THEFT OF TRADE SECRETS, EMPLOYEE RAIDING, AND UNFAIR COMPETITION

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I. PRACTICAL CONSIDERATIONS IN DEALING WITH INTELLECTUAL CAPITAL

All too often, employers ask their in-house counsel or outside lawyers to draft a standard covenant not to compete for their employees. With those instructions in hand, lawyers present their clients with an agreement. If the attorney is an employment lawyer, the form agreement sometimes contains cutting-edge language based on the most recent appellate decisions. Handed the "perfect" agreement, employers, sometimes mistakenly, believe that they have solved their intellectual capital problem.

Form agreements that contain every imaginable protection for an employer bring with them a number of practical problems. First, the agreement itself may lead to a round of negotiations with a prospective employee. Few employees, particularly those who truly merit a covenant not to compete, sign agreements without questions. Is it really worth management's time to continually negotiate over a covenant not to compete? Does an employer really want to start an employment relationship with a valuable employee by haggling over a document that by its nature deals with termination of employment? In larger companies, line managers sometimes "forget" to get an employee to sign an covenant not to compete rather than deal with the hassle of negotiating with a resisting employee.

Second, broad agreements inevitably lead to selective enforcement. In the abstract, the broadest possible agreement appears to satisfy an employer's desire to anticipate every way that they might be harmed by departing employee. When faced with reality, however, few employers are willing to actually enforce covenants not to compete to their fullest extent. In a slowing economy, many employers are more understanding (or compassionate) when a laid-off employee goes to work for a competitor. Some employers take the view that as long as the former employee doesn't solicit "his" customers, they can work for a competitor. Others only care about the use of confidential information. Some only want to prosecute the high-profile defector. Given the belt-tightening that all companies have gone through recently, you can't blame a company for avoiding expensive litigation when the breach of a covenant not to compete doesn't matter.

Selective enforcement, while equitable, has its problems. If you believe that the real value in a covenant not to compete is that the very document deters violations, then selective enforcement diminishes that deterrent effect. While the employer may have an actual strategy driving its selective enforcement, it is difficult for employees to glean that strategy when they learn that one of their former colleague is working for a competitor with no apparent repercussions.

Another problem with selective enforcement is that it can affect the outcome of an actual case. Let's face it, if a judge hears that the employer never enforces its covenants not to compete, she may be less inclined to enforce one in a close case. Smart lawyers can argue that the employer's selective enforcement is evidence that the covenant is not necessary to protect a legitimate interest. If it was so necessary, why wasn't it enforced in the past? In the case of trade secrets and confidential information, the fact that an employee has failed to take steps to protect the information is actually part of the legal test for determining whether the information is a trade secret or confidential.

A. Know What You Need to Protect and Only Protect What You Need

In order to avoid the problems associated with kitchen-sink covenants not to compete, an employer has to identify what intellectual property is really worth protecting and narrowly tailor an agreement to protect those interests. Easier said than done. Far too often, employers and their lawyers want to protect against the case that they can't anticipate. Business involves taking risks. Lawyers can't eliminate all risks, all we can do is help our clients understand the real risks in a given course of action.

1. Is it Competition or the Use of Information That is the Real Problem?

Far too often, employers attempt to protect confidential information through a blanket covenant not to compete. If an employer really isn't worried about a former employee competing but is instead worried that the employee will use confidential information unfairly, a broad covenant may not be necessary. If an employer wants to protect confidential information, the following techniques may be more effective:

- Use a confidentiality/non-disclosure agreement;
- Make sure you protect your "confidential" information from disclosure by taking visible steps such as using passwords, confidential stamps, and document control logs to ensure that you have access to common law protection of trade secrets; and
- Use a non-solicitation agreement that is limited to customers that the employee serviced or learned about through her employment if customer lists are the information you are trying to protect.

Each of these techniques is easier to defend in court, cheaper to enforce, and less likely to draw objections from a potential employee. If information is easy to protect through other means, why bother with a covenant not to compete?

2. Are you Worried about Employee Raiding?

If an employee is truly the employer's intellectual capital, then employee raiding, by competitors and former employees, is a real concern. Once again, don't reflexively assume that to be the case. A sales person is an important asset. That does not mean that the sales person is the intellectual capital that needs protection. Losing a sales person is manageable so long as confidential information and other employees don't follow suit. Even losing a group of sales people is manageable, in some cases.

