Wolfe on Texas Non-Compete Litigation

or

My Big Fat Texas Non-Compete Paper

by Zach Wolfe

Version 1.3

About the Author

Zach Wolfe (zwolfe@fleckman.com) is a trial lawyer recognized as an authority on Texas non-compete and trade secret litigation. He frequently teaches continuing legal education courses to other lawyers on non-compete law and related topics.

Zach is a principal at Fleckman & McGlynn, PLLC, which has offices in Austin and Houston. In 2020 Thomson Reuters named Zach a Texas "Super Lawyer" for Business Litigation. He is rated AV (Preeminent) by Martindale-Hubbell.

Zach also hosts the YouTube channel That Non-Compete Lawyer and publishes the award-winning blog Five Minute Law.

© Zach Wolfe (2021)

Table of Contents

© Zach Wolfe (2021)

© Zach Wolfe (2021)

© Zach Wolfe (2021)

1. Introduction

This paper is about Texas non-compete litigation. I thought about calling it Wolfe on Texas Non-Compete *Law*, but "Litigation" seemed more appropriate.

Don't get me wrong. There is plenty of law in this paper, i.e. case law. But I'm primarily a litigator, my interest in non-compete law is more practical than theoretical, and litigation is where the rubber meets the road in non-compete cases. So, Wolfe on Texas Non-Compete Litigation it is.

I mean this paper to provide an in-depth guide to practitioners who deal with non-competes and non-compete disputes. If you're not a lawyer, you may still find it useful, and I have tried to write it in plain language as much as feasible. But it's mainly for lawyers, particularly lawyers faced with non-compete litigation.

I've organized it roughly to match the way a litigator would think about the issues in a non-compete lawsuit. We start with some general public policy principles lawyers should keep in mind, some "ancient" pre-statute case law establishing the basic principles of Texas non-compete law, and the 1989 Texas non-compete statute, which is probably the most important thing you should read other than this paper.

Then we go to the threshold questions you should ask yourself: Is the agreement at issue a non-compete in the first place, and does Texas law apply to it?

Assuming the agreement is a non-compete and Texas law applies, the next question is the big one: is the non-compete enforceable? Or more precisely, is the non-compete enforceable *as written*, considering that reformation is a potential remedy.

If you've read the Texas non-compete statute, you know it has two main requirements: (1) the non-compete must be "ancillary to an otherwise enforceable agreement," and (2) it must be "reasonable" in time, geographic area, and scope. The real meat of this paper is digging in to the application of these principles. I don't include *every* Texas non-compete case applying these requirements—there are hundreds of them—but I've tried to make the scope as comprehensive as practicable.

Once you have an idea of whether the non-compete is enforceable as written, your focus will shift to what is going to happen in a lawsuit. So next I cover the temporary injunction stage and summary judgment. In a later edition I hope to cover the trial, but this will be a good start.

Enjoy the ride.

© Zach Wolfe (2021)

2. Brief overview of competing public policy considerations

I presume there is a vast scholarly literature addressing non-competes from a public policy perspective, but I am not familiar with any of it. It is probably interesting, but as a practicing litigator I just don't have the time.

Still, it is useful for the practitioner to give some thought to the public policy interests at stake in a non-compete case, if only for the purposes of (a) understanding what is going on in the statutes and case law, (b) honing your arguments and anticipating your opponent's arguments, and (c) understanding how a judge, jury, or arbitrator will react to the case.

There are four basic public policy principles that just about any non-compete case implicates. Those principles are:

1. Courts should respect "freedom of contract."

2. People should honor their agreements.

3. Agreements that restrain competition harm customers and the public.

4. People should be free to practice their trades or professions and make a living.

It is probably obvious that principles 1 and 2 tend to favor enforcement of non-competes, while principles 3 and 4 do not.

At the most fundamental level, these competing principles explain why non-compete cases are hard, or at least harder than an "ordinary" breach of contract case.

It gets even more complicated, because most people subscribe to all four principles, but to varying degrees. The weight that a person's ideology or world view gives to each principle probably does a lot to explain how that person looks at non-competes.

The main thing to keep in mind is that there are always countervailing principles in a non-compete case. This is especially true as to "freedom of contract."

The freedom of contract argument is usually pretty superficial, for two reasons. First, the *general* rule is that private parties are *not* free to enter into contractual restraints of trade or commerce; non-competes are an exception, not the rule. Second, the whole point is to figure out when freedom of contract must yield to some other principle, such as the public interest in free competition.

You can see these dueling principles at work in the case law decided before Texas adopted a non-compete statute in 1989.

3. Pre-statute non-compete cases and principles

When you read older Texas non-compete cases, it's striking how familiar the issues are. Take *Patterson v. Crabb*, 51 S.W. 870 (Tex. Civ. App. 1899), for example. The Patterson Institute, a small music school in Hillsboro, Texas, hired young Bill Crabb to teach piano, organ, violin, mandolin, and banjo, as well as music theory, harmony, and history. Crabb signed a 10-month employment contract, which included a non-compete barring him from teaching music in Hillsboro if he quit the job. *Id*. at 871-72

Crabb quit and opened a small music school of his own in Hillsboro. The Patterson Institute filed suit and obtained a temporary injunction, but the trial court dissolved the injunction after a trial.

The Court of Appeals reversed, holding that the statute prohibiting restraints of trade did not apply. The court reasoned that it would be inequitable for Crabb to teach at an independent school in Hillsboro, that the statute did not bar the restrictive covenant, and that the Institute was entitled to an injunction. The court cited *Gates v. Hooper*, in which the Texas Supreme Court held that a non-compete in the sale of a business was not an illegal restraint of trade.

These are the same fundamental issues you will encounter in a Texas non-compete suit today. Here are some of basic principles we can extract from a sample of older Texas cases, in chronological order.

3.1 Texas courts generally favor non-competes in the sale of a business.

Gates v. Hooper, 39 S.W. 1079, 1080 (Tex. 1897), was the case cited in *Patterson v. Crabb*. It's the oldest Texas non-compete case I have found so far. (If you find an older one, please email me.) You can tell it's an old case because the opinion is short but the paragraphs long.

This was the Gilded Age when monopolistic "trusts" were a major concern. But the court in *Gates* upheld a one-year non-compete in a contract for the sale of a mercantile business in Batesville. The court held that the non-compete was not a prohibited "trust" or "combination" because the transaction did not combine the capital, skill, or acts of the parties into any kind of "union, association, or co-operative action." *Id*. at 1080-81.

That was it. Nothing about reasonableness. But it set a precedent favoring non-competes in the sale of a business.

© Zach Wolfe (2021)

3.2 Non-competes are unique in protecting goodwill.

The two most common justifications for non-competes are (1) protecting a company's goodwill and (2) protecting a company's confidential information.

Reading between the lines, we can imagine both issues were present in *Patterson v. Crabb*. The opinion is pretty thin on reasoning, but we can assume the Patterson Institute established goodwill with its customers, i.e. its students. We can also assume that Mr. Crabb knew the students, knew the tuition they were paying, and could use that knowledge to set his own school's tuition just low enough to "undercut" the Institute.

But there's a fundamental difference between these two interests. There are multiple areas of law that protect an employer's confidential information, such as fiduciary duty and trade secrets law. In contrast, there is really only one legal mechanism to protect goodwill: a non-compete.

And a non-compete always has two fundamental problems. First, it hurts customers. If Mr. Crabb can't teach music in Hillsboro, the students in Hillsboro may have only one place to go. Second, a non-compete can prevent someone from making a living doing the thing they do best. It doesn't seem right to force Mr. Crabb to either move out of Hillsboro or change careers.

3.3 Non-competes should not restrain the right to earn a living.

These problems are not new. Over a hundred years ago, in *Miller v. Chicago Portrait Co.*, 195 S.W. 619 (Tex. Civ. App.—San Antonio 1917, writ ref'd), Mr. Miller signed an employment contract with Chicago Portrait Company, which was in the business of enlarging photographs into portraits. The contract contained a one-year non-compete. *Id.* at 619.

The Court of Appeals reversed an injunction issued by the trial court. As to confidentiality, the court noted there was "no evidence of trade secrets connected with inducing people to have their photographs magnified into portraits and placed in expensive frames." *Id.* at 620.

As to goodwill, the court distinguished between a contract for the purchase of a business and an employment contract, citing an employee's interest in earning a living:

> Courts will not favor contracts that would drive a man out of Texas to seek occupation in a business, with which he is perhaps better acquainted than any other, or put him in another business for which he is not trained or suited. This is a different case from the sale of a

© Zach Wolfe (2021)

> business induced by a contract not to engage in a similar business in a named locality in a specified time. The contract in this case is aimed at the right to obtain employment in a similar business. It is an attempt to restrain the right to earn a living.

Id. at 621.

So yes, there is a legitimate interest in protecting goodwill, but that interest must be weighed against an employee's right to earn a living (and to stay in Texas), especially where no real trade secrets are involved.

Today, the Texas non-compete statute does not expressly refer to the employee's interest in making a living, but that interest is embedded in the statute's key concept: reasonableness.

3.4 Reasonableness is the key to non-compete law.

Given the competing interests at stake in any non-compete dispute, the fuzzy standard of "reasonableness" is critical.

The idea of measuring the enforceability of a non-compete by its reasonableness made an early appearance in Texas law in *Randolph v. Graham*, 254 S.W. 402 (Tex. App.—San Antonio 1923, writ ref'd). In that case, Dr. Randolph sold his medical practice to Dr. Graham, who agreed not to practice medicine within a 20-mile radius of Schertz, Texas. *Id*. at 402.

The Court of Appeals affirmed the trial court's temporary restraining order enforcing the non-compete. The court first cited the policy in favor of enforcing non-competes tied to the sale of a business, reasoning that "professional men" or "skilled artisans" ought to be able to sell the goodwill of their businesses, and invoking "liberty and freedom of contract." *Id*. at 402-3.

But the court implicitly recognized the limits of freedom to contract by then addressing the *reasonableness* of the restriction. The court cited cases from other jurisdictions holding that a contract in restraint of trade is unreasonable and void when it is unlimited in time and space. While the non-compete at issue was unlimited in time, it was limited to the Schertz area, and the court found that limitation sufficient to make the non-compete reasonable and enforceable. *Id*. at 403-4.

This would not be the last time that parties argued about whether the scope of a Texas non-compete was reasonable.

© Zach Wolfe (2021)

3.5 Reasonableness means a non-compete injunction should do no more than necessary to protect the goodwill the employee developed for the company.

By 1925, the essential elements of early Texas non-compete law came into focus, as illustrated by *City Ice Delivery Co. v. Evans*, 275 S.W. 87 (Tex. Civ. App.—Dallas 1925, no writ).

That case involved an employment contract between a driver and an ice delivery business in Dallas. The business divided its territory into districts, assigning each district to an employee. The contract prohibited the driver, Mr. Evans, from engaging in the ice business within the territory covered by his route, or within five squares of his route. *Id*. at 88-89.

By this time, the court said it was the "settled law" of Texas that a contract for the sale of a business may include a non-compete reasonably necessary to protect the purchaser's interest in the goodwill of the business. *Id*. at 89.

But did the same principle apply to an *employment* contract? Looking to authorities outside Texas, the court found that non-competes in employment contracts should be governed by the same principles:

> The test generally applied to determine the validity of such a covenant in a contract of employment depends upon whether or not restraint placed upon the employé after employment has ceased is necessary for the protection of the business or good will of the employer, and whether it imposes on the employé any greater restraint than is reasonably necessary to secure protection to the business of the employer or the good will thereof. If the covenant in question goes no farther than to accomplish this purpose, it is generally held to be valid.

Id. at 90.

In short, like a non-compete in the sale of a business, a non-compete in an employment contract is governed by the related principles of *reasonableness* and *necessity* to *protect goodwill*.

Thus, the court said, the burden is on the employer to establish both the "necessity for" and the "reasonableness of" the non-compete. Applying this principle to the employer's claim for an injunction, the court said that the evidence clearly established the necessity of the non-compete as to the immediate territory where Evans delivered ice to the company's customers. *Id*.

© Zach Wolfe (2021)

But there was no such necessity for the five squares outside of his territory, the court reasoned, because the company had no goodwill outside of the employee's territory that was due to the employee's "personal contact" with the trade while in service of the employer. *Id.*

This critical principle, though sometimes ignored, still applies today. An injunction should extend no further than necessary to protect the goodwill that the employee developed on behalf of the employer.

Seven years later, the Dallas Court of Appeals would cite *City Ice Delivery* and other cases, distilling the essential requirements of Texas non-compete law as follows:

> (1) Is the restraint placed upon the employee, after the employment had ceased, necessary for the protection of the business or good will of the employer?
>
> (2) Does it impose upon the employee any greater restraint than is reasonably necessary to procure protection to the business of the employer or the good will thereof.

Martin v. Hawley, 50 S.W.2d 1105, 1108 (Tex. App.—Dallas 1932, no writ).

This language is strikingly similar to the language the legislature would use over 50 years later in the 1989 non-compete statute. The court also cited the general principle that "contracts restricting the liberty of employment are not viewed by the courts with favor." *Id.* at 1108.

