the employer may employ hundreds, if not thousands, of employees, and it would be difficult to agree to control the actions of its employees. Typically, however, the employer can agree that it will give a neutral reference, at the very least for such employee, in the event that a certain person within human resources is contacted. Normally, the employer is willing to specify a certain person for such reference. It is probably in the employee's interest to negotiate as good of a reference as possible, but in no event less than a neutral reference. Many times the employer will agree to a favorable reference for the employee.

I. Governing Law.

In my judgment, the law governing the severance agreement should be in the place of the employee's last employment. Obviously, that is typically Texas. However, if the employer insists on another state's laws being applicable, that state's law should be examined in the event that it is more favorable than Texas. Since Texas provides relatively little protection for employees, the possibility that another state's law provides more protection is relatively likely.

J. Unemployment Compensation.

Severance agreements can be considered wages in lieu of notice, and therefore a credit, to any potential unemployment compensation claims. As a result, it should therefore be spelled out what rights, if any, the employee has to apply for

unemployment compensation benefits. As an additional guide, four fairly typical severance agreements have been attached hereto as Exhibits A-D.

K. Amount of Severance Payment.

There are essentially two types of severance negotiations. First, there is the negotiation of a viable claim by the employee. Secondly, however, there are many situations in which the employee has no viable claim and yet the employer is offering severance as a gesture of goodwill. Typically these severance negotiations involve employees of long tenure and/or upper management. Obviously, the amount of the severance for the employee with a viable claim varies greatly depending upon the value of the claim. With respect to the second situation, the employee may have very little leverage depending upon how much value the employer puts on the employee's future goodwill.

There are instances, however, where the employee has some leverage even absent a viable claim for a variety of reasons. For example, the employer may wish to solidify or obtain a covenant not to compete, confidentiality, or trade secret agreement. Moreover, an employer may wish to continue to do business with the employee on a consultant or advisory basis. After all, the employee may have knowledge that would continue to be valuable to current employees of the employer. In fact, on some occasions, the departing employee is the most knowledgeable person in a given area. Also, there are situations in which the employer needs the employee's future cooperation. For example, there may be an important lawsuit in which the departing employee is a significant witness. Obviously in those situations, the employee's goodwill may be critical.

Absent those considerations, however, the employee has little negotiating leverage and must generally accept whatever the employer is offering in terms of severance. While there is no "typical" severance because the employer has no obligation whatsoever to provide severance, I have seen anywhere from one to four weeks per year of employment granted by the employer in situations in which the employee had no viable claim. It should be noted that increasingly, one week per year is much more common than four weeks per year.

III. COVENANTS NOT TO COMPETE

The next topic that frequently occurs with the departing employee is whether they can find a new job despite having signed a covenant not to compete. Covenants not to compete are governed by Section 15.50 of the Tex. Bus. & Com. Code. The relevant provisions read:

> Notwithstanding Section 15.05 of this code, 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 on trade than is necessary to protect the goodwill or other business interest of the promisee.

Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 1987).

Section 15.50 is not limited to traditional covenants prohibiting an employee from working for or engaging in a competing business. Any provision that has the practical effect of restraining competition will be analyzed as a covenant not to compete. *See, e.g., Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381 (Tex. 1991) (agreement which provided liquidated damages for employer if former employee performed services for former customers analyzed as covenant not to compete because practical effect was to restrict competition). Thus, agreements that prohibit solicitation of customers are regularly analyzed as covenants not to compete. *Id.*; *See also John R. Ray & Sons, Inc. v. Stroman*, 923 S.W.2d 80 (Tex. App. – Houston[14th Dist.] 1996, writ denied) (treating a non-solicitation agreement as a covenant not to compete).

The leading case on covenants not to compete is *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642 (Tex. 1994). In it, the Texas Supreme Court set out the requirements for an enforceable covenant not to compete:

(1) The covenant must "be ancillary to or part of an otherwise enforceable agreement at the time the agreement is made"; and

(2) The covenant must contain reasonable restrictions that are not greater than what is necessary to protect the goodwill or other business interests of the promisee.

Id. at 644. The enforceability of a covenant not to compete is a question of law for the court. *Id.*

A. <u>The Covenant Not to Compete Must Be Ancillary to or Part of an Otherwise Enforceable Agreement.</u>

The first inquiry in the enforceability of a covenant not to compete under *Light* is whether there is an enforceable agreement separate and apart from the covenant not to compete itself. *Id.* ("Section 15.50 requires us to make two initial inquiries . . . (1)

is there an otherwise enforceable agreement, to which (2) the covenant not to compete is ancillary to . . . at the time the agreement is made"). Because the statute requires the Court to determine the validity of a covenant "at the time the agreement is made," the question of whether there is an otherwise enforceable agreement is made at that time as well.