On the other hand, software companies and other similar industries really have employees who are the company's intellectual capital. A group of software engineers working on the latest release of a software product can leave to work for a non-competitor and still cause damage. Here, a covenant not to compete won't always help. You can include one to keep the employee from going to a competitor, but what you really need is good management and strong confidentiality and non-solicitation of employee agreements to prevent one defection from leading to a mass exodus.

There is no clear way to prevent employee solicitation or employee raiding. All an employer can do is take prophylactic measures to protect itself and pursue legal remedies when those measures fail. Some protective measures include:

- Confidentiality agreements;
- Employee non-solicitation agreements; and
- Covenants not to compete.

3. How Broad Should A Covenant Not to Compete Be?

Finally the covenant not to compete itself should be tailored to an employer's reasons for asking for one. Management level employees probably deserve a covenant not to compete because a customer non-solicitation agreement doesn't solve the problems of the person leaving. Management level employees are privy to sensitive information and strategies that may only be protected by a covenant not to compete. Even so, should the covenant bar competition locally or nationally? It doesn't make sense to overreach if it doesn't hurt the company for a management level employee to work for a competitor in another city. If an employer needs a covenant not to compete for a sales person, does it really matter if they work for a competitor as an accountant? If not, then limit the covenant to performing similar duties as the former employee did for the employer.

II. COVENANTS NOT TO COMPETE AND OTHER RESTRAINTS ON COMPETITION

Covenants not to compete are restraints on trade and thus generally prohibited by the Texas Fee Enterprise and Antitrust Act of 1983 (the "Antitrust Act"). TEX. BUS. & COM. CODE § 15.01, *et. seq.*; *APRM, Inc. v. Regis F. Hartnett, Jr.*, No. 01-01-00831-CV (Tex. App.–Houston [1st Dist.] July 3, 2002), 2002 WL 1435995, ("A covenant not to compete is in restraint of trade and is unenforceable as a matter of public policy unless it is reasonable."). Depending on the fact pattern, a covenant not to compete could violate two different provisions of the Antitrust Act. The first is the provision which makes every "contract, combination, or conspiracy in restraint of trade or commerce" unlawful. TEX. BUS. & COM. CODE ANN. § 15.05(a) (Vernon 2002). The second is the provision against monopolies and attempts to monopolize. TEX. BUS. & COM. CODE § 15.05(b).

The Antitrust Act provides a limited exception to its enforcement for covenants not to compete that meet the standards set forth in Section 15.50(a) of the Texas Business and Commerce Code. The relevant provisions read:

> Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b),[1] 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 § 15.50(a).

The Antitrust Act's prohibitions are 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

[1] Section 15.50(b) contains special requirements for covenants not to compete for persons licensed as a physician by the Texas State Board of Medical Examiners.

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. The Covenant Not to Compete Must Be Ancillary to or Part of an Otherwise Enforceable Agreement

1. Is there an Otherwise Enforceable Agreement?

The first inquiry into 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 analyzed as of the time that the agreement is made. As will be discussed below, this has important implications in at-will employment situations.

The requirement of an "otherwise enforceable agreement" does not mean that there need to be separate documents with separate agreements. Instead, it means that there must be a set of promises between an employer and an employee other than the promise not to compete. *Tom James v. Cobb*, 109 S.W.3d 877, 886 (Tex.App.–Dallas 2003, no pet.) ("the issue is whether, 'at the time the agreement is made,' there exists other mutually binding promises to which the covenant not to compete is ancillary or part and parcel"). The example that is most often used is a promise by an employer to give an employee confidential information and a return promise by the employee to keep the information confidential. *See, e.g. Id.* at 647 n. 14 (explaining why a confidentiality agreement is an agreement to which a covenant not to compete would be ancillary).

Generally, all of the relevant agreements will be contained in a single document, whether it is an employment agreement or a non-disclosure agreement. In certain circumstances, multiple agreements between the employee and the employee can be considered jointly for purposes of determining whether there is an otherwise enforceable agreement. *See Ikon Office Solutions, Inc. v. Eitert*, 2 S.W.3d 688, 693 (Tex. App.–Houston [14th Dist.] 1999, no pet.) (treating separate agreements as one when both were signed at the same time and one expressly incorporates the other by reference); *Rako v. Tifco Indus., Inc.,* No. 14-02-00017-CV (Tex. App.–Houston [14th Dist.] July 18, 2002 (not designated for publication), 2002 WL 1608625 (same).