Thus, even back in 1932, we can clearly see the two competing considerations: protect the employer's goodwill to the extent necessary, but without unduly restricting employee mobility. The dividing line is what is *reasonably necessary* to protect the employer's goodwill.

3.6 Generally Texas courts will enforce an unreasonable non-compete to a reasonable extent.

While the basic reasonableness concept took shape in Texas cases as early as the 1930s, it was not entirely clear what a Texas court was to do if a non-compete was unreasonably broad.

This issue was implicit in *City Ice Delivery*, where the court enforced the non-compete only in part, to the extent of prohibiting competition in the driver's immediate territory. Later the Texas Supreme Court addressed the issue more directly in *Lewis v. Krueger, Hutchinson & Overton Clinic*, 269 S.W.2d 798 (Tex. 1954).

In that case, young Dr. Lewis signed an employment contract with a clinic that barred him from practicing medicine in Lubbock County if his employment ceased. The trial court found the non-compete entirely unenforceable because it had no time limitation. The Court of Appeals disagreed but reduced the limitation to three years. *Id.* at 798-99.

Dr. Lewis argued the court could not make a new and different contract for the parties, but the Texas Supreme Court rejected this argument. Even though the non-compete could be interpreted as applying for life, "it would hardly be doing violence to the established principles to hold that the restriction is merely void or unenforceable with respect to that portion of the time beyond what the court considers reasonable." *Id.* at 799-800.

This "blue pencil" rule allows the court to effectively rewrite the non-compete, and it still applies today. Enforcement of a non-compete is not all or nothing in Texas. Generally, if the non-compete is unreasonably broad, it can still be enforced, but only to a reasonable extent.

3.7 You can't get damages for breach of an unreasonably broad non-compete.

But what about damages? Can the employer get damages for the employee's breach of a non-compete that's unenforceable as written?

The Texas Supreme Court addressed this issue in *Weatherford Oil Tool Co. v. Campbell*, 340 S.W.2d 950 (Tex. 1960). Citing *Martin v. Hawley*, the court said the non-compete as written was unreasonable because it had no territorial limitation. Then, citing *Lewis*, the court said an injunction could still be granted to restrain the employee from competing within a reasonable area. *Id.* at 952.

But the court said a claim for damages was not available prior to reformation. "We hold that an action for damages resulting from competition occurring before a reasonable territory and period have been prescribed by a court of competent jurisdiction must stand or fall on the contract as written." *Id.* at 953.

In other words, if the employer drafts a non-compete that is too broad, the employer can still seek an injunction, but it can't get damages that occur before the court narrows the scope of the non-compete.

The Texas Supreme Court later clarified that the court's power to reform the non-compete applies to both time *and* area. *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 685 (Tex. 1973).

Weatherford's rule concerning damages was later codified in the 1989 statute.

© Zach Wolfe (2021)

4. The Texas non-compete statute

There's a whole story about why the Texas legislature passed the Covenants Not to Compete Act in 1989, which is found in Sections 15.50-52 of the Texas Business and Commerce Code, but I will save that for another day. The statute was amended slightly in 1993.

A lawyer handling a Texas non-compete case for the first time should probably start by reading the statute several times. I will point out some key features of each section of the statute:

Section 15.50(a): "Ancillary" and "Reasonable"

- Section 15.50(a) has two general requirements:

  (1) The non-compete must be "ancillary to an otherwise enforceable agreement."

  (2) The non-compete will be enforced to the extent that it contains "limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee."

- As the language in Section 15.50(a) indicates, the test for what is reasonable is whether the scope is no greater than necessary to protect *goodwill* or another business interest. The most common "other business interest" is confidential information.

Section 15.50(b): Physician non-competes

- There are special provisions in Section 15.50(b) for licensed physicians (to be covered in a later edition of this paper).

Section 15.51(a): Remedies

- Section 15.51(a) provides that the party enforcing a non-compete can obtain damages, injunctive relief, or both.

- Note that attorneys' fees are *not* included as a remedy for the party enforcing the non-compete.

© Zach Wolfe (2021)

<u>Section 15.51(b): Burden of Proof</u>

- Section 15.51(b) governs who has the "burden of establishing" that the non-compete meets the requirements of Section 15.50. If the "primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, for a term or at will," then the party seeking to enforce the non-compete has the "burden of establishing" that the non-compete meets the criteria of Section 15.50. Otherwise, the person seeking to avoid enforcement has the burden of establishing that the non-compete does not meet those criteria.

- The "burden of establishing" a fact "means the burden of persuading the triers of fact that the existence of the fact is more probable than its nonexistence."

- This section—especially the definition of "burden of establishing," which mentions "fact" three times—makes it clear that the enforceability of a non-compete can be a question of fact. Otherwise, how could there be a burden of proof on the issue? Nonetheless, many Texas cases recite that enforceability is a question of law (discussed later).

<u>Section 15.51(c): Effect of Unreasonable Non-Compete</u>

- If the non-compete meets the "ancillary" requirement but not the "reasonableness" requirement, Section 15.51(c) has good news and bad news for the party seeking to enforce the non-compete. The good news is that reformation is mandatory: the court "shall" reform the non-compete to the extent necessary to make it reasonable. The bad news is that the party seeking to enforce the non-compete cannot recover damages for a breach of the covenant before reformation; only injunctive relief will be available.

- The rest of Section 15.51(c) provides for potential recovery of costs and attorneys' fees by the party seeking to avoid enforcement, if the party seeking to enforce the non-compete knew at the time of execution the non-compete was unreasonable.

<u>Section 15.52: Preemption</u>

- The provisions of Sections 15.50 and 15.51 are exclusive and preempt any other law regarding enforceability of a non-compete or procedures and remedies in an action to enforce a non-compete.

- One important consequence of preemption is that the party seeking to enforce the non-compete may not recover attorneys' fees under other law. *See Glattly* *v. Air Starter Components, Inc.*, 322 S.W.3d 620, 645 (Tex. App.—Houston [1st Dist.] 2010, pet. denied); *Perez v. Tex. Disposal Sys., Inc.*, 103 S.W.3d 591, 594 (Tex. App.—San Antonio 2003, pet. denied).

All of the sections summarized above are important to understand, but perhaps the two biggest takeaways from the statute are: (1) a non-compete must meet the "ancillary" requirement and the "reasonableness" requirement; (2) if the non-compete is unenforceable as written, it will be reformed, but there will be no damages for any breach before reformation.

There is much more to come about what "ancillary" and "reasonable" mean, but first let's look at the threshold question of whether the agreement at issue is a "covenant not to compete" subject to the requirements of the statute.

5. Is the agreement at issue a non-compete?

In most non-compete lawsuits, it is undisputed that the agreement at issue is a non-compete subject to the requirements of the non-compete statute. But in some cases, it is not that clear. Let's see how Texas courts decide whether the non-compete statute applies to the agreement at issue.

5.1 A non-solicitation agreement is a form of non-compete.

It is common for employment agreements to contain one section restricting *competition* and another section restricting *solicitation*. Lawyers and non-lawyers alike sometimes think that the restriction on solicitation is not subject to the requirements of the non-compete statute, but this is generally wrong.

In *Marsh USA Inc. v. Cook*, 354 S.W.3d 764, 768 (Tex. 2011), the Texas Supreme Court clarified Texas law on enforceability of non-competes. The agreement in *Marsh* prohibited the employee from soliciting a certain type of business from people who were clients or prospective clients of his employer within two years of his termination.

Under the heading "Enforceability of the Covenant Not to Compete," the Texas Supreme Court began its analysis by stating:

> Covenants that place limits on former employees' professional mobility or restrict their solicitation of the former employers' customers and employees are restraints of trade and are governed by the [Covenants Not to Compete] Act.

In support, the court cited two state court cases and two federal court cases treating non-solicitation agreements as non-competes.

© Zach Wolfe (2021)

So that should settle it. A non-solicitation covenant is a kind of "covenant not to compete."

Note that *Marsh* referred to solicitation of both customers *and* employees. So, a restriction on a former employee soliciting *employees* of her former employer is also a non-compete.

Or is it?

5.2 There is conflicting case law on whether a restriction on soliciting employees is a non-compete.

As noted above, the Texas Supreme Court said in *Marsh* that restrictions on soliciting the former employer's "customers and employees" are non-competes governed by the non-compete statute. But *Marsh* was not about solicitation of *employees*, so the part about soliciting employees could be viewed as dicta.

There is conflicting Texas case law on whether a restriction on soliciting a former employer's employees (as opposed to customers) is a non-compete subject to the requirements of the non-compete statute.

Some Texas courts have held that a restriction on employee non-solicitation is not a restriction on competition. *See, e.g., Totino v. Alexander & Associates, Inc.*, No. 01-97-01204-CV, 1998 WL 552818, at *8-9 (Tex. App.—Houston [1st Dist.] Aug. 20, 1998) (not designated for publication); *Nova Consulting Group, Inc. v. Eng'g Consulting Servs., Inc.*, No. Civ. SA-03-CA-305-FB, 2005 WL 2708811, at *18 (W.D. Tex. June 3, 2005) (citing *Totino*).

Other cases have held that it is. *See, e.g., Smith v. Nerium International, LLC*, No. 05-18-00617-CV, 2019 WL 3543583, at *4 (Tex. App.—Dallas Aug. 5, 2019, no pet.) (mem. op.) (citing *Marsh*).

The better view is that a restriction on soliciting employees is a form of non-compete. (As always, this is just my opinion, not the opinion of my firm or clients.)

Think about it. Imagine that two competitors enter into an agreement not to solicit each other's employees. Are you telling me such an agreement would not raise any antitrust concerns? No, of course it would.

Both the *motive* and *effect* of a restriction on soliciting employees are to prevent competitors from "poaching" employees. The company's motive is to protect itself from competition. And the effect—if the restriction accomplishes its intended purpose—is to inhibit competition. So, a restriction on soliciting employees raises the same kind

© Zach Wolfe (2021)

of anti-competitive concerns as a restriction on soliciting customers and should be treated as a non-compete.

Plus, if you say that a restriction on soliciting employees is not a non-compete, be careful what you wish for. Let's say it's not a "covenant not to compete." In that case, it could still be a contract in restraint of trade or commerce, right? And that would make it illegal. *See* Tex. Bus. & Com. Code § 15.05. Or at the least, it would at least be subject to some reasonableness limitation.

I suppose you could argue that a restriction on soliciting employees is neither a restraint of trade and commerce nor a non-compete. But in that case, there would be no reasonableness limitation. Are you saying that a restriction on soliciting employees could have a ten-year term, or no time limit at all? That would be an untenable result. It makes more sense to treat a restriction on soliciting employees as a form of non-compete—as the Texas Supreme Court did in *Marsh* (though admittedly, in passing).

But what about the Texas decisions that said a restriction on soliciting employees is not a non-compete?

Some of those cases were decided before *Marsh*. So you could argue they were implicitly overruled by the contrary statement in *Marsh*.

Even aside from that, I don't find the reasoning of those cases persuasive. In the *Totino* case, the court considered whether a non-recruitment covenant was a prohibited contract "in restraint of trade or commerce." The court held it was not, reasoning that non-recruitment agreement is more like a nondisclosure covenant, which is not a non-compete. *Totino*, 1998 WL 552818, at *8-9.

Non-recruitment agreements, the court said, "do not necessarily restrict a former employee's ability to compete with his or her former employer and, like nondisclosure covenants, should not significantly restrain trade." The court added that an agreement not to solicit employees does not restrict those employees from leaving but only bars the former employee from soliciting them. *Id*. at *9.

I see some flaws in this reasoning. First, the premise that a nondisclosure agreement is not a restraint of trade or commerce is too broad. A confidentiality agreement can be so broad that it functions as a non-compete. *See Thoroughbred Ventures, LLC v. Disman*, No. 4:18-CV-00318, 2018 WL 3752852, at *4 (E.D. Tex. Aug. 8, 2018) (nondisclosure agreement that has the practical effect of preventing the former employee from using general knowledge, skill, and experience should be treated as a non-compete).

© Zach Wolfe (2021)

Second, even if we assume nondisclosure agreements are not non-competes, the comparison seems inapt to me. The primary purpose of a confidentiality agreement is to protect confidential information; the effect on competition is incidental. But as noted earlier, with an agreement not to solicit employees, the primary purpose is to protect the employer from competition, and the effect is to inhibit competition.

That leads me to the third flaw in the *Totino* reasoning. To me, the argument that the nonsolicitation agreement is not an absolute bar to employees leaving goes to the reasonableness of the restriction, not whether it restrains competition. A contract term does not have to absolutely *prohibit* competition to implicate the reasonableness. concerns of the non-compete statute. *Restraining* competition—to some degree—should be enough.

I'm not saying that a restriction on soliciting employees is *prohibited*. I'm just saying that it should be treated as a non-compete subject to the limitations of the non-compete statute, particularly the reasonableness requirement. Ultimately, I think that was the real rationale of *Totino*—that the restriction was reasonable. It would have been better for the court to say, "yes, a restriction on soliciting employees is a restraint on competition, but we find this one to be reasonable."