As a result, at-will employment is not an otherwise enforceable agreement that will support a covenant not to compete. *Id*. at 645. If the consideration given for a promise is illusory at the time the promise is made, then the promise will not support a covenant not to compete because it is not enforceable at the time the covenant is made. Thus, in at-will employment situations, a promise by an employer to do something that is dependant on future employment, will fail to support a covenant not to compete. That is not to say that a covenant not to compete is not enforceable in an at-will situation. What is necessary is an agreement between the employer and employee that does not depend on illusory consideration such as the employer promising to provide something to the employee if the employee is still employed in the future. *Id*. ("In short, we hold that 'otherwise enforceable agreements' can emanate from at-will employment so long as the consideration for any promise is not illusory.").

The next step is determining whether the covenant is "ancillary" to that otherwise enforceable agreement.[2] The Texas Supreme Court has adopted the "designed-to-enforce-a-contractual-obligation" standard for determining whether a covenant is ancillary to an otherwise enforceable agreement. *Id*. at 647 (adopting the dissent in *Business Electronics v. Sharp Electronics*, 485 U.S. 717 (1988)). Under that standard, there must be a separate agreement that the covenant is intended to enforce and that agreement must give rise to an "interest worthy of protection." *Id*. (citations omitted). Thus, the Texas Supreme Court set out a two-prong test for determining whether a covenant not to compete is "ancillary" to an otherwise enforceable agreement. They are:

(1) the consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in restraining the employee from competing; and

(2) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.

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[2] For all practical purposes, the Texas Supreme Court has collapsed the language of the statute that requires that the covenant be "ancillary to or part of" an otherwise enforceable agreement into the "ancillary" test.

Id. Both parts of the test must be met. *Id*.

The first prong of the test focuses on the consideration that the employer gives in the otherwise enforceable agreement. The key question is whether the employer has provided the employee some consideration that is worthy of protection. The Texas Supreme Court indicated that business goodwill and confidential or proprietary information are examples of interests worthy of protection. *Id*. at 647 (citing *DeSantis v. Weekenhut Corp.*, 793 S.W.2d 670, 683 (Tex. 1990)). *See also* RESTATEMENT (SECOND) OF CONTRACTS §188 cmt. b, g (1981); *Light*, 883 S.W.2d at 647 n. 14 (acknowledging that if an employer gives an employee confidential and proprietary information in return for a promise not to disclose the information, then the covenant not to compete would be ancillary to that agreement).

It is important to note that under *Light* an agreement to provide consideration such as confidential information in the future will not satisfy the first prong of the ancillary test. *Light* makes clear that an employer cannot argue, after the fact, that the employer did provide the employee with confidential information. Instead, the promise to provide such information must require the employer to provide that information and must exist and be enforceable at the time the agreement is signed. *Id.* at 645 n. 6. If the employer can fire the employee and avoid providing the consideration to the employee, the consideration will be considered illusory. The court will ask whether at the time the agreement was signed was there an enforceable promise by the employer to provide confidential information to the employee.

Whether the employer provided confidential information to the employee in the past or actually provided the information to the employee after the employment agreement was signed is irrelevant. *CRC-Evans Pipeline Intern v. Myers*, 927 S.W.2d 259, 263 n.3 (Tex. App.–Houston [1st Dist.] 1996, no writ) (refusing to enforce covenant not to compete when the employee had received the confidential information before ever signing the agreement). Because *Light* requires that the consideration given by the employer actually give rise to the employer's interest in restraining competition, it requires an exchange of enforceable promises.

The second prong of the test focuses on the return promise of the employee and whether the covenant is actually designed to enforce that return promise. This is an essential element that many employers fail to consider. In order for a covenant to be ancillary, it must be designed to enforce a return promise by the employer that is linked to the consideration worthy of protection. In *Light*, the employer promised to train the employee. The Court assumed that there would be an exchange of confidential information. Because there was no return promise in the agreement by the employee to keep the information confidential, the Court held that the covenant not

to compete was not designed to enforce the any of the employee's return promises. *Id.* at 647.