The central holdings of *Light* is that at-will employment is not an otherwise enforceable agreement that will support a covenant not to compete. *Light*, 883 S.W.2d at 645. The *Light* court relied on simple contract principals to reach its conclusion. Like any other contract, the "otherwise enforceable agreement" must be supported by consideration. If the consideration is illusory, then the agreement lacks consideration. In at-will employment situations, a promise by an employer to do something that is dependant on future employment is illusory because the employer can terminate the employee's employment at any time to avoid the employer's obligation.[2] According to the *Light* court, actual performance by the employer is irrelevant because the validity of the "otherwise enforceable agreement" must be determined "at the time" that the contract is made. *Id.* at 645 n. 6.

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's promise 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."). Thus, contracts that promise to provide an employee confidential information "during employment" have been held to be illusory in at-will employment relationships because the promise is dependent on the illusory right to future employment. *See, e.g., Tom*

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[2] Thus, an agreement to provide confidential information in the future will be considered illusory in an at-will employment setting. *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.

James v. Cobb, 109 S.W.3d 877, 886-87 (Tex.App.–Dallas 2003, no pet.) (holding that contractual provision to provide training during employment was illusory).

An illusory promise cannot be cured by future performance. In a footnote, the *Light* court addressed the situation of a unilateral contract. *Id.* at 645 n. 6. The court recognized that an illusory promise, essentially an offer, that is accepted and later performed can normally give rise to a binding unilateral contract. *Id.* the court used an example of an employer's illusory promise to provide confidential information to an employee in return for a promise by the employee to keep such information confidential. *Id.* If the employer performed by providing confidential information to the employee, a valid contract would be created. *Id.* The contract would not, however, be an "enforceable agreement" under Section 15.50 because it was not an agreement "at the time it was made" but instead became one at a later date. *Id.*

2. Is the Covenant not to Compete Ancillary to that Agreement?

The next step is determining whether the covenant is "ancillary" to that otherwise enforceable agreement.[3] 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.

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

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[3] 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.

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).

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. *Light*, 883 S.W.2d at 647.

3. Key Cases on Ancillary Agreements

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.

a. Confidentiality Agreements

The *Light* decision and subsequent cases decided after it make clear that a confidentiality agreement, if properly worded, is an otherwise enforceable agreement to which a covenant not to compete is ancillary. *See Light,* 883 S.W.2d at 647 n.14. In an at-will employment setting, it is advisable for an employer to use language such as "will provide confidential information" or "shall provide confidential information" to avoid the argument that the promise by the employer to provide confidential information is dependent on future employment.

Where the promise by the employer to provide an employee with confidential information is not illusory courts have routinely found the covenant not to compete to be ancillary to such a non disclosure agreement. *Rako v. Tifco Indus., Inc.,* No. 14-02-00017-CV (Tex. App.–Houston [14th Dist.] July 18, 2002 (not designated for publication), 2002 WL 1608625 (same) (enforcing a covenant not to complete in an at-will employment situation where employer promised employee with specific confidential information and specified training); *Curtis v. Ziff Energy Group, Ltd.*, 12

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); *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).

It is important to note, however, that some courts look beyond the language of the confidentiality agreement to determine whether or not the employer has actually provided new confidential information to the employee. In cases where an employee has worked for the employer before signing the covenant not to compete or had access to the so-called confidential information before signing the confidentiality agreement, courts have found the employer's promise to provide confidential information to be illusory. *Tom James*, 109 S.W.3d at 887 (holding that contractual recitation that employee had confidential information prior to signing agreement rendered the covenant not to compete unenforceable "because past consideration, such as the sharing of trade secrets in the past, will not support a subsequent promise."); *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). *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 (finding no consideration for an agreement because employer had prior access to confidential information); *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 (finding no consideration where employee had access to confidential information prior to entering into confidentiality agreement)*; 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).

b. Cash Payments and Other Consideration

Some lawyers mistakenly assume that you can pay an employee for a covenant not to compete. Under the logic of *Light*, such a promise by the employer would not give rise to an interest worthy of protection.