That was essentially what the court did in *Everett Financial, Inc. v. Primary Residential Mortgage, Inc.*, No. 3:14-CV-1028-D, 2016 WL 7378937 (N.D. Tex. Dec. 20, 2016). The reasonableness requirement of Section 15.50(a) applies to employee non-solicitation agreements, the court said, citing *Marsh*. *Id*. at *8. But the court held that the restriction on solicitation at issue was reasonable in scope, despite the lack of a geographic limitation, and did not have to be limited to soliciting employees with whom the former employee had "personal contact." *Id*. at *8-9.

Bottom line: *Totino* does not provide a solid basis for holding that a restriction on soliciting employees is not a non-compete, especially in the face of the contrary statement in *Marsh*.

5.3 Can a confidentiality agreement be a non-compete?

Some employee confidentiality agreements are written so broadly that they function as de facto non-competes. For example, if a confidentiality agreement defines all information about an employee's customers as confidential information the employee is not allowed to use after leaving, that would effectively bar the employee from competing.

Does that mean employee confidentiality agreements are subject to the requirements of the non-compete statute? Watch this space. I'll cover that in a later version of this paper.

5.4 A forfeiture clause can be a non-compete.

Sometimes a Texas non-compete will take the form of a forfeiture clause rather than an express prohibition on competing. For example, a company might award equity ownership interests to valued employee, with a clause stating that the employee will forfeit those interests if he competes. Is that a non-compete? And does it matter whether a court classifies it as a non-compete or something else?

There are several *plausible* answers under current Texas case law:

1. The forfeiture clause functions as a non-compete and therefore must meet the requirements of the non-compete statute.

2. The forfeiture clause is not a non-compete because it doesn't actually prohibit the employee from competing; it just says the employee will forfeit some benefit if he competes.

3. Whether the forfeiture clause is a non-compete depends on the nature of the incentive plan; if it is a non-contributory profit-sharing plan, it probably isn't a non-compete, but if the employee owns vested shares in the company, it probably *is* a non-compete.

4. Regardless of whether the forfeiture clause is a non-compete, it must be reasonable to be enforceable.

The bottom line is that the answer is unclear.

For Texas lawyers who draft non-competes for employers, there are two essential things to remember. First, putting the non-compete in the form of a forfeiture clause won't necessarily avoid the requirements of the non-compete statute. Second, regardless of what you call it, it is unlikely that a Texas court will enforce a forfeiture clause that functions as an unreasonably broad non-compete. So you might as well make the scope of the discouraged competition reasonable.

The trouble is that we have two Texas Supreme Court opinions that cut in different directions on this issue.

In *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381, 385 (Tex. 1991), the court held that an agreement that does not expressly prohibit competition but imposes a financial penalty for competition is subject to the requirements of the non-compete statute.

But in *Exxon Mobil Corp. v. Drennen*, 452 S.W.3d 319, 329 (Tex. 2014), the court said that a forfeiture clause in an employee's non-contributory profit-sharing

© Zach Wolfe (2021)

plan is not a "covenant not to compete," reasoning that it does not restrict the employee's future employment but only makes the employee choose between keeping the profit-sharing and working for a competitor.

There are several plausible ways to interpret these apparently contradictory holdings:

1. *Drennen* implicitly overruled *Haass*, establishing a broad rule that places form over substance by simply asking whether the agreement expressly prohibits competition.

2. *Drennen* established a narrow exception to *Haass* for forfeiture of unvested shares that had been awarded but not yet delivered pursuant to a non-contributory profit-sharing plan; it does not apply to forfeiture of vested shares the employee already owns.

3. *Drennen* and *Haass* can be reconciled based on some other distinguishing factor.

4. It ultimately doesn't matter whether *Drennen* conflicts with *Haass*, because regardless of whether you call a forfeiture clause a non-compete or not, it still must be reasonable in scope.

In my opinion, no. 1 is the worst interpretation, nos. 2 and 3 are reasonable, and no. 4 is the simplest and best way to reconcile the cases. To understand why, let's dig into these two cases and see how Texas courts have applied them.

Haass involved an agreement between an accounting firm and one of its partners, Haass. The agreement had a liquidated damages clause requiring Haass to compensate the firm if he withdrew and took clients with him. *Id*. at 383. Haass left, opened his own firm, and clients followed. *Id*. at 384. The firm argued that the damages clause was not a non-compete, while Haass contended it operated as a non-compete and therefore had to be reasonable. *Id*.

The damages clause did not expressly prohibit Haass from providing accounting services to clients of the firm. Rather, the clause provided that if Haas did compete, he had to pay the liquidated damages. *Id*. at 385. But the court agreed with Haass that the damages clause was effectively a non-compete.

Surveying case law from other jurisdictions, the *Haass* court said:

> Most courts have analyzed such provisions as restraints on trade sufficiently similar to covenants not to compete to be governed by the same general reasonableness principles in order to be enforceable. Even

© Zach Wolfe (2021)

> those courts that have declined to treat such damages provisions as restraints on trade have required them to be reasonable to be enforced.

Id. (internal citations omitted). Noting that the reasonableness test in either case was essentially the same, the court concluded that "the view adopted by most courts, that such covenants should be subject to the same standards as covenants not to compete, is the correct one." *Id*.

The *Haass* court cited two additional reasons for treating a damages clause as a non-compete. First, the court reasoned that "[i]f the damages provided are sufficiently severe, then the economic penalty's deterrent effect functions as a covenant not to compete as surely as if the agreement expressly stated that the departing member will not compete." *Id*. at 385. "The practical and economic reality of such a provision," the court said, "is that it inhibits competition virtually the same as a covenant not to compete." *Id*. at 385-86.

Second, the *Haass* court said treating the damages provision as a non-compete was consistent with the court's prior cases. *Id*. at 386 (citing *Henshaw v. Kroenecke*, 656 S.W.2d 416 (Tex. 1983), and *Frankiewicz v. National Comp Associates*, 633 S.W.2d 505 (Tex. 1982)).

Applying the reasonableness standard for non-competes, the *Haass* court went on to hold that the damages clause was overbroad and unenforceable because it imposed an industry-wide exclusion (more about industry-wide exclusions later).

Haass established two broad common-sense principles:

(1) A contractual provision that does not expressly prohibit competition can still be a non-compete if it imposes a significant financial penalty for competing. The "practical and economic reality" of the clause is more important than the label.

(2) Regardless of whether a contractual penalty is classified as a non-compete, it must meet the same reasonableness requirements as a non-compete to be enforced.

Following *Haass*, Texas courts treated forfeiture clauses as non-competes regardless of how the clauses were worded or labeled.

For example, in *Valley Diagnostic Clinic, P.A. v. Dougherty*, 287 S.W.3d 151 (Tex. App.—Corpus Christi 2009, no pet.), the forfeiture clause expressly stated that it was *not* a covenant not to compete, but the court was not persuaded. "Although the provision at issue here is a forfeiture clause and expressly states that it is not a covenant not to compete," the court said, "the Texas Supreme Court has analyzed

© Zach Wolfe (2021)

such clauses in the same manner as covenants not to compete because they share the same objective—to restrain a former employee from competing against the employer." *Id*. at 155.

But then the Texas Supreme Court muddied the waters in *Exxon Mobil v. Drennen*, 452 S.W.3d 319 (Tex. 2014).

Drennen was an ExxonMobil VP who received restricted stock subject to the terms of an incentive program. *Id*. at 322. The agreements included both a New York choice-of-law clause and a forfeiture clause allowing ExxonMobil to terminate outstanding stock awards if the employee engaged in "detrimental activity," which included becoming employed by a competitor. *Id*.

When Drennen left ExxonMobil and went to work for Hess, another large energy company, ExxonMobil cancelled Drennen's outstanding restricted stock awards based on his employment by a competitor. *Id*. at 323. Drennen sued for a declaratory judgment that (1) the detrimental activity clause was a non-compete, (2) the non-compete was unenforceable because it was not limited in time, geographic area, or scope of activity, and (3) therefore ExxonMobil's purported cancellation of the restricted shares was invalid. *Id*.

The Houston Court of Appeals held that the forfeiture provision was an unreasonable and unenforceable non-compete and refused to apply New York law because the result would be against fundamental Texas policy. *Id*.

The Texas Supreme Court disagreed and reversed. The court viewed the forfeiture clause as similar to the provision at issue in *Haass*. But the court did not interpret *Haass* as holding that a forfeiture clause is a non-compete. "While we ultimately determined that the provision in *Haass* was an unreasonable restraint of trade," the *Drennen* court said, "we never concluded that the damage provision was, itself, a covenant not to compete." *Id*. at 329.

Let's pause on that point. *Drennen*'s interpretation of *Haass* is strained at best. The *Haass* opinion expressly stated that a forfeiture clause should be judged by the same reasonableness standard as a non-compete and then applied that standard to the forfeiture clause at issue. *Haass*, 452 S.W.3d at 385-87. The reasoning of *Haass* was that a forfeiture clause that functions as a non-compete should be treated as a non-compete. To say that *Haass* did not hold that a forfeiture clause *is* a non-compete seems like an academic distinction.

But that was not the worst part of the *Drennen* opinion. It went on to say the following:

There is a distinction between a covenant not to compete and a forfeiture

© Zach Wolfe (2021)

> provision in a non-contributory profit-sharing plan because such plans do not restrict the employee's right to future employment; rather, these plans force the employee to choose between competing with the former employer without restraint from the former employer and accepting benefits of the retirement plan to which the employee contributed nothing. *See Dollgener v. Robertson Fleet Servs., Inc.,* 527 S.W.2d 277, 278–80 (Tex. Civ. App.—Waco 1975, writ ref'd n.r.e.). Whatever it may mean to be a covenant not to compete under Texas law, forfeiture clauses in non-contributory profit-sharing plans, like the detrimental-activity provisions in ExxonMobil's Incentive Programs, ***clearly are not covenants not to compete***.

Id. at 329.

This sort of thing really bothers me. The court pretends the issue is easy, cites one Waco case from 1975, and then gets the answer wrong.

In my view, a forfeiture clause conditioned on the employee competing is obviously a non-compete and should be treated as such. But even if I'm wrong, the *Drennen* court at least should have acknowledged there is a reasonable disagreement on the issue. Heck, three justices on the Court of Appeals ruled the other way, citing *Haass* in support of holding that the forfeiture clause *was* a non-compete. Are they just morons?

My beef is not so much with the result as the way the *Drennen* opinion got there. The court could have acknowledged that there are two reasonable arguments, discussed both sides of the issue, and then explained which argument it found more persuasive and why.

Instead, *Drennen* simply made the statement quoted above and then said "we hold that, under Texas law, this provision is not a covenant not to compete." *Id*. 329.

But to the court's credit, it added this important qualification: "Whether such provisions in non-contributory employee incentive programs are unreasonable restraints of trade under Texas law, such that they are unenforceable, is a separate question and one which we reserve for another day." *Id*.

That statement is important because it acknowledges that a forfeiture clause, even if it is not a non-compete, may still be an unenforceable restraint of trade. Keep in mind, section 15.05 of the Texas Business and Commerce Code provides that all contracts in restraint of trade or commerce are unlawful. The Texas non-compete statute provides an *exception* to that rule for non-competes that meet the requirements of the statute.

© Zach Wolfe (2021)

So, *Drennen* leaves open the argument that, even if a forfeiture clause is not a non-compete, an unreasonably broad forfeiture clause is an unenforceable restraint of trade.

Drennen also leaves open the argument that a clause requiring forfeiture of vested shares the employee *already owns* is a non-compete subject to the requirements of the non-compete statute.

This distinction finds support in the one case *Drennen* cited for the distinction between a forfeiture clause and a non-compete, *Dollgener v. Robertson Fleet Services, Inc.*, 527 S.W.2d 277 (Tex. App.—Waco 1975, writ ref'd n.r.e.).

Dollgener held that a forfeiture provision in a noncontributory profit-sharing trust was not a covenant not to compete. *Id.* at 278-80. Thus, like *Drennen*, *Dollgener* did not involve forfeiture of vested shares the employee had already earned and can be distinguished on that ground.

The Houston Court of Appeals applied this very distinction in *Rieves v. Buc-ee's Ltd.*, 532 S.W.3d 845 (Tex. App.—Houston [14th Dist.] 2017, no pet.). The court held that an agreement that imposes a severe economic penalty on an at-will employee for quitting must meet the reasonableness requirements for non-competes, even if the agreement does not expressly prohibit competition. *Id.* at 851. Quoting *Haass*, the court reasoned that the "practical and economic reality" of such a contractual penalty is that it inhibits employee mobility in virtually the same manner as a non-compete. *Id.*

The employer in *Buc-ee's* cited *Drennen* for the proposition that a forfeiture provision is not a non-compete, but the Court of Appeals rejected this argument. Characterizing *Drennen* as a "choice-of-law case," the *Buc-ee's* court distinguished *Drennen* as involving "cancellation of future payments of unvested stock options that had been awarded but not delivered to Drennen, an ExxonMobil vice president, under a non-contributory profit-sharing plan." *Buc-ee's*, 532 S.W.3d at 852. One critical distinction was that "*Drennen* did not involve ExxonMobil seeking the return of Drennen's salary or any ***stock options that had already vested***." *Id.* (emphasis added).

So, *Buc-ee's* also supports the argument that *Drennen* does not apply to a contract requiring forfeiture of vested shares the employee already owns. This is interpretation no. 2 outlined above. It reconciles *Haass* and *Drennen* based on whether the forfeiture involves equity ownership interests that have already vested.