Because the question of whether a covenant is ancillary to an otherwise enforceable agreement is such a fact intensive inquiry, each case will be decided differently. Below are some cases that will serve as a guide to how courts tackle the issue:

Rimkus Consulting Group, Inc. v. Dupre, No. 14-99-01338-CV (Tex. App. – Houston [14th Dist.] Sept. 6, 2001) (not designated for publication), 2001 WL 1013834 (refusing to enforce a covenant not to compete in an at-will employment relationship because promises by the employer were illusory);

Security Telecom Corp. and Law Enforcement Technologies, Inc. v. Meziere, No. 05-98-00059-CV (Tex. App.–Dallas March 22, 2000) (not designated for publication), 2000 WL 295098 (Covenant not to compete was not ancillary because it was not designed to enforce an obligation of the employee);

Terminex International Co. v. Denton, No. 04-99-00563-CV (Tex. App.–San Antonio, Jan. 26, 2000) (not designated for publication), 2000 WL 84888 (Contract provides for at-will employee to receive confidential information throughout employment. Contract illusory and employee had information before he signed the contract);

Ad Com, Inc. v. Helms, No. 05-96-01706-CV (Tex. App.–Dallas, Jan. 21, 2000) (not designated for publication), 2000 WL 45880 (Contract provides for at-will employee to receive confidential information throughout employment. Contract illusory and employee had information before she signed the contract);

Cutris v. Ziff Energy Group, Ltd., 125 S.W.3d 114, 118 (Tex. App.–Houston [14th Dist.] 1999, no pet.) (Promise to provide confidential information supports a covenant not to compete);

Evan's World Travel, Inc. v. Adams, 978 S.W.2d 225, 232 (Tex. App.– Texarkana 1998, no pet.) (Employer gives employee access to customer files and client information in exchange for non-disclosure agreement. Covenant not to compete is ancillary to the otherwise enforceable non-disclosure agreement);

Totino v. Alexander & Associates, Inc., No. 01-97001204-CV (Tex. App.–Houston [1st Dist.] 1998) (not designated for publication), 1998 WL 552818 (Court enforces covenant not to compete where at-will employee was promised confidential information because employee received the confidential information immediately);

Ireland v. Franklin, 950 S.W.2d 155, 158 (Tex. App.–San Antonio 1997, pet. denied) (Covenant not to compete is ancillary to agreement to share trade secrets in exchange for non-disclosure agreement);

Donahue v. Bowles, Troy, Donahue, Johnson, Inc., 949 S.W.2d 746 (Tex. App.–Dallas 1997, pet. denied) (Recognizing that a covenant not to compete would be ancillary to an agreement by an employer to provide confidential information in exchange for a non-disclosure agreement);

CRC-Evans Pipeline Intern v. Myers, 927 S.W.2d 259, 263 n.3 (Tex. App.–Houston [1st Dist.] 1996, no writ) (Covenant not to compete unenforceable when employee had worked at company for some time and already had the confidential information before he signed a covenant not to compete);

John R. Ray & Sons, Inc. v. Stroman, 923 S.W.2d 80 (Tex. App.–Houston [14th Dist.] 1996, writ denied) (In a personal services occupation a restraint on solicitation can only extend to clients with whom the employee actually had dealings during his employment); and

America Express Financial Advisors, Inc. v. Scott, 955 F.Supp. 688, 691-92 (N.D. Tex. 1996) (Employee training, confidential information and trade secrets are protectable interests).

B. The Restraint Must be Reasonable.

1. The Covenant Not to Compete Must Contain Reasonable Restrictions as to Time and Geographic Area.

Covenants not to compete that contain no geographical limitations or fail to limit the scope of activity to be restrained are unreasonable and unenforceable. *Juliette Fowler Homes, Inc. v. Welch Associates, Inc.*, 793 S.W.2d 660, 663 (Tex. 1990) (an agreement that contained no limit on geographic area or scope of activity was "an unreasonable restraint of trade and unenforceable on grounds of public policy"). Generally, a reasonable area of restraint consists only of the territory in which the employer worked while employed by the former employer. *Diversified Human Resources Group, Inc.* v. *Levinson-Polakoff*, 752 S.W.2d 8, 12 (Tex. App. – Dallas 1998, no writ).

Courts have refused to enforce agreements with nationwide applicability when the employee did not truly have nationwide responsibilities for the former employer. *Allan J. Richardson & Associates, Inc. v. Andrews*, 718 S.W.2d 833, 835-36 (Tex. App.–Houston [14th Dist.] 1986, no writ). *See also Posey v. Monier Resources, Inc.*, 768

S.W.2d 915, 919 (Tex. App. – San Antonio 1989, writ denied) (reforming nationwide restriction to the area of work of the former employee).