In *American Fracmaster Ltd. v. Richardson*, 71 S.W.3d 381 (Tex. App.–Tyler 2001), the Tyler Court of Appeals analyzed whether several promises by an employer would give rise to an employer's interest in restraining competition. The court held that a promise to give notice of termination, and a promise by the employer to pay $182,083.00 too the employee did not give rise to an interest worthy of protection. *Richardson*, 71 S.W.3d at 387-88. Other cases have reached similar results. *Strickland v. Medtronic,* 97 S.W.3d 835, 839 (Tex. App.–Dallas 2003) (90-day notice of termination provision does not give rise to any legitimate business interest requiring protection); *Id.* (provision requiring employer to pay employee during non-compete period does not give rise to any legitimate business interest requiring protection):

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 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).

With respect to time limitations, courts have upheld time limitations of two years or less and sometimes up to five years. *AMF Tuboscope v. McBride*, 618 S.W.2d 105, 108 (Tex. Civ. App.–Corpus Christi 1981); *Electronic Data Systems Corp. v. Powell*, 508 S.W.2d 137 (Tex. Civ. App.–Dallas 1974, writ ref'd n.r.e.); *Chandler v. Master Craft Dental Corp. of Texas, Inc.*, 739 S.W.2d 460 (Tex. App.–Fort Worth 1987, writ denied).

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);

- *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);

- *Evans v. World Travel, Inc. v. Adams*, 978 S.W.2d 225 (Tex. App.–Texarkana 1998, no pet.) (geographic restriction tied to employer locations where employee did not work was unreasonable);

- *Oliver v. Rogers*, 976 S.W.2d 792 (Tex. App.–Houston [1st Dist.] 1998, no pet.) (covenant not to compete in a sale of a business was not unreasonable even though it lacked a time restriction)[4]; and

- *Emercare Systems Corp. v. Bourden*, 942 S.W.2d 201 (Tex. App.–Eastland 1997, no pet.) (geographic restriction tied to employer locations where employee did not work was unreasonable) (time restriction that was tied to employer's contract with a customer as opposed to the employee's employment was unreasonable because it was identified and not related to employee's termination)

[4] This is an extraordinary case given that Section 15.50 expressly requires a time limitation. The court appeared to limit itself to covenants arising out of the sale of a business. *Oliver*, 976 S.W.2d at 801. Given that the court relied on cases that pre-dated the passage of Section 15.50, it was most likely wrongly decided.

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

Covenants not to compete must contain a reasonable limitation on the scope of activity to be restrained. *Juliette Fowler Home*, 793 S.W.2d at 663. 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,* 793 S.W.2d at 663. *See also Wright v. Sport Supply Group, Inc.,* No. 09-03-538CV (Tex.App.–Beaumont, April 29, 2004), 2004 WL 944003 (holding that "a covenant not to compete that extends to clients with whom a salesman had no dealings during his employment is unenforceable"); *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).

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 no 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., APRM, Inc. v. Regis F. Hartnett Jr. And Philip Corrosion Services, Inc.*, No. 01-01-00831-CV (Tex. App.–Houston [1st Dist.] July 3, 2002) (not designated for publication) 2002 WL 1435995; *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. Enforcement of A Covenant Not To Compete

Section 15.51 of the Texas Business and Commerce Code sets out a comprehensive scheme for enforcing covenants not to compete. It also sets forth what remedies are available in a dispute. Section 15.51(a) provides that a court may award both damages and injunctive relief for breach of the covenant.

Section 15.51(b) establishes which party has the burden of proof in establishing the enforceability of the covenant. For covenants that are ancillary to agreements with a primary purpose of obligating the employee to render personal services, whether for a term or at-will, the employer has the burden of establishing that the covenant meets the criteria set forth in Section 15.50. TEX. BUS. & COM.. CODE § 15.51(b). If the agreement has a different purpose, the employee bears the burden of establishing that the covenant does not meet those criteria. *Id.*

Section 15.52 states that Section 15.50 and 15.51 are the exclusive criteria and enforceability of the covenant not to compete and preempt any actions under the common law. TEX. BUS. & COM.. CODE § 15.52.