Is this the right way to reconcile *Haass* and *Drennen*? As a practical matter, we won't know the answer until the Texas Supreme Court addresses the issue. When it is unclear whether two cases conflict or can be reconciled based on some

© Zach Wolfe (2021)

distinguishing factor, the answer really depends on how the third case treats them. And we don't have that case yet. (The issue is currently before the 14th Court of Appeals in *Avalon Advisors, LLC v. Luke*, No. 14-20-00473-CV.)

But we don't need that third case to know that regardless of whether a forfeiture clause is classified as a non-compete or not, it must be reasonable. An unreasonably broad forfeiture clause would be an unenforceable restraint of trade. *Haass* and *Drennen* seem to agree on that point.

So, if an employer wants to use a forfeiture clause to discourage employees from competing, the lawyer who drafts the agreements should at least include reasonable limitations on the scope of competition that triggers the forfeiture. The safer course is to assume the clause will be treated *like* a non-compete, and to include reasonable limitations on time, geographic area, and scope of activity restrained.

6. Does Texas law apply to the non-compete?

When a company sues a former employee in Texas for violating a non-compete, will Texas law—or some other state's law—determine whether the non-compete is enforceable? It sounds like a question only a law school professor would love, but it is hardly academic. In non-compete law, there are significant distinctions between Texas and other states, so determining which state's law applies can make all the difference. This was the issue in *ADP, LLC v. Capote*, No. A-15-CA-714-SS, 2016 WL 3742319 (W.D. Tex. July 7, 2016).

Based on *ADP* and the cases it cites, the short answer is this:

- If the employee is now working in Texas, then Texas law will *probably* apply to enforceability of the non-compete.

- If the employee worked for the company in Texas *and* is now working in Texas, then Texas law will *almost certainly* apply. This will be true **even if the non-compete says that some other state's law applies**.

- On the other hand, if the employee did not work for the company in Texas and/or is not working in Texas now, some other state's law may apply.

Determining whether Texas law applies to a non-compete in a Texas lawsuit has several steps. Let's assume for example that the other state at issue is New York. Applying the analysis from *ADP v. Capote*, here is how the issue breaks down.

A. **<u>If the non-compete does not have a choice of law clause</u>**, the court will apply the "most significant relationship" test to determine whether Texas or New York law applies.

© Zach Wolfe (2021)

In determining which state has the "more significant relationship," Texas courts examine (a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties. In non-compete cases, "place of performance"–the place where the employee worked–will typically be the most important factor.

B. **<u>If the non-compete has a clause stating that Texas law applies</u>**, then as a practical matter a Texas court is going to apply Texas law as long as the case has some reasonable connection to Texas. (You didn't have to study any case law to figure that out.)

C. **<u>If the non-compete has a clause stating that New York law applies</u>**, then it gets more complicated. In that case the court will still apply Texas law if:

1. <u>The chosen state has "no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice."</u> If the employer is located in the chosen state, that will be sufficient to show a "substantial relationship" or "reasonable basis" for the choice.

OR

2. Each prong of this three-pronged test is met:

a. <u>Texas has a "more significant relationship" with the parties and the transaction at issue than New York</u>. One way this prong will be satisfied is if the employee signed the non-compete in Texas, worked in Texas, and managed a sales territory in Texas.

AND

b. <u>Texas has a "materially greater interest" than New York in the enforceability of the non-compete</u>. One way this prong will be satisfied is if the employee has left a Texas job for employment with a competing Texas business.

AND

c. <u>Texas has a fundamental policy that would be contravened by the application of New York law</u>. This one is easy. If the issue is enforceability of a non-compete, Texas courts have already held that Texas law on enforceability of a non-compete **<u>is</u>** a fundamental policy of the great State of Texas. But note that this rule only applies if the agreement at issue is truly a non-compete. In *Exxon Mobil Corp. v. Drennen*, the Texas Supreme Court held that this rule

© Zach Wolfe (2021)

> did not apply to a clause the court categorized as a *forfeiture* provision rather than a non-compete.

See ADP v. Capote, 2016 WL 3742319 at *2, citing *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670 (Tex. 1990), *Cardoni v. Prosperity Bank*, 805 F.3d 573 (5th Cir. 2015), and *Exxon Mobil Corp. v. Drennen*, 452 S.W.3d 319, 327-29 (Tex. 2014).

Applying these principles, the court in *ADP v. Capote* held that **Texas law applied to the enforceability of a non-compete where the employee worked for a New Jersey company in Texas and left to work for a competitor in Texas**, even though the agreement had a clause stating that New Jersey law applied. *ADP v. Capote* at *3-6.

What if the employee in *ADP* had worked for the company in New Jersey and then left to work for a competitor in Texas? That would be a slightly harder case, but I would expect most Texas judges would still apply Texas law, because of the Texas interest in competition occurring in the state.

What if the employee worked for a New Jersey company in Texas and then left to work for a competitor in New Jersey, or some other state? Then the choice of law issue would get difficult. If the employee is no longer working in Texas and the parties chose some other state's law, in most cases I would expect the judge to enforce the parties' choice of law.

Some subsequent federal district court decisions illustrate that the law of the state where the employee worked is likely to apply, even if the contract selects some other state's law. In *McKissock v. Martin*, 267 F. Supp. 3d 841, 850-52 (W.D. Tex. 2016) (J. Martinez), the court held that Texas law applied to the non-compete, despite the agreement's choice of Pennsylvania law, where the employee was a Texas resident and did most of her work from her home in Texas.

Similarly, in *ECL Group, LLC v. Mass*, No. 3:17-CV-2399-D, 2018 WL 949235, at *6-8 (N.D. Tex. Feb. 20, 2018) (J. Fitzwater), the court held that *California* law applied, despite the agreement's selection of Texas law, where the employee was a California resident who primarily worked in California and made a substantial number of his sales there.

But if the agreement specifies Texas law and at least one of the parties performed in Texas, the court may apply Texas law. In *Bay Cities Recovery, Inc. v. Digital Recognition Network, Inc.*, No. 4:18-CV-280-A, 2018 WL 4903233, at *4 (N.D. Tex. Oct. 5, 2018) (J. McBryde), the court enforced the agreement's choice of Texas law, where the agreement was between two corporations and, although one company did most of its work in California, it transmitted information to the other party in Texas, where the information was compiled and analyzed before being disseminated.

© Zach Wolfe (2021)

SPBS, Inc. v. Mobley, No. 4:18-CV-00391, 2018 WL 4185522, at *12 (E.D. Tex. Aug. 31, 2018) (J. Mazzant), presented a somewhat closer call because the employee resided in Oklahoma, but the court enforced the non-compete's choice of Texas law where the company was based in Texas and had many Texas clients the employee allegedly pursued after leaving. The court reasoned that place of performance was the most significant factor.

All of these cases applied the three-pronged test discussed above.

7. Enforceability of a non-compete

Enforceability is usually the big issue in a non-compete lawsuit. The statute has two requirements for enforceability:

(1) the non-compete must be "ancillary" to an otherwise enforceable agreement

(2) the non-compete must be "reasonable" in time period, geographic area, and scope of activity restrained.

TEX. BUS. & COM. CODE § 15.50(a).

The statutory requirements are clear. The harder part is applying them.

7.1 Is enforceability a "question of law" or "question of fact"?

Is enforceability of a non-compete a "question of law" or a "question of fact"?

As with almost any legal question, the answer is "it depends." If the facts material to enforceability are undisputed, then enforceability is a question of law. Conversely, if there is conflicting evidence concerning the facts material to enforceability, then enforceability is a question of fact.

I don't know why it is so hard for courts to just acknowledge this obvious fact, instead of engaging in the formalistic exercise of labeling an issue a "question of law" or "question of fact." But they've been doing it for generations and will probably keep on doing it.

In any case, let's apply this to enforceability of a Texas non-compete.

Texas, like most states, requires a non-compete to be reasonable in time period, geographic area, and scope of activity restrained. What do we mean by "reasonable," as applied to a non-compete?

© Zach Wolfe (2021)

The Texas non-compete statute says the non-compete must have "limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee." Tex. Bus. & Com. Code § 15.50(a). For the typical Texas non-compete, which is tied to a confidentiality agreement, reasonableness comes down to whether the limitations are no greater than necessary to protect the company's goodwill and confidential information.

So how about a three-year time period? Is that reasonably necessary to protect the employer's goodwill and confidential information? And what about a geographic area of the State of Texas? Is that reasonable?

You're probably having trouble answering these questions in the abstract. That's because *you don't know anything about the facts of the case*. It would make a difference whether it takes three months or three years for the confidential information to become outdated and useless. It would make a difference whether the company sells products to customers throughout the State of Texas or in just one county.

If you don't know the answers to these questions, there is no way you can know if the time period and geographic area are reasonable. You simply cannot determine the reasonableness of the non-compete in the abstract.

And yet, many Texas cases recite that the reasonableness of the non-compete is a question of law. As I said earlier, that is either wrong or only partially correct. Reasonableness is only a question of law if the facts concerning reasonableness are not in dispute. If there is conflicting evidence relevant to reasonableness, it's a question of fact.

And I can prove it. My witness is the Texas legislature, and my Exhibit 1 is Section 15.51 of the Texas Business and Commerce Code, which says:

> If the primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, for a term or at will, the promisee has the burden of establishing that the covenant meets the criteria specified by Section 15.50 of this code. . . . For the purposes of this subsection, the "burden of establishing" a fact means the burden of persuading the triers of fact that the existence of the fact is more probable than its nonexistence.

Let me translate. This means that for a non-compete in a typical employment agreement, the employer has the burden of proving the non-compete is reasonable.

This proves my point that the reasonableness of a non-compete can be a

© Zach Wolfe (2021)

question of fact, provided there is conflicting evidence. How else could there be a burden of proof on the issue? Questions of law don't have a burden of proof.

Is this just a case of sloppy language? Opinions that say it's a question of law may still be getting the *result* right, if the undisputed facts of the case establish that the non-compete was either reasonable or unreasonable.

True. But the issue is not purely academic. For one thing, treating reasonableness of a non-compete as a question of law tends to favor enforcement of the non-compete. In theory, the judge could just as easily find a non-compete *unenforceable* as a matter of law. But in practice, in the vast majority of cases where the court says that reasonableness is a question of law, the court decides that the non-compete was reasonable, and therefore enforceable. So, the outcome of this philosophical issue can make a real practical difference.

7.2 What is the effect of a contractual stipulation of reasonableness?

Most non-competes contain a stipulation that the non-compete's limitations are reasonable. These stipulations should be ignored, for obvious reasons. It would defeat the entire public policy purpose of the statute if you could get around the reasonableness requirement simply by having the non-compete state that the restrictions are reasonable.

Most Texas courts seem to recognize this. For example, in *TENS Rx, Inc. v. Hanis*, No. 09-18-00217-CV, 2019 WL 6598174, at *4 (Tex. App.—Beaumont Dec. 5, 2019, no pet.) (mem. op.), the company argued that the employee admitted the restrictions were reasonable because the agreement stipulated they were reasonable. The court appeared to give this argument no weight, instead evaluating for itself whether the geographic scope and scope of activity restrained were reasonable. *Id.* at *4-5.

Still, if you represent the party trying to enforce the non-compete, you can cite the contractual stipulation of reasonableness, and the judge may give it some weight. In addition, you might try using that stipulation to get the opposing party to admit that the restrictions are reasonable.

© Zach Wolfe (2021)

8. When is a non-compete with an at-will employee "ancillary to an otherwise enforceable agreement"?

When the Texas legislature codified Texas non-compete law in the Covenants Not to Compete Act in 1989, the statute included the requirement that a non-compete must be "ancillary to an otherwise enforceable agreement." Tex. Bus. & Com. Code § 15.50(a).

That's all the statute said. But this requirement did not come from nowhere. There were already decades of Texas cases saying a non-compete must be ancillary to some other agreement. *See Justin Belt Company, Inc. v. Yost*, 502 S.W.2d 681, 683 (Tex. 1973).

But *why* must a non-compete be ancillary to another agreement? Why not just let two parties agree not to compete with each other on terms they define in their contract?

The answer, of course, has to do with the strong public policy against restraining competition. This policy is reflected in section 15.04 of the Texas Business Commerce Code, which provides that contracts in restraint of trade or commerce are generally illegal. Enforcement of non-competes is an *exception* to that general rule.

Requiring a non-compete to be ancillary to another agreement is an effort to balance the public policy against restraints of competition with the desire to enforce reasonable agreements between private parties. The rationale is that a "pure" or "naked" non-compete is objectionable, because it serves no purpose other than restraining competition, while a non-compete that is ancillary to some other kind of agreement serves the additional purpose of effectuating that other agreement.

Pure non-compete, bad. Non-compete tied to some other enforceable agreement, good.

Simple, right?

8.1 A short history of the *Light* case's interpretation of "ancillary to an otherwise enforceable agreement"

When I started practicing law in the late 90s, the key non-compete case was *Light v. Centel Cellular Company of Texas*, 883 S.W.2d 642 (Tex. 1994). *Light* held that a non-compete in an at-will employment agreement was not "ancillary" to an otherwise enforceable agreement (under the 1989 non-compete statute, as amended in 1993).