Examples of other cases analyzing these limitations include:

Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787 (Tex. App.–Houston [1st Dist.] 2001, no pet.) (reforming a covenant not to compete by narrowing the geographic area and scope of activity);

Stone v. Griffin Communications and Security Systems, Inc., 53 S.W.3d 687 (Tex. App.–Tyler 2001, no pet.) (enforcing broad covenant covering 22 counties in Texas with a five year duration); and

Curtis v. Ziff Energy Group, Ltd., 12 S.W.3d 114 (Tex. App.–Houston [14th Dist.] 1999, no pet.) (enforcing a covenant not to compete for all of the United States and Canada).

2. The Covenant Not to Compete Must be Reasonable as to the Scope of Activity Restrained.

To be enforceable, a covenant not to compete must restrain no more activity than is necessary to protect the legitimate business interest of the employer. In the context of the agreements prohibiting solicitation of customers or clients, Texas courts have insisted that such covenants be narrowly designed to negate the competitive advantage and knowledge the former employee might have gained about the clients *because of* his former employment. *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381 (Tex. 1991) (finding non-solicitation agreement unreasonable where it prohibited former employee from soliciting client with whom former employee had no contract through employer); *Juliette Fowler Homes Inc. v. Welch Associates Inc.,* 793 S.W.2d 660, 663 (Tex. 1990). *See also John R. Ray & Sons, Inc. v. Stroman*, 923 S.W.2d 80 (Tex. App.–Houston [14th Dist.] 1996, writ denied) (refusing to enforce covenants not to compete that include an industry-wide prohibition).

In *Haass*, the court stated that the "fundamental legitimate business that may be protected by such covenants is in preventing employees . . . from using the contacts and rapport established during the relationship . . . to take the firm's customers with him." *Haass*, 818 S.W.2d at 387. Accordingly, the only customers to whom the non-solicitation agreement could reasonably apply would be those with whom the defendant was "personally involved." *Id.* ("[T]he restrictive covenant must bear some relation to the activities of the employee. It must not restrain his activities into a territory into which his former work has not taken him or given him the opportunity to enjoy some

undue advantages in later competition with his employer.") (Internal quotation marks omitted).

Texas courts have refused to enforce agreements that vaguely prohibit all competitive activity or prohibit employment in any capacity for a competitive entity. *See, e.g., Posey v. Monier Resources, Inc.*, 768 S.W.2d 915, 918 (Tex. App.– San Antonio 1989, writ denied); *McNeilus Companies, Inc. v. Sams,* 971 S.W.2d 507 (Tex. App.–Dallas 1997, no pet.). Texas courts have also refused to enforce agreements that prohibit activity unrelated to the work the employee performed for the former employer. *Bertotti v. C.E. Shepherd Co.,* 752 S.W.2d 648, 656 (Tex. App.–Houston [14th Dist.] 1988, no writ) (language "selling or offering to sell goods or materials of any kind" was overbroad and reforming agreement to allow employee to sell non-competing products); *Diversified Human Resources Group, Inc. v. Levinson-Polakoff*, 752 S.W.2d 8, 11 (Tex. App.–Dallas 1988, no writ) (holding that agreement prohibiting recruiter from placing any type of employee was overbroad).

C. Confidential Information and Trade Secrets.

Employees are also often subject to an agreement of non-disclosure of confidential information and trade secrets. As opposed to covenants not to compete, non-disclosure agreements covering confidential information and trade secrets are easily enforceable. *See Zep Manufacturing Co., v. Harthcock*, 824 S.W.2d 654, 663 (Tex. App.–Dallas 1992, no writ). Even if the non-disclosure agreement is in the same agreement as an invalid covenant not to compete, some courts have agreed to enforce a valid non-disclosure agreement. *Miller Paper Co. v. Roberts Paper Co.,* 901 S.W.2d 593, 603 (Tex. App.–Amarillo 1995, no writ) (noting that a bar on the use of confidential information to solicit is not a restriction on solicitation); *Rugen v. Interactive Business Systems, Inc.* 864 S.W.2d 548, 551 (Tex. App.–Dallas 1993, no writ).