1. Reformation of an Invalid Covenant Not To Compete

Section 15.51 provides that a court shall reform a covenant that contains limitations to the time, geographical area, or scope of activity to be restrained that are not reasonable and impose a greater restraint than is necessary to protect the good will or other business interest of the employer. TEX. BUS. & COM.. CODE § 15.51(c). When a covenant is reformed, however, a court may not award the employer damages for a breach of the covenant before its reformation and the only relief an employer may receive is injunctive relief. *Id.*

In a personal services contract, an employee can recover reasonable attorney fees in defending a reformed covenant not to compete if the employee shows that the employer knew that the covenant's restrictions were overly broad and the employer sought to enforce those overly broad restrictions. *Id.*

Although the language on reformation is mandatory, at least one court has held that a party can waive reformation on appeal if it does not ask the trial court to reform the covenant. *APRM, Inc. v. Regis F. Hartnett, Jr.*, 01-01-00831-CV (Tex. App.–Houston [1st Dist] July 3, 2002), 2002 WL 1435995.

2. Temporary Injunctions

Because of the preemption clause contained in Section 15.52, a number of courts have recently grappled with how to apply temporary injunction standards in a context of covenants not to compete. These cases turn on the interpretation of Section 15.51 which appears to set forth the remedies available for an enforcing party and the preemption clause contained in Section 15.52.

In the case of temporary injunctions, appellate courts have overruled prior decisions and have found that Section 15.52 does not preempt the equitable standards for securing a temporary injunction. Thus, as in all other cases, a party seeking a temporary injunction must plead and prove a cause of action, a probable right to relief sought, and a probable, imminent, and irreparable injury in the interim. *Cardinal Health Staffing Network, Inc. v. Boeing*, 106 S.W.3d 230 (Tex. App.–Houston [1st Dist.] 2003, no pet.) (overruling *Norlyn Enterprises, Inc. v. APDP, Inc.*, 95 S.W.3d 578 (Tex. App.–Houston [1st Dist.] no pet.)); *see also NMTC Corp. v. Conarroe*, 99 S.W.3d 865, 867-68 (Tex. App.–Beaumont 2003).

In temporary injunction cases, an employee's breach of a covenant not to compete creates a rebuttable presumption that the employer will suffer irreparable injury. *Wright*, 2004 WL 944003, *3; *Unitel Corp. V. Decker*, 731 S.W.2d 636, 641 (Tex.App.–Houston [14th Dist.] 1987, no writ) (finding *prima facie* proof of probable injury through evidence of employee's continued breach of covenant not to compete). One court has found that a contractual provision providing that an employee will not contest that the employer does not have an adequate remedy at law is sufficient, for appellate purposes, to support an injunction. *Wright*, 2004 WL 944003, *2.

3. Attorney's Fees

At this time the question of whether or not a prevailing party can recover attorney's fees under Texas Civil Practice and Remedies Code Section 38.001 is unclear. In a case decided before Sections 15.51 and 15.52 were enacted, the Houston Court of Appeals affirmed an award of attorney's fees under Section 38.001 under the theory that attorney's fees were in the nature of cost but not damages. *Williams v. Compressor Engineering Corp.,* 704 S.W.2d 469, 471 (Tex. App.–Houston [14th Dist.] 1986, writ ref'd n.r.e.). In another case out of the Houston Court of Appeals, the court affirmed an award of attorney's fees without discussing the issue of preemption. *Butler v. Aero Mirror & Glass, Inc.*, 51 S.W.3d 787, 796 (Tex. App.–Houston [1st Dist.] 2001, no pet.)).

The San Antonio Court of Appeals has ruled that attorney's fees are not available under the Texas Civil Practice and Remedies Code in a covenant not to compete case. *Perez v. Texas Disposal Sys., Inc.*, 103 S.W.3d 591 (Tex. App.–San

Antonio 2003, pet. denied). The San Antonio Court of Appeals strictly construed the preemption language of Section 15.52 and held that attorney's fees are not available to a prevailing party under Section 38.001 of the Civil Practice and Remedies code. *Id.*

4. Tortious Interference Claims

When a former employee has gone to work for a competitor, employer may seek a remedy by asserting a tortious interference claim against that third party. The elements of a tortious interference claim are (1) the existence of a contract, (2) an act of willful interference, (3) causation, (4) and actual damages. *Victoria Bank & Trust Co. v. Brady*, 811 S.W.2d 931 (Tex. 1991).