© Zach Wolfe (2021)

Today, *Light* is not such a big deal, as subsequent decisions have largely abandoned it. You might say it's the *Pennoyer v. Neff* of Texas non-compete law, in that it presents a dilemma for anyone teaching the subject. Does *Light* only deserve a brief mention, considering it is now largely obsolete, or is it worth getting down in the weeds and understanding all of its nuances and the subsequent decisions that tried to apply it?

I'm opting for a middle approach. You can find other papers that get down in the weeds. And sure, it would be fun to chronicle the 90s turf battle between the Texas Supreme Court and the Texas legislature over non-competes (see the snark in footnote 7 of *Light*, for example).

But I'm just going to focus on three key hurdles *Light* created for enforcement of non-competes: (1) the "illusory contract" problem; (2) the "give rise to" requirement; and (3) the "designed to enforce" requirement.

The Texas Supreme Court would later knock down two of these hurdles, but one remains (maybe).

8.1.1 The "illusory contract" problem

Let's start with the illusory contract problem. *Light* reasoned that an agreement to provide at-will employment cannot not be the "enforceable agreement" in "ancillary to an otherwise enforceable agreement" because the agreement is not really enforceable by the employee. "Describing something as an at-will obligation is nonsensical," *Light* said. *Id*. at 645 n.7.

You can see the logic. If the employer can fire the employee at any time for any reason or no reason, then what rights does the employee actually have to enforce? Thus, *Light* said that an agreement to provide at-will employment cannot be the "otherwise enforceable agreement" to satisfy the "ancillary to an otherwise enforceable agreement" requirement. *See id*. at 644-46.

Did this mean you can't have an enforceable non-compete in an at-will employment relationship? No. *Light* made it clear that an otherwise enforceable agreement "can emanate from at-will employment so long as the consideration for any promise is not illusory." *Id*. at 645.

This theorizing about illusory promises was all well and good, but employers just wanted to know, how do we meet this "ancillary" requirement if an agreement to provide at will employment is illusory? The *Light* opinion gave them an answer in its famous footnote 14: an employer's agreement to provide an employee confidential information or trade secrets can be the "otherwise enforceable agreement."

© Zach Wolfe (2021)

Predictably, that is exactly how employers tried to make non-competes stick after *Light*. The standard form of non-compete would have a non-compete tied to a confidentiality agreement.

But there was a problem, one based on the reasoning of *Light* itself. If the employment is at-will, isn't the employer's agreement to provide the employee confidential information also "illusory"?

That objection was correct in theory, but unworkable in practice. What are we supposed to do, exasperated employers asked, draft the contract to require handing the employee a stack of confidential documents at the moment she signs the contract?

And believe me, there was much confusion and uncertainty.

The Texas Supreme Court later cleared this up. As discussed below, the *Alex Sheshunoff* case solved the "illusory contract" problem by holding that an agreement to provide confidential information to an at-will employee becomes an "otherwise enforceable agreement" when the employer performs its obligation to provide the confidential information. *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644, 655 (Tex. 2006). Thus, the "illusory contract" problem addressed in *Light* has largely been solved.

8.1.2 The "give rise to" requirement

Light also grappled with the meaning of "ancillary." What does it mean for a non-compete to be "ancillary" to an otherwise enforceable agreement?

Let's step back and revisit the more fundamental question: what is the point of the "ancillary" requirement in the first place?

Put simply, the purpose of the "ancillary" requirement is to balance two interests discussed earlier: the interest in enforcing the contracts of private parties and the interest in encouraging free competition.

Let's illustrate. Imagine you're an ice delivery business in the 1920s making huge profits. The last thing you want is for a salesman to quit and start selling ice to your customers. So any time an employee quits, you offer to pay him $500 in exchange for agreeing not to compete for a year.

That would be a "naked" non-compete, i.e. a non-compete that is not "ancillary" to an otherwise enforceable agreement, and we don't want that. In that scenario, we give more weight to the interest in free competition than the interest in enforcing contracts.

© Zach Wolfe (2021)

So, the "ancillary" requirement has to mean something more than requiring the non-compete in exchange for some benefit provided to the employee. But what?

Citing to the U.S. Supreme Court, the Restatement (Second) of Contracts, and the Texas Supreme Court's decision in *DeSantis v. Wackenhut*, *Light* reasoned that "ancillary" means two things:

> (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. at 647.

To illustrate the first prong, the "give rise to" requirement, *Light* cited the example already mentioned, a confidentiality agreement. In that case, the confidential information is the consideration given by the employer. Providing confidential information to the employee "gives rise to" the employer's interest in restraining competition, at least where the employee could use the confidential information to compete. *See id*. at 647 n.14.

Personally, I think *Light* got this point exactly right. "Ancillary," in this context, has to mean something more than just *related*. The non-compete will always be *related* to some benefit provided to the employee; otherwise, it would be void for lack of consideration under basic contract law principles.

But Texas employers didn't like this "give rise to" requirement, and the Texas Supreme Court sympathized. Yes, this requirement was fairly easy to apply in the typical case where the non-compete was tied to a confidentiality agreement, but in other contexts it presented more of a problem. For example, suppose an employer requires a non-compete as part of an agreement to provide stock options to a trusted executive. It's hard to see how the stock options "give rise to" an interest in restraining the executive from competing.

To clear the way for broader enforcement of non-competes, the Texas Supreme Court jettisoned *Light*'s "give rise to" requirement in *Marsh USA Inc. v. Cook*, 354 S.W.3d 764, 773-76 (Tex. 2011). Instead of requiring the consideration to "give rise to" the employer's interest in restraining competition, Marsh held that it is sufficient for the consideration to be "reasonably related" to an interest worthy of protection, such as confidential information or goodwill. *Id*. at 775. Applying this new "reasonably related" test, *Marsh* held that stock options were "reasonably related" to the protection of goodwill. *Id*. at 777.

© Zach Wolfe (2021)

"Reasonably related" is pretty weak sauce. Personally, I think getting rid of the "give rise to" requirement was a mistake, for reasons already covered. Plus, the majority opinion in *Marsh* is heavy on economic theory and light on practical experience.

But most lawyers probably applauded *Marsh*, because applying the "give rise to" requirement outside the typical confidentiality agreement scenario was such a headache. And I will acknowledge that by getting rid of *Light*'s "give rise to" requirement, *Marsh* at least had the benefit of making the "ancillary" requirement simpler to apply.

Still, *Marsh* did not completely extinguish *Light*.

8.1.3 The "designed to enforce" requirement

Remember, *Light* also said "the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement." In the typical case where the non-compete is tied to a confidentiality agreement, the non-compete meets this requirement because it is designed to enforce the employee's promise not to use or disclose the employer's confidential information. At least, that's the theory.

So, in the typical case involving a confidentiality agreement, *Light*'s "designed to enforce" requirement will usually be satisfied.

But what about other types of "otherwise enforceable agreements"? Do they still have to meet *Light*'s "designed to enforce" requirement? Or did *Marsh* jettison that requirement too?

This was the issue in *Titan Oil & Gas Consultants, LLC v. Willis*, No. 06-20-00026-CV, 2020 WL 6878418 (Tex. App.—Texarkana Nov. 24, 2020, no pet. h.). In that case, the employer argued that *Marsh* overruled *Light*'s "designed to enforce" requirement, but the Court of Appeals disagreed. *Marsh* specifically stated that it was only addressing the "give rise to" prong of *Light*, the court said, not the "designed to enforce" prong. *Id*. at *5.

The Court of Appeals was therefore bound to follow the "designed to enforce" requirement. "Neither *Marsh* nor any other Texas Supreme Court that has considered *Light* has overruled *Light*'s designed-to-enforce element of an enforceable covenant not to compete," the court said. And it is not the function of a court of appeals to abrogate or modify Texas Supreme Court precedent. *Id*. at *6.

So, *Light*'s "designed to enforce" requirement survives. For now.

© Zach Wolfe (2021)

Does the requirement make any practical difference? It did in *Titan*, but the circumstances there were unusual. The employee signed a contract with one company (Titan) but received confidential information from a different company (Apache), and the non-compete only restricted the employee from working for Apache. The court reasoned that a restriction on working *for Apache* was not designed to enforce the employee's promise not to disclose Apache's confidential information. *Id.* at *6.

Outside of oddball situations like *Titan*, the "designed to enforce" requirement probably doesn't do much for the employee. But the employee's lawyer should at least be aware of the requirement and consider it.

8.2 The *Sheshunoff* requirement: an agreement to provide confidential information + providing the information

As noted above, the Texas Supreme Court clarified and simplified application of the "ancillary" requirement in *Alex Sheshunoff Management Services, L.P. v. Johnson*, 209 S.W.3d 644 (Tex. 2006).

The *Sheshunoff* court solved the "illusory contract" problem this way: a non-compete is ancillary to an otherwise enforceable agreement if the employer agrees to provide the employee with confidential information *and the employer later provides the confidential information.*

The non-compete becomes enforceable not when the employee signs the non-compete, but at the moment the employee receives the confidential information.

So, if the employer provided confidential information, the ancillary requirement is satisfied, and the non-compete is potentially enforceable (if it's reasonable). If the employer did not provide confidential information, the ancillary requirement is not satisfied, and the non-compete is unenforceable.

In the vast majority of cases the employee received *some* information from the employer that is at least *arguably* confidential. It may be as simple as learning the company's prices, the identity of the company's customers, and information about the customers. Is the ancillary requirement satisfied when the employee simply received the same kind of basic information that employees always receive?

Language in *Sheshunoff* suggests the answer is yes. Addressing the "ancillary to an otherwise enforceable agreement" element of the statute, the *Sheshunoff* court said:

> Concerns that have driven disputes over whether a covenant is ancillary to an otherwise enforceable agreement—such as the amount of

© Zach Wolfe (2021)

> information an employee has received, its importance, its true degree of confidentiality, and the time period over which it is received—are better addressed in determining whether and to what extent a restraint on competition is justified.

Id. at 655-56.

In other words, let's not sweat the details about the confidential information when we're applying the "ancillary" requirement of the statute. We can worry about the details when we apply the second requirement of the statute, reasonableness.

So, for example, if the employee only received a tiny bit of information, or if the information was not highly confidential, the court can consider that in determining whether the scope of the non-compete is reasonable.

The implication is that the amount of information, its importance, and its "true degree of confidentiality" don't make a difference to whether the non-compete is "ancillary to an otherwise enforceable agreement." One could interpret *Sheshunoff* to mean that, for the purpose of the ancillary requirement, it's enough to show that the employee received a little bit of confidential information, and the information doesn't have to be *that* confidential, or even important.

The trouble with this interpretation is that it threatens to render the statute's "ancillary" requirement effectively meaningless. That brings me to the employee's argument.

In practice, the employee will almost always receive information that the employer *claims* is confidential. Let's take a typical sales position. A sales person is always going to receive information about who her customers are, how much they pay, and what they buy. Usually, you can't get all that information just by Googling it. But it's not the secret formula to Coke, either. The sales person could probably put together the same information using a web browser and a telephone.

The employee's argument is that it's not enough to show the employee received information that the employer can plausibly argue was confidential. The employer has to prove the information provided to the employee was actually confidential. This simply follows from *Sheshunoff*'s requirement that the employer prove that it performed its promise to provide the confidential information.

It cannot be enough, this argument says, for the employer merely to recite the "magic words" in the agreement and then say that the information is confidential. That would make the ancillary requirement virtually meaningless, and we should not assume the legislature included the ancillary requirement for no reason.

In other words, the requirement of providing confidential information must have *some* teeth to it.

8.3 Cases Applying the *Sheshunoff* requirement

Cases applying the *Sheshunoff* requirement run the gamut from cases holding that the requirement was satisfied as a matter of law, to cases holding the evidence raised a fact issue, to cases holding the evidence was insufficient to meet the requirement. As these cases illustrate, it depends on the evidence.

a. *Powerhouse Productions*: Employer failed to meet the *Sheshunoff* requirement

Powerhouse Productions, Inc. v. Scott, 260 S.W.3d 693 (Tex. App.—Dallas 2008, no pet.), indicated that meeting the *Sheshunoff* requirement would require including a promise to provide confidential information in the non-compete *and* persuading the factfinder that confidential information was actually provided.

The employer in *Powerhouse* argued that continued employment was consideration for a non-compete, but the court disagreed. *Id.* at 697. "If the mere opportunity to continue performing one's job could be consideration," the court said, "then an employer could spring a non-compete covenant on an existing employee and enforce such a covenant absent new consideration." *Id.* (quoting *Sheshunoff*).

The company also argued that the non-compete was supported by the consideration of past and future provision of confidential information and training, but the court disagreed. As to the past, the court said the training and confidential information the employer provided before the employee signed the non-compete could not form the consideration, because "past consideration is not competent consideration for contract formation." *Id.*

As to confidential information and training provided *after* the employee signed the non-compete, there was conflicting testimony. The Court of Appeals found that the evidence was sufficient to support the trial court's finding that the employee was not given anything of value in exchange for signing the non-compete. *Id.* at 698. Plus, the agreement did not contain any promise to provide the employee more training or confidential information in exchange for signing the agreement. *Id.*

b. *Gallagher*: Evidence met *Sheshunoff* requirement as a matter of law

Gallagher Healthcare Insurance Services v. Vogelsang, 312 S.W3d 640 (Tex. App.—Houston [1st Dist.] 2009, pet. denied), held that the employer, an insurance brokerage company, met the *Sheshunoff* requirement by offering detailed affidavit testimony about confidential information provided to the employee. *Id.* at 652-53.