The strongest case for enforcing a non-disclosure agreement is in the case of trade secrets, which are also entitled to common law protection. A trade secret may consist of any formula, pattern, device, or compilation of information which is used in one's business and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. *Computer Associates Int'l, Inc. v. Altai, Inc.*, 918 S.W.2d 453, 455 (Tex. 1996). *See also* RESTATEMENT OF TORTS § 757 cmt. b (1939). The criteria for determining whether a trade secret exists include: (1) the extent to which the information is known outside of the business; (2) the extent to which it is known by employees and others involved in the business; (3) the extent of measures taken to guard the secrecy of the information; (4) the value of the information to the business and to competitors; (5) the amount of effort or money expended in developing

the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. RESTATEMENT OF TORTS § 757 cmt. b (1939).

Not all valuable confidential information qualifies as a trade secret. According to the Restatement of Torts, "A trade secret . . . is not simply information as to single or ephemeral events in the conduct of the business, as, for example, the amount or other terms of a secret bid for a contract . . ." *Id*.

Customers lists are a common subject of trade secret litigation. Whether a customer list is a trade secret depends on multiple factors: (1) the extent to which the information is known outside the business; (2) the extent to which it is known by employees and others involved in the business; (3) the extent of measures taken by the employer to guard the secrecy of the information; (4) the value of the information to the employer; (5) the amount of effort or money expended by the employer in developing the information; and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. *American Derringer Corp. v. Bond*, 924 S.W.2d 773, 777 n. 2 (Tex. App.–Waco 1996, no writ).

The advantage of a written non-disclosure agreement is that an employer may be able to secure greater protection for confidential information than the common law affords to "trade secrets." To the extent the employee's use of confidential information – whether or not an actual "trade secret" – is in violation of the employee's confidentiality agreement, the employer is enforcing a contractual right and not a common law duty. Although there is limited authority on the enforceability of non-disclosure agreements that impose duties that are more restrictive than the duties imposed under the common law, there is a good basis for arguing that courts should award a remedy in the event of a breach, at least where the non-disclosure agreement does not prohibit the employee from using his general knowledge. *See Zep Manufacturing Co. v. Harthcock,* 824 S.W.2d 654, 663 (Tex. App.–Dallas 1992, no writ) (holding that non-disclosure agreements are not restraints of trade, at least where they do not restrict the employee's use of the "*general* knowledge, skill, and experience acquired in former employment"). *But see* RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 41 cmt. d (1995) (noting that non-disclosure agreements that protect more than actual trade secrets "may be unenforceable as an unreasonable restrain of trade"). Some court decisions do imply or suggest, however, that an injunction will be awarded only to the extent necessary to protect the employer's trade secrets. *See Miller Paper Co. v. Roberts Paper Co.*, 901 S.W.2d 593, 603-604 (Tex. App. – Amarillo 1995, no writ).

Whether or not the information is the type that can be classified as a trade secret, it is important that an employer maintain the secrecy of the information. Although courts have prohibited employees from using information that is no longer

secret, those cases involve unique circumstances. In one case, a Texas court found that business forms were misappropriated by a former employer even though the forms were available in manuals distributed by a State agency. *See Gonzales v. Zamora*, 791 S.W.2d 258 (Tex. App.–Corpus Christi 1990, no writ). The central factor was the former employee's breach of confidence. Because the employee obtained the information through a confidential relationship, he was prohibited from using or disclosing the information that subsequently became public knowledge. *Id. See also American Derringer Corp. v. Bond*, 924 S.W.2d 773, 777 (Tex. App.–Waco 1996, no writ) (the mere fact that knowledge of a product might be acquired through lawful means such as inspection, experimentation, and analysis does not preclude protection from those who would secure that knowledge by unfair means); *Miller Paper*, 901 S.W.2d at 601 n.3 (refusing to follow cases that fail to follow the rule that one who obtains information due to a confidential relationship can be prohibited from using the information, even if such information was readily discoverable through proper means). One Texas court case has held that confidential information cannot be protected unless it as at least somewhat secret. *Stewart & Stevenson Services, Inc. v. Serv-Tech, Inc.*, 879 S.W.2d 89 (Tex. App.– Houston [14th Dist.] 1994, writ denied).

D. Common Law Protection of Confidential Information and Trade Secrets.

It should be noted that there is a common-law tort duty not to disclose, according to some courts, information that "can be properly classified as a trade secret." *Zoecon Industries v. American Stockman Tag Co.,* 713 F.2d 1174, 1179 (5th Cir. 1983); *T-N-T Motorsports, Inc. Hennessey Motorsports, Inc.*, 965 S.W.2d 18, 21-24 (Tex. App.–Houston [14th Dist.] 1998, no pet.) (enjoining the use of trade secrets in the absence of a confidentiality agreement). Nonetheless, even if the information is not a "trade secret" and even if there is no contractual duty not to disclose the information, disclosure of the information may violate a duty arising out of a confidential relationship. One who receives information in a confidential relation or discovers it through improper means may be under a duty not to disclose or use it, regardless of whether the information is a trade secret. RESTATEMENT OF TORTS § 757, cmt. b.