An employer can bring a claim for tortious interference against a competitor if the competitor causes the former employee to breach a contract with the employer. A breach is necessary. If an employee merely exercises a contractual right, such as a right to terminate after a notice period, than a tortious interference claims does not exist. *Juliette Fowler Homes v. Welch Associates, Inc.*, 793 S.W.2d 660, 667 (Tex. 1990).

In Texas, a claim for tortious interference with contract may lie for interference with an at-will employment agreement. *Sterner v. Marathon Oil Co.,* 767 S.W.2d 686 (Tex. 1989). In order for such inferences to be actionable, the third party must exceed to bounds of permissible competition. *See, e.g., Times Herald Printing Co. v. A.H. Belo Corp.*, 820 S.W.2d 206, 215 (Tex. App.–Houston [14th Dist.] 1991, no writ). *See* RESTATEMENT (SECOND) OF TORTS § 768(1) (setting forth the privilege of competition for termination of a contract terminable at-will). Under the Restatement, some "wrongful means," such as physical violence, fraudulent misrepresentations, and the threat of civil or criminal litigation is necessary for a competitor to be held liable for tortious interference with a contract terminable at-will. RESTATEMENT (SECOND) OF TORTS § 768(1) cmt. e. This heightened requirement of wrongful conduct does not apply outside of contracts terminable at-will.

In addition, tortious interference claim may lie for a breach of a covenant not to compete. However, if the covenant not to compete is void, a claim for tortious interference is not available. *Travel Masters, Inc. v. Star Tours, Inc.*, 827 S.W.2d 830 (Tex. 1991). *See also Juliette Fowler Homes, Inc. v. Welch Associates, Inc.*, 793 S.W.2d 660, 667 (Tex. 1990).

If a new employer uses a former employee to solicit other employees in violation of a non-solicitation agreement or use confidential information in violation of a confidentiality agreement, a tortious interference claim is also possible. Since these contracts are not terminable at-will, the heightened requirement of wrongful conduct does not apply.

III. CONFIDENTIALITY AGREEMENTS

One method of protecting confidential information and trade secrets is through a non-disclosure agreement. 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 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).

IV. PROTECTING TRADE SECRETS

A. What is a Trade Secret?

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).

B. Common Law Protection of Trade Secrets

The common-law tort duty not to disclose is, according to some courts, "breached only when the information disclosed 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).

C. State Statutory Protection of Trade Secrets

Theft of a trade secret is crime under the Texas Penal Code. Specifically, the penal code provides that:

> (b) A person commits an offense if, without the owner's effective consent, he knowingly:
> (1) steals a trade secret;
> (2) makes a copy of an article representing a trade secret; or
> (3) communicates or transmits a trade secret.

TEXAS PENAL CODE § 31.05.

The Texas Civil Practice and Remedies Code provides for a private right of action for thefts of trade secrets that are actionable under the Texas Penal Code. TEX. CIV. PRAC. & REM. CODE § 134.001 *et seq*. A prevailing party is entitled to recover attorneys' fees and costs. TEX. CIV. PRAC. & REM. CODE § 134.005(b).

D. Federal Statutory Protection of Trade Secrets

The Economic Espionage Act of 1996 provides for criminal penalties for misappropriation of trade secrets. 18 U.S.C. § 1831 *et. seq*. The Act does not provide for civil causes of action.

The definition of trade secrets under the Economic Espionage Act is generally consistent with the definition of a trade secret under the Uniform Trade Secrets Act.

Schaffer, Frederick P. and Robert C. Welsh, Corporate Raiding 2000 48 Practicing Law Institute (2000).

The Act makes it a felony to sell, disseminate or otherwise deal in trade secrets, or attempt to do so, without the owner's consent. *United States v. Lange*, 312 F.3d 263, 264 (7^{th} Cir. 2002). Like other criminal statutes that criminalize an "attempt," criminal liability attaches when a party takes a substantial step toward completion of the offense. Consequently, impossibility is not a defense to prosecution under the Act. *United States v. Ho.* 982 F. Supp. 1022, 1027-28 (E.D. Penn. 1997).