© Zach Wolfe (2021)

The court cited the affidavit of the company's President, which included detailed facts supporting the company's claim that it provided confidential information to the employee, including client lists, information about clients' insurance coverage and loss histories, a client prospects database, and the "books of business" served by the office where the employee worked. The affidavit also stated that the company's confidential information took years to acquire and was only shared with employees on a "need to know" basis. *Id*. at 650-51.

The court reversed the summary judgment for the employee and held that the employer was entitled to summary judgment that the non-compete was enforceable. *Id*. at 655.

c. ***Gorman*: Evidence raised fact issue on *Sheshunoff* requirement**

In *Gorman v. CCS Midstream Services, L.L.C.*, No. 12-09-000204-CV, 2011 WL 1642624, at *8 (Tex. App.—Tyler Apr. 29, 2011, no pet.) (mem. op.), the court held there was a fact issue as to whether the employer actually provided the employee confidential information that was reasonably related to an interest worthy of protection.

d. ***Republic Services*: Evidence raised fact issue on *Sheshunoff* requirement**

In *Republic Services, Inc. v. Rodriguez*, No. 14-12-01054-CV, 2014 WL 2936172, at *5 (Tex. App.—Houston [14th Dist.] June 26, 2014, no pet.) (mem. op.), the court held there was sufficient evidence to meet the *Sheshunoff* requirement, where the employee had "access to and some awareness of" the employer's "pricing practices and financial performance."

While the employee claimed she did not receive any confidential information, the court said that "at most" she had only challenged the "true degree of confidentiality" of the information. *Id*. (citing *Sheshunoff*).

e. ***McKissock*: Court grants preliminary injunction despite argument that employer never provided confidential information**

In *McKissock, LLC v. Martin*, 267 F. Supp. 3d 841, 853-54 (W.D. Tex. 2016), the court granted a preliminary injunction enforcing the non-compete, despite the employee's argument that the employer never provided her any confidential information.

f. *Miner*: Evidence did not persuade trial court that employer met *Sheshunoff* requirement

In *Miner, Ltd. v. Anguiano*, No. EP-19-CV-00082-FM, 2019 WL 2290562, at *9 (W.D. Tex. May 29, 2019), the employer argued that the employee, an account executive, was privy to confidential information because the confidential information was required for the work to be performed. At the preliminary injunction hearing, the employer said "the confidential information includes things like business strategy, where are we going, pricing information, margins."

That sounds like *plausibly* confidential information. But the court was not having it. "Plaintiff has not persuaded this court that this case involved the dissemination of 'confidential information.'"

The district court cited *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670 (Tex. 1990), where "the Texas Supreme Court rejected the plaintiff's claim that its supposed confidential information—the identity of their customers, pricing policies, cost factors, and bidding strategies—was protectable under the confidentiality agreement." The court in *Wackenhut* explained that the plaintiff "failed to show that its customers could not readily be identified by someone outside its employ, that such knowledge carried some competitive advantage, or that its customers' needs could not be ascertained simply by inquiry addressed to those customers themselves."

Applying *Wackenhut*, the federal district court found that the employer had failed to make a strong enough case that the information it provided the employee was truly confidential:

> Like *Wackenhut*, Plaintiff has not shown its business practices, pricing, margin, or strategy were uniquely developed or not readily accessible. Furthermore, Plaintiff's alleged "confidential information" is vague at best. Plaintiff struggles to identify and expand upon the alleged confidential information. The court will not infer a fact into existence. The Employment Agreement lacks consideration and is unenforceable.

Finding the non-compete unenforceable, the court in *Miner, Ltd. v. Anguiano* declined to issue a preliminary injunction to enforce it. (The court granted a preliminary injunction on other grounds.)

The quoted section from *Miner* suggests that application of the "ancillary" requirement in Texas non-compete litigation still raises a fundamental question: how confidential is "confidential"?

The *Sheshunoff* opinion said don't worry too much about the "importance" or "true degree of confidentiality" of the information at issue. But *Miner* suggests that

© Zach Wolfe (2021)

Texas judges are not going to assume the information is confidential just because the employer says it is. At least not until the Texas Supreme Court says they have to.

g. *Petrochoice*: Evidence raised fact issue on *Sheshunoff* requirement

In *Petrochoice Holdings, LLC v. Pearce*, 2021 WL 126591, No. 12-20-00106-CV (Tex. App.—Tyler Jan. 13, 2021, no pet. h.) (mem. op.), the court held that conflicting evidence raised a fact issue on whether the employer provided the employee with confidential information after the agreement was signed. So, neither side was entitled to summary judgment.

8.4 *Mann Frankort*: The promise to provide confidential information can be implied.

Despite the clear guidance provided by *Sheshunoff*, some lawyers still draft non-competes that do not contain an express promise to provide confidential information. For example, sometimes the employment agreement will contain a confidentiality clause requiring the employee to keep the employer's information confidential, but nothing in the agreement expressly obligates the employee

The Texas Supreme Court solved this problem for employers in *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844 (Tex. 2009). The court held that the agreement to provide confidential information under *Sheshunoff* can be satisfied by an *implied* agreement. "When the nature of the work the employee is hired to perform requires confidential information to be provided for thew work to be performed by the employee," the court said, "the employer impliedly promises confidential information will be provided." *Id*. at 850. The court held there was an implied promise where "[t]he circumstances surrounding [the employee's] employment indicated that his employment necessarily involved the provision of confidential information by Mann Frankfort before Fielding could perform the work he was hired to do." *Id*. at 851.

If the agreement says the job requires confidential information, does the employer need to offer evidence that this is true? In *Realogy Holdings Corp. v. Jongebloed*, 957 F.3d 523 (5th Cir. 2020), the Fifth Circuit suggested the answer is no. The agreement stated that the employee's employment "has required, and will continue to require, that [the employee] has access to, and knowledge of, Confidential Information." Without considering whether there was actually evidence that access to confidential information was required, the Fifth Circuit found this language showed that the employer "impliedly promised to provide confidential information." *Id*. at 535.

© Zach Wolfe (2021)

8.5 The "ancillary" requirement in the sale of a business

A sale of a business is different from an at-will employment relationship. In a typical sale, the buyer acquires the assets of the business, including goodwill. And in this information age, the goodwill is often the most valuable asset of the business.

Trouble is, you can't just load goodwill on a truck like it's office furniture or shop tools. Goodwill primarily consists of relationships with customers or clients, and in many cases the customer relationship is with an individual who works for the business, not so much the business itself.

A non-compete is ancillary to the sale of the goodwill because it is necessary to make the transfer effective. *See, e.g., Chandler v. Mastercraft Dental Corp. of Texas Inc.*, 739 S.W.2d 460, 464-65 (Tex. App.–Fort Worth 1987, writ denied) ("the covenant was necessary to protect the business goodwill, the key asset"). Imagine if the seller, after selling the goodwill, could set up a new business the next day and start soliciting the sold business's customers. Then the buyer would not get the benefit of the transferred goodwill.

If the law refused to enforce a non-compete in this situation, it would hurt the buyer *and* the seller. No buyer is going to pay the full value of the goodwill without assurance that the seller cannot immediately start competing for the customers of the business. And then business owners would not be able to cash out the full value of their businesses.

So, if anything, enforcing a non-compete makes *more* economic sense in the sale of a business than in the employer-employee context. That explains why even California, which generally prohibits non-competes, has an exception for the sale of a business. *See* Cal. Bus. & Profs. Code § 16600-16602.5.

It also explains why Texas courts have said that "[a] noncompete signed by an owner selling a business is quite different than one signed by an employee." *Heritage Operating, L.P. v. Rhine Bros., LLC*, 02-10-00474-CV, 2012 WL 2344864, at *5 (Tex. App.—Fort Worth June 21, 2012, no pet.) (mem. op.). Texas courts have been more inclined to enforce long, or even limitless, time periods barring competition after a sale of a business. *Id.* (citing cases).

For example, in *Oliver v. Rogers*, 976 S.W.2d 792, 801 (Tex. App.—Houston [1st Dist.] 1998, pet. denied), the court held that the lack of a time limitation did not render a non-compete unreasonable when it was part of the sale of a business.

But let's not get carried away. Since 1989, all Texas non-competes are governed by the Covenants Not to Compete Act. In addition to the "ancillary" requirement, the statute requires a non-compete to contain "limitations as to time, geographical area,

© Zach Wolfe (2021)

and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee." Tex. Bus. & Com. Code § 15.50(a). To the extent that any Texas case—especially a pre-1989 case—suggests that these limitations are not required in the sale of business, it should be taken with a grain of salt.

The non-compete statute does give the buyer of a business one advantage that may not be immediately obvious. In an employment agreement, the burden of proving the reasonableness of the non-compete is usually on the employer. But in the sale of a business, the burden of proof will usually be on the *seller* to show that the non-compete is unreasonable. *See* Tex. Bus. & Com. Code § 15.51(b) (placing burden of proof depending on whether the "primary purpose" of the agreement is to obligate the promisor to render "personal services").

But again, reasonableness is still required. And here's the slightly counter-intuitive part: if you represent the buyer in the sale of a business, you don't want to go overboard on drafting a super-broad non-compete. In fact, it will usually be in your client's interest to tailor the non-compete as narrowly as possible to the legitimate purpose of protecting the *goodwill* of the business. Anything more is too much.

What does that mean specifically?

First, you should include a reasonable time period. The time period should be no longer than necessary to protect the goodwill. Will the previous owner's relationships with customers really have significant value four or five years later? Consider whether a two or three-year period would be enough.

Second, you should include a geographic area. This will depend on the type of business, but generally a reasonable geographic area will coincide with the area where the company is doing business with its existing customers.

Third, the scope of activity restrained should be limited. This is perhaps the most neglected limitation. Remember, the purpose is to protect the goodwill of the business, which means relationships with existing customers. If the non-compete would bar the seller from competing in any way, for *any* customers, a judge might consider it an unenforceable "industry-wide exclusion." The case law prohibiting industry-wide exclusions focuses on the employer-employee context, but the same concept can be applied to the sale of a business.

Ok, the seller of a business might say, but why not draft the non-compete as broadly as possible, and then if there's a dispute you negotiate down from there?

Good question. Texas non-compete law is quite "pro-reformation," especially in comparison to some other states. If a non-compete is unreasonably broad, that's not

© Zach Wolfe (2021)

the end of the story. The statute *requires* the trial court to reform the agreement to the extent necessary to make it reasonable. So, all is not lost if the buyer's lawyer drafts the non-compete too broadly.

But there is a cost to be paid for making the non-compete too broad. First, if things go wrong and the seller of the business starts competing for the business's customers, the new business owner may need to go to court to get a temporary injunction enforcing the non-compete. As a litigator who handles temporary injunction hearings, I can tell you it will be easier to make a case for a temporary injunction if the non-compete is already reasonably limited.

Second, if the non-compete is written too broadly, it effectively means that the buyer will be unable to recover *damages* for the seller's breach. *See* TEX. BUS. & COM. CODE §15.51(c). That's a big bargaining chip to give away by making the non-compete too broad.

So if you represent the buyer, consider making the non-compete as narrow as you can while still protecting the goodwill your client is buying.

That brings up one more tip: the agreement should actually provide for the sale of the goodwill. If the purchase agreement does not expressly identify the goodwill as part of the assets being sold, there is a risk that a judge could say that the non-compete was not ancillary to an otherwise enforceable agreement. *See, e.g., Bandera Drilling Co. v. Sledge Drilling Corp.*, 293 S.W.3d 867, 872-75 (Tex. App.–Eastland 2009, no pet.).

You could argue the sale of the goodwill is *implied* when all the other assets of the business were sold. *See Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844 (Tex. 2009). But why chance it? Unless there is a good reason not to include the goodwill, the safer course is to include an express recitation that the goodwill is part of the assets being sold.

8.6 The "ancillary" requirement in an agreement not to solicit employees

In *Smith v. Nerium Int'l, LLC*, No. 05-18-00617-CV, 2019 WL 3543583, at *5-6 (Tex. App.—Dallas Aug. 5, 2019, no pet. h.) (mem. op.), a multi-level marketing company had a legitimate interest in barring solicitation of its employee "brand partners," where there was evidence the company provided training and access to confidential information to help the brand partners build their businesses. The company provided consideration reasonably related to protecting its goodwill by giving the employees confidential performance data concerning brand partners in the employees' "downlines," which was information the employees could use to increase their downlines' performance and enhance their own compensation. *Id.* at *11.

© Zach Wolfe (2021)

8.7 Can a mid-stream or exit non-compete meet the "ancillary" requirement?

The *Sheshunoff* framework fits best when an employee signs the non-compete before or shortly after starting employment. It's more complicated when the employee signs a non-compete in the middle of a period of employment or on the way out the door.