1. Elements of the Claim.

The tort claim of misappropriation of trade secrets requires a showing that: (1) a trade secret existed; (2) the trade secret was acquired through a breach of a confidential relationship or discovered by improper means, and (3) the trade secret was used or disclosed without authorization from its owner. *See, e.g., Phillips v. Frey*, 20 F.3d 623, 627 (5th Cir. 1994); *Murrco Agency, Inc. v. Ryan*, 800 S.W.2d 600, 605 (Tex. App.–Dallas 1990, no writ).

Anyone who discloses or uses another's trade secret without a privilege to do so is liable if he: (1) discovered the secret by improper means; (2) disclosed or used the information in violation of a confidence reposed in him by another; (3) learned a secret from a third person with notice that the third person discovered it by improper means or disclosed it in violation of a breach of duty to another; or (4) learned the secret with notice of the fact that it was a secret and that its disclosure was made to him by mistake. *Computer Associates, Int'l v. Altai, Inc.*, 918 S.W.2d 453 (Tex. 1996).

The most common misappropriation case involves the confidential relationship between an employer and an employee and the subsequent use or disclosure by the former employee.

The new employer of a former employee can also be held liable for misappropriation of trade secrets. Under *Computer Assoc.*, one who discloses or uses another's trade secret after discovering it by "improper means" or after learning it with notice that it is being disclosed in violation of a confidence may be held liable for misappropriation. A company that benefits from a wrongfully misappropriated trade secret can therefore be liable for the misappropriation if the company was aware that the trade secret was wrongfully appropriated. The company must, however, engage in commercial use of the trade secret to be liable. "Commercial use" has been broadly defined to include any misappropriation followed by an exercise of control or domination. *Garth v. Staktek Corp.*, 876 S.W.2d 545, 548 (Tex. App.–Austin 1994, writ dism'd w.o.j.). Still, some courts indicate that the company must at least seek to profit from use of the information. *Atlantic Richfield Co. v. Misty Products, Inc.*, 820 S.W.2d 414, 422 (Tex. App.–Houston [14th Dist.] 1991, writ denied).

2. Employee's General Knowledge, Skills and Experience.

A former employee is permitted to use his general knowledge, skills and experience acquired during his prior employment, even to compete with his former employer and do business with the employer's customers. *Miller Paper Co. v. Roberts Paper Co.*, 901 S.W.2d 593, 600-01 (Tex. App. – Amarillo 1995, no writ); *American Derringer Corp. v. Bond*, 924 S.W.2d 773 (Tex. App. – Waco 1996, no writ). Such skill, knowledge and experience are not trade secrets, but belong to the employee. If the subject matter of the alleged trade secret is created through the initiative of the employee, the employee may then have an interest in the subject matter at least equal to that of his employer or in any event, such knowledge is part of the employee's skill and experience and is not misappropriation. Thus, an employee who takes nothing from his former employer other than his memory will be in a better position to defend against a claim of misappropriation of trade secrets.

3. "Inevitable Disclosure"

In limited circumstances, a court will dispense with a showing that there has been an actual disclosure of a trade secret. These inevitable disclosure cases involve situations where the former employee's new job is so similar to the former job that the former employee cannot prevent his knowledge of his "former employer's confidential methods from showing up in his work." *Electronic Data Systems Corp. v. Powell*, 524 S.W.2d 393, 398 (Tex. Civ. App.–Dallas 1975, writ ref'd n.r.e.). *See also Conley v. DSC Communications Corp.*, No. 05-98-01051 (Tex. App. – Dallas Feb. 24, 1999) (not designated for publication), 1999 WL 89955 (enjoining former employee based on inevitable disclosure); *Williams v. Compressor Engineering Corp.,* 704 S.W.2d 469, 472 (Tex. App.–Houston [14th Dist.] 1986, writ ref'd n.r.e.) (citing *Electronic Data Systems,* 524 S.W.2d at 397-98, for the same proposition). *But see Conley*, 1999 WL 89955 (James, J., dissenting) (arguing that the inevitable disclosure doctrine should not be recognized under Texas law).