Penalties under the Act include fines up to $10,000,000 and prison terms of up to 15 years.

V. NON-SOLICITATION AGREEMENTS

Another common method to prevent employee raiding, and one that is effective against employers who do not compete, is a contractual provision that prohibits existing employees from soliciting other employees after the termination of their employment. To be even more effective, the agreement should prohibit the employee from assisting another in soliciting an employee. The prohibitions should apply both during and after the employee's employment.[5]

It is unclear whether a Texas court will evaluate a non-solicitation agreement as a covenant not to compete. Texas courts have analyzed agreements prohibiting the solicitation of customers as covenants not to compete because the practical effect of the non-solicitation agreement is a restrain on competition. *See, e.g., Peat Marwick Main & Co. v. Haass,* 818 S.W.2d 381 (Tex. 1991). In *Miller Paper*, the court analyzed an agreement prohibiting solicitation of both customers and employees as a covenant not to compete. In that case, however, the court's analysis was focused entirely on the language prohibiting solicitation of customers. *Miller Paper*, 901 S.W.2d at 599.

Despite the decision in *Miller Paper*, there is a strong argument that an agreement prohibiting solicitation of employees should not be analyzed as a covenant not to compete. The practical impact of the agreement is not to prevent an employee from competing against his former employer. Absent that practical effect, the rationale in *Haass* should not apply.

Because the issue is unsettled in Texas case law, an employer drafting a non-solicitation agreement should follow the same steps that they would in drafting a

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[5] Imagine a situation where a current employee gives a competitor the names and phone numbers of key employees and then quits to go work for the competitor. A provision that only applies post-termination is worthless.

covenant not to compete. By addressing each of the elements set out in *Light*, an employer can avoid the risk that a future court may find that a non-solicitation agreement is subject to the same restrictions as covenants not to compete.

Some employers attempt to argue that a former employee's knowledge of her co-workers is a protectable trade secret. There is some authority for that proposition. *See Rugen v. Interactive Business Systems, Inc.*, 864 S.W.2d 548, 552 (Tex. App.–Dallas 1993, no writ). That case, however, involved a former employee who was soliciting consultants of a staffing company. In that case, the former employee wasn't really soliciting co-workers but instead was using information she learned about her former employee's end product, the consultants.

VI. CHOICE OF LAW

If an employer has national operations or is hiring a former employee of a competitor with national operations, then the employer will ultimately face issues involving the enforcement of covenants not to compete drafted or enforced in different jurisdictions. In deciding whether to hire an employee or enforcing a covenant not to compete in a foreign jurisdiction, the threshold question will be what law is applicable?

The normal rule in employment cases is that the law of the state were services, or a major portion of services, are rendered will govern. *Maxus Exploration Co. v. Moran Bros. Inc.*, 817 S.W.2d 50, 53 (Tex. 1991); *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 679 (Tex. 1990).

If a contract has a choice of law provision, many jurisdictions will respect that choice of law provision. How courts outside of Texas will decide the issue is outside the scope of this paper, but as a general rule, a choice of law provision will be enforced unless (1) another state has a materially greater interest in the issue and (2) the chosen law would violate a fundamental policy of the state with the greater interest. RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 187.

Texas courts will generally apply Texas law despite a choice of law provision to the contrary. In *DeSantis*, the Court applied Texas law to a dispute between a Florida employer and a Texas resident employee where the parties had chosen Florida law. Despite the fact that the employee sometimes flew to his employer's headquarters in Florida, the Texas court applied Texas law because Texas' interest in employment activities in Texas outweighed any generalized interest Florida might have.

In the context of covenants not to compete, a Texas court might find that enforcement of a different state's non-compete laws would violate Texas' public policy against such covenants. In *DeSantis*, the Texas Supreme Court noted that holding to the contrary would encourage employers "to invoke the most favorable state law available to govern their relationship with their employees in Texas." *DeSantis*, 793 S.W.2d at 680.

VII. CONCLUSION

Employers seeking to protect their intellectual capital from raiding have two important steps to take. First is the business of decision, guided by Texas law on what is permissible, of what assets to protect and how. The second is to fashion the agreements that comply with the sometimes strict standards of Texas law.