In these scenarios, the employee may question whether there was new consideration for the non-compete. Generally, continued at-will employment is not consideration, because as *Light* said, the promise of at-will employment is illusory. *See JM Davidson Inc. v. Webster*, 128 S.W.3d 223, 228 (Tex. 2003) ("At-will employment does not preclude formation of other contracts between employer and employee, so long as neither party relies on continued employment as consideration for the contract") (citing *Light*); *Eurecat US, Inc. v. Marklund*, 527 S.W.3d 367, 389 (Tex. App.—Houston [14th Dist.] 2017, no pet.) (agreements with at-will employees were not supported by new consideration because "a promise of continued employment is illusory and does not constitute consideration").

If the non-compete is tied to a confidentiality agreement, the employee may also challenge whether the non-compete meets the *Sheshunoff* requirement. In the midstream scenario, often the employee continues to receive the same *kind* of confidential information after signing the non-compete. The employer will argue that providing new confidential information is sufficient, regardless of whether it is the same kind of confidential information the employee was already getting. *Sheshunoff*'s emphasis on avoiding overly technical disputes about confidential information seems to favor this argument. On the other hand, the employee can argue there is no real new consideration if she just continues receiving the same kind of information she did before. This is a relatively untested issue.

The exit scenario is more difficult for the employer. Sometimes companies will include a non-compete in a severance agreement. Such non-competes will usually struggle to meet the "ancillary" requirement. Typically, the employee will not continue to receive confidential information, so the *Sheshunoff* framework does not help, and the promise to pay the employee severance is usually not going to meet the "ancillary" requirement. *See Am. Fracmaster, Ltd. v. Richardson*, 71 S.W.3d 381, 389 (Tex. App.—Tyler 2001, pet. granted, judgm't vacated w.r.m.) (non-compete was not ancillary to agreement to pay severance benefits, under *Light*)

On the other hand, an award of post-employment equity ownership to the employee may have a better chance of meeting the ancillary requirement. Under the loosened standard adopted in *Marsh*, the question will be whether the non-compete is "reasonably related" to an interest worthy of protection. *Marsh*, 354 S.W.3d at 775.

© Zach Wolfe (2021)

9. The reasonable time period requirement for non-competes

For almost a century, Texas case law required that a non-compete be limited to a reasonable time period, and in 1989 the legislature codified this requirement in the Texas Covenants Not to Compete Act. The time period must be no longer than necessary to protect the employer's goodwill or other business interest (usually confidential information). *See* Tex. Bus. & Com. Code § 15.50(a). And in the typical context of an employment contract, the burden is on the employer to prove the time period is reasonable. *See* Tex. Bus. & Com. Code § 15.51(b).

The time period of a Texas non-compete must be reasonable. That much is clear. But what does "reasonable" mean in practice? Is there any rule we can discern from the decades of case law?

Unfortunately, the Texas case law applying the reasonable time period is remarkably thin and unsatisfying. You're just not going to find much analysis defining what makes a time period reasonable or not. The best I can do to synthesize a "rule" from the cases is the "Five-Year Rule."

The Five-Year Rule says that when addressing the reasonable time period requirement, the court will declare that Texas cases have upheld non-competes of two to five years, and if the time period at issue is five years or less, the court will then find the time period reasonable, without discussing any specific evidence.

As you might have guessed, I don't find the Five-Year Rule very helpful or persuasive. As the statute indicates, the question is whether a shorter time period would be sufficient to protect the interest at issue, which is usually the employer's confidential information and/or goodwill.

I propose an alternate rule, the Wolfe Rule. The Wolfe Rule says that when there is conflicting evidence about whether the time period of a non-compete is reasonable, it presents a fact issue for the jury.

Now, you're not going to find the Wolfe Rule stated explicitly in any Texas cases, but it is the correct rule. I would even go as far as saying it is *obviously* the correct rule, and the fact that Texas courts have not expressly stated it presents something of a mystery. And one more thing: the Wolfe Rule does not necessarily conflict with the Five-Year Rule.

How can all of this be true?

Sadly, I suspect the answer to the mystery is that Texas lawyers representing employees in non-compete cases have been dropping the ball on the reasonable time period requirement for decades.

© Zach Wolfe (2021)

To understand what I mean, first need some historical perspective.

9.1 The questionable origins of the Five-Year Rule

We'll start in the Ice Age. I call it that because you could almost write the entire early history of Texas non-compete law based on cases involving the ice delivery business. There were at least five Texas appellate opinions about ice delivery non-competes in the 1920s alone. *Oak Cliff Ice Delivery Co. v. Peterson*, 300 S.W. 107 (Tex. Civ. App.—Dallas 1927, no writ); *Carpenter v. Southern Properties, Inc.*, 299 S.W. 440 (Tex. Civ. App.—Dallas 1927, writ ref'd); *Texas Ice & Cold Storage Co. v. McGoldrick*, 284 S.W.615 (Tex. Civ. App.—San Antonio 1926, writ ref'd); *Bettinger v. North Fort Worth Ice Co.*, 278 S.W. 466 (Tex. Civ. App.—Fort Worth 1925, no writ); *City Ice Delivery Co. v. Evans*, 275 S.W.88 (Tex. App.—Dallas 1925, no writ).

You can find in these cases many of the principles that still apply in Texas non-compete law today, including the requirement that the non-compete must have a reasonable time period. For example, in *Carpenter v. Southern Properties* the court said a non-compete can only prohibit competition "for a reasonable space of time" after employment, and the employer has the burden to prove that the non-compete is reasonable "in its duration of time." 299 S.W. at 443.

The non-compete at issue in *Carpenter* had a two-year time period. *Id*. at 442. Was this reasonable? The Court of Appeals said: "the trial court has found that the negative covenant sought to be enforced was both reasonable and necessary, and we are not prepared to say that there is not substantial evidence sustaining such finding." *Id*. at 444.

That was it. Nothing about what the evidence regarding the time period was. Nothing about why the evidence established that two years was reasonable. And the depth of analysis of the reasonable time period requirement in the next century of Texas case law would not significantly improve.

By 1960, it was well established that a non-compete should be limited "for such a time as is reasonably necessary to protect the employer's business and good will," and that the "burden of proof is on the former employer" to establish "by satisfactory evidence" the reasonableness of the non-compete. *Weber v. Hesse Envelope Co.*, 342 S.W.2d 652, 654-55 (Tex. Civ. App.—Dallas 1960, no writ).

And by that time Texas courts had moved from ice delivery to a more fascinating business: envelope sales. Yes, *Weber* was about a two-year non-compete signed by an envelope salesman. No word on whether Weber also owned a beet farm.

© Zach Wolfe (2021)

This battle in the great Metroplex envelope wars was tried to the bench, the salesman was the only witness, and the trial court declared the non-compete enforceable. *Id*. at 653. As to the two-year time period, the Court of Appeals said only that there was "ample support in the evidence" for the trial court's implied finding that the two-year period of the non-compete was reasonable. *Id*. at 655.

That was it. The court didn't cite any of the "ample" evidence or explain how the evidence established that two years was reasonable.

Are you detecting a pattern?

About 20 years later, the superficial treatment of the reasonable time period requirement got worse in *AMF Tuboscope v. McBryde*, 618 S.W.2d 105 (Tex. App.—Corpus Christi 1981, writ ref'd n.r.e.). That case addressed another two-year non-compete, this one involving the oilfield pipe inspection business. On an application for temporary injunction, the trial court found the time period unreasonable. *Id*. at 108.

The Corpus Christi Court of Appeals disagreed. The court did not cite any evidence from the record on the reasonableness of the time period, but it stated that the employees had cited no case authority for the proposition that two years is unreasonable. *Id*. The court then declared: "Two to five years has repeatedly been held a reasonable time in a noncompetition agreement." *Id*.

This appears to be the earliest statement of the Five-Year Rule.

AMF Tuboscope cited three cases in support of the Five-Year Rule, but curiously, none of those cases supported the Rule:

- In *Arevalo v. Velvet Door, Inc.*, 508 S.W.2d 184, 185 (Tex. Civ. App.—El Paso 1974, writ ref'd n.r.e.), there was a three-year non-compete but "no contention that the time or space limitation is unreasonable."

- In *Electronic Data Systems Corp. v. Powell*, 508 S.W.2d 137, 138-40 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.), the court upheld the limited scope of the trial court's temporary injunction. The non-compete at issue had a three-year period, but the reasonableness of that time period was not one of the issues raised in the case.

- As we have seen, in *Weber v. Hesse Envelope*, the court said there was ample evidence to support finding the two-year period reasonable, but the opinion said nothing about five years.

© Zach Wolfe (2021)

So, while I hate to be harsh, the statement of the Five-Year Rule in *AMF Tuboscope* is at worst dishonest, and at best inaccurate.

9.2 Post-statute repetition of the Five-Year-Rule

Almost 30 years later, after adoption of the 1989 non-compete statute, the Houston Court of Appeals repeated this error verbatim in *Gallagher Healthcare Insurance Services v. Vogelsang*, 312 S.W.3d 640 (Tex. App.—Houston [1st Dist.] 2009, pet. denied), a case involving a two-year non-compete in the insurance brokerage business. The trial court granted summary judgment that the non-compete was unenforceable, but the Court of Appeals reversed. *Id*. at 642-43.

Gallagher reasoned that the two-year period was "not unreasonable" because the evidence showed that insurance contracts lasted for a year. *Id*. at 655. The court then declared: "Two to five years has repeatedly been held as a reasonable time in a noncompetition agreement," citing the same three cases cited in *AMF Tuboscope*. *Id*.

Thus, not only did *Gallagher* repeat the same error made in *AMF Tuboscope*, it did so while addressing a ***two-year*** non-compete.

But once the Five-Year Rule was expressly stated in at least two opinions, Texas courts started to invoke it almost routinely, and not just for two-year non-competes.

For example, in *Salas v. Chris Christensen Systems, Inc.*, No. 10-11-00107-CV, 2011 WL 4089999 (Tex. App.—Waco Sept. 14, 2011, no pet.), the court considered the reasonableness of a five-year non-compete in the dog grooming products industry. The court did not cite any *evidence* about the reasonableness of the time period. Instead, it simply said "Texas courts have held that two to five years is a reasonable time restriction in a non-competition agreement," citing *Gallagher* and the same three cases cited by *Gallagher* and *AMF Tuboscope*. Id. at *19. "Given this," the court said, "we cannot say that the Agreement's five-year restraint is per se unreasonable." *Id*.

This, of course, misstated the issue. The question should have been whether the employer met its burden to prove that the five-year period was reasonable, not whether a five-year period was "per se" unreasonable.

But the damage has been done. Since *Salas*, both state and federal courts in Texas have continued to cite the Five-Year Rule, even when the non-compete at issue has a time period of just one or two years:

- *Weber Aircraft, L.L.C. v. Krishnamurthy*, No. 4:12-CV-666, 2014 WL 12521297, at *6 (E.D. Tex. Jan. 27, 2014) (one year)

© Zach Wolfe (2021)

- *Brink's Inc. v. Patrick*, No. 3:14-CV-775-B, 2014 WL 2931824, at *5 (N.D. Tex. June 27, 2014) (effectively four years)

- *In re Gomez*, 520 B.R. 233, 239 (S.D. Tex. Bankr. 2014) (five years)

- *Merritt Hawkins & Associates, LLC v. Gresham*, 79 F. Supp. 3d 625, 640 (N.D. Tex. 2015) (three years)

- *Toddy, LLC v. Simpson*, No. 1-15-CV-940 RP, 2016 WL 10520965, at *7 (W.D. Tex. May 12, 2016) (five years)

- *OrchestrateHR, Inc. v. Trombetta*, No. 3:13-CV-2110-KS-BH, 2016 WL 4563348, at *3-4 (N.D. Tex. 2016) (three years)

- *McKissock, LLC v. Martin*, 2667 F. Supp. 3d 841, 857 (W.D. Tex. 2016) (two years)

- *Smith v. Nerium Int'l, LLC*, No. 05-18-00617-CV, 2019 WL 3543583, at *10 (Tex. App.—Dallas Aug. 5, 2019, no pet.) (two years)

- *Expo Group, Inc. v. Castillo*, No. 3:19-CV-1356-G, 2019 WL 4671511, at *6 (N.D. Tex. Sept. 25, 2019) (two years)

- *Le-Vel Brands, LLC v. Bland*, No. 3:19-CV-00154-L, 2019 WL 4753041, at *7 (N.D. Tex. Sept. 30, 2019) (12 months)

All of these cases cite the Five-Year Rule uncritically, perhaps without realizing that the rule was basically just made up in *AMF Tuboscope* almost 40 years ago. But in a sense, the Five-Year Rule has become a self-fulfilling prophecy. Now that so many Texas courts have cited and applied it, it has essentially become true.

But is it the right rule?

Some courts have taken a less superficial approach to the reasonableness of the time period, focusing on the *evidence*.

In *CDX Holdings, Inc. v. Heddon*, No. 3:12-CV-126-N, 2012 WL 11019355, at *9 (N.D. Tex. Mar. 2, 2012), the court held that the plaintiffs failed to meet their burden to show the one-year limitation was reasonable, where there was testimony that the information was confidential and would be valuable to competitors, but there was also testimony that the information was "continually changing and updated" and had a "short shelf life."

© Zach Wolfe (2021)

In *StoneCoat of Texas, LLC v. ProCal Stone Design, LLC*, 426 F. Supp. 3d 311, 353 (E.D. Tex. 2019), the court said the "Plaintiffs fail to address the reasonableness of the five year period in the non-compete provision, which is on the far end of what Texas courts have found reasonable." Also noting the absence of any geographic limitation, the court found the scope of the non-compete unreasonable and granted summary judgment for the defendants. *Id*.

9.3 Is reformation available when there is no time limitation?

In *W&O Supply, Inc. v. Pitre*, No. 4:19-CV-00153, 2019 WL 15592090 (S.D. Tex. Apr. 10, 2019), the non-competes had no time limitation. The legal question was whether W&O was entitled to reformation. Specifically, should the judge effectively "rewrite" the agreement to add a reasonable time limitation?

Let's start with the text of the statute. It says, in pertinent part:

> If the covenant . . . contains limitations as to 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 goodwill or other business interest of the promisee, the court shall reform the covenant to the extent necessary to cause the limitations contained in the covenant as to time, geographical area, and scope of activity to be restrained to be reasonable . . .

The "shall reform" language indicates the legislature intended reformation to be mandatory. But the clause starts with a significant "if." Reformation is only mandatory *if* the non-compete "contains limitations as to time, geographical area, or scope of activity to be restrained . . ."

That "if" clause is a condition precedent. That means the rest of the clause only applies if the condition is met.

So, if a non-compete has limitations that are unreasonably broad, the condition precedent applies, and reformation is mandatory. But if the non-compete has no time limitation whatsoever, then the condition precedent does not apply, and reformation is not required.

At least that's what the employees in *W&O Supply* argued, and the judge agreed:

> It is the Court's view that it is empowered only to reform existing terms. Where the Agreement lacks a critical term, such as a time limitation, placing a time limitation in the Agreement is to rewrite the Agreement.

© Zach Wolfe (2021)

> The Agreement lacks an unenforceable provision that the Court can revise; therefore, reformation is impermissible.

W&O Supply, 2019 WL 15592090 at *3.

The unavailability of reformation was not academic. Because the non-competes were unenforceable and could not be reformed, the court not only denied a preliminary injunction, it *dismissed* the lawsuit. *Id*.

Ok, then why is the availability of reformation an unanswered question?

Well, *W&O Supply* is just one case, and there are other arguments that could be made.

First, you could argue that *W&O Supply* reads the non-compete statute too literally. The purpose of the statute is to provide for reformation of overbroad non-competes. One might argue that reformation should be just as available when the agreement lacks a limitation as when the limitation is too broad.

Second, there are cases saying the court can enter a preliminary or temporary injunction enforcing an overbroad non-compete to a limited extent. *See, e.g., Transperfect Translations, Inc. v. Leslie*, 594 F.Supp.2d 742, 756 (S.D. Tex. 2009) (noting uncertainty in Texas cases and holding that non-compete would be temporarily reformed for purpose of preliminary injunction).

Third, the statue also requires a geographic limitation. *See Tranter Inc. v. Liss*, No. 02-13-00167-CV, 2014 WL 1257278, at *5 (Tex. App.—Fort Worth Mar. 27, 2014) (non-compete that contained no geographic restriction at all was unreasonable and unenforceable as written). But there are cases enforcing non-competes that contain no geographic limitation whatsoever. *See Gallagher Healthcare Ins. Servs. v. Vogelsang*, 312 S.W.3d 640, 654-55 (Tex. App.—Houston [1st Dist.] 2009, pet. denied) ("A number of courts have held that a non-compete covenant that is limited to the employee's clients is a reasonable alternative to a geographical limit").

If the absence of a geographic limitation is not fatal to a non-compete, why should the absence of a time limitation be any different?

9.4 Are "tolling" clauses enforceable?

A tolling clause extends the time period of the non-compete by the time that the employee was violating the non-compete. So, for example, if an employee competes for six months before a court enters an injunction to stop the competition, the time period of the non-compete would be extended by six months.

The upside to the employer is obvious. The downside is that it gives the employee an argument that the time period is indefinite and unenforceable. *See Central States Logistics, Inc. v. BOC Trucking, LLC*, 573 S.W.3d 269, 277 (Tex. App.—Houston [1st Dist.] 2018, pet. denied) (citing *Cardinal Personnel, Inc. v. Schneider*, 544 S.W.2d 845 (Tex. App.—Houston [14th Dist.] 1976, no writ)).

The issue isn't totally settled under Texas law, so if you're drafting a non-compete you can include a tolling clause if you want, but why complicate the time period unnecessarily?

10. The reasonable geographic limitation requirement for non-competes

The Texas non-compete statute requires a non-compete to have a reasonable limitation as to "geographical area." Tex. Bus. & Com. Code § 15.50(a). A reasonable geographic limitation is one that does not "impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee." *See id*.

This is the general rule for the geographic limitation of a Texas non-compete. It's pretty simple, but to understand how it applies in practice, you have to look at the "sub-rules" established by the case law.

The case law applying the reasonable geographic area requirement can be summarized in these general sub-rules:

1. Non-executive + no geographic limitation = probably unreasonable

2. Non-executive + ill-defined geographic limitation = probably unreasonable

3. Non-executive + well-defined geographic area broader than sales territory = probably unreasonable

4. Non-executive + geographic area basically matching sales territory = probably reasonable

5. High-level executive + no geographic limitation = possibly reasonable if there is a reasonable limitation on scope in lieu of a geographic limitation

6. High-level executive + broad geographic area = probably reasonable if the executive was responsible for that area, knows confidential information about customers in that area, and/or the agreement has a reasonable limit on scope

7. You can't *expand* the geographic limitation after the fact.

© Zach Wolfe (2021)

These are, of course, just general rules. In each case, the rationale for the rule is protecting customer goodwill. But what's the connection between customer goodwill and a geographic limitation?

10.1 The traditional connection between physical proximity and customer goodwill

This is perhaps the most old-fashioned part of Texas non-compete law. It hearkens back to a time when physical proximity was the key to a salesman maintaining goodwill with the customer.

Consider *Randolph v. Graham*, 254 S.W. 402, 403-4 (Tex. App.—San Antonio 1923, writ ref'd), where the court held that a medical practice non-compete was reasonable and enforceable, despite having no time limitation, where it was limited to practicing medicine within a 20-mile radius of Schertz, Texas.

The court didn't explain *why* the geographic area was reasonable, but it's easy to understand. People like to go to a doctor with an office near them. So, if a doctor sells his practice in Schertz and moves to Austin, it is unlikely his patients will follow him to Austin. A 20-mile radius sounds about right to prevent the doctor from taking advantage of the goodwill he developed with his patients.

Two years later, the geographic limitation requirement took shape in *City Ice Delivery Co. v. Evans*, 275 S.W. 87 (Tex. Civ. App.—Dallas 1925, no writ). The court said the test for enforceability of a non-compete in an employment contract was whether it imposed "any greater restraint than is reasonably necessary to secure protection of the business of the employer or the good will thereof." *Id*. at 90.

Applying this principle to the geographic area of the non-compete, the court held that the employer was entitled to an injunction against the employee competing in the ice delivery business in the territory where he had delivered ice to the company's customers. But the company was not entitled to an injunction against competition outside of the territory, where the company had no goodwill based on the employee's "personal contact" with customers. *Id*.

Again, we can see why it made sense to limit the non-compete to the employee's delivery area. In a business that involves physical delivery of the product to the customer, it was unlikely that a salesman was going to develop goodwill with customers outside his delivery area. Especially in 1925, when the ice could melt if you had to go too far to deliver it.

So there you have it. Two keys to the geographic area requirement: (1) it should be limited to the territory where the employee interacted with customers, because (2)

© Zach Wolfe (2021)

that is the area where the employee developed goodwill with the customers on behalf of the company.

64 years later, the Texas legislature enacted the 1989 non-compete statute. As noted earlier, it provides that a non-compete must contain limitations as to time, geographical area, and scope of activity to be restrained that are "reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee." Tex. Bus. & Com. Code § 15.50(a).

How have Texas courts interpreted the statute's reasonable geographic area requirement? In principle, not much has changed since *City Ice Delivery*.

10.2 The Sales Territory principle

In most cases, where the employee worked in some kind of customer-facing sales role within a defined territory, the reasonableness of the geographic area will turn on whether it matches the employee's sales territory. Let's call this the Sales Territory principle.

When the case involves a sales person or other low to mid-level employee, the Sales Territory principle will usually explain why the court found the geographic area reasonable or unreasonable. In other words, the Sales Territory principle usually applies when the case does not involve a high-level executive. That leads to our first general rule.

10.3 Non-executive + no geographic limitation = probably unreasonable

The easiest cases are those involving a non-executive who has a non-compete with no geographic limitation.

One of the first cases to apply the statute's geographic area requirement was *Zep Manufacturing Co. v. Harthcock*, 824 S.W.2d 654 (Tex. App.—Dallas 1992, no writ). That case involved a non-compete between Zep, an industrial chemical manufacturer, and Harthcock, an industrial chemist. *Id.* at 656-57. Harthcock's non-compete barred him from performing services similar to those he performed for Zep for two years following termination, with no geographic limitation. *Id.* at 660.

The court cited the general principle that "what constitutes a reasonable area generally is considered to be the territory in which the employee worked while in the employment of his employer," citing two pre-statute cases. *Id.* (citing *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 685 (Tex. 1973), and *Diversified Human Resources Group v. Levinson-Polakoff*, 752 S.W.2d 8, 12 (Tex. App.—Dallas 1988, no writ)).

© Zach Wolfe (2021)

The court then said the non-compete failed to comply with the statute because it contained no limitation as to geographic area. *Id.* at 661. Thus, the non-compete would prohibit Harthcock from working as an industrial chemist anywhere, regardless of whether it was in an area not serviced by Zep or not serviced by Harthcock during his employment with Zep.

"Noncompete covenants with broad geographical scopes have been held unenforceable," the court said "particularly when no evidence establishes that the employee actually worked in all areas covered by the covenant." Because the non-compete contained no geographic restriction, the court held it was unenforceable. *Id.*

But today, most Texas lawyers are smart enough to include *some* geographic limitation in the non-compete. What then?

10.4 Non-executive + ill-defined geographic limitation = probably unreasonable

If the non-compete has some geographic limitation, but it is so broad or vague that it has no connection to protecting the goodwill developed by the employee, it is probably unreasonable.

For example, in *TENS Rx, Inc. v. Hanis*, No. 09-18-00217-CV, 2019 WL 6598174, at *1 (Tex. App.—Beaumont Dec. 5, 2019, no pet.) (mem. op.), the non-compete applied "in any state or geographical territory in which Employer is conducting, has conducted or anticipates conducting is business."

The employee filed a motion for summary judgment that the non-compete was unenforceable because the geographic limitation and scope of activity restrained were unreasonable. *Id.* at *2. The employer argued that the employee was bound by the contractual stipulation that the geographic restriction was reasonable, stating it was "disingenuous" for the employee to now assert the contrary. *Id.* at *3.

Lawyers for the first employer love to argue that the employee is somehow being dishonest or "disingenuous" when the non-compete recites that its limitations are reasonable and the employee later takes a contrary position. I don't find this persuasive. Almost every non-compete contains self-serving recitals like this. Even when I'm representing the employer trying to enforce the non-compete, I would rather just demonstrate that the limitation is reasonable than play this game.

In any case, the trial court in *TENS Rx* didn't buy the "disingenuous" argument. It granted summary judgment that the non-compete was unreasonable in geographic scope and scope of activity restrained. *Id.*

© Zach Wolfe (2021)

Because the non-compete related to provision of personal services, the employer had the burden to prove the non-compete was reasonable. *Id.* at *4. On appeal, the employer cited no authority that the restrictions were reasonable, instead merely arguing that the employee was bound by the contract's stipulation that the restrictions were reasonable. *Id.* at *4. The court appeared to reject this argument, instead looking to Texas case law on reasonableness of a geographic limitation. *Id.*

The question is "whether the covenant contains limitations that are reasonable as to geographical area and do not 'impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.'" *Id.* (citing *Marsh USA Inc. v. Cook*, 354 S.W.3d 764, 777 (Tex. 2011)).

"The territory in which the employee worked for an employer is generally considered to be the benchmark of a reasonable geographic restriction," the court said. *Id.* (citing *Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 793 (Tex. App.—Houston [1st Dist.] 2001, no pet.), and *Zep Mfg. Co. v. Harthcock*, 824 S.W.2d 654, 660 (Tex. App.—Dallas 1992, no writ)). "Noncompete covenants with broad geographical scopes have been held unenforceable, particularly when no evidence establishes that the employee actually worked in all areas covered by the covenant." *Id.* (citing *Zep Mfg. Co.*, 824 S.W.2d at 661).

"Here, there is no definite territory stated and no evidence that Hanis worked in all areas covered by the covenant," the court said. "It is also unreasonable to impose a condition upon Hanis that would require her to know where TENS 'anticipates doing its business.'" *Id.*, citing *Cobb v. Caye Publ'g Grp., Inc.*, 322 S.W.3d 780, 785 (Tex. App.—Fort Worth 2010, no pet.) ("The parties have not cited, and we have not found, a case in which a geographical limitation including areas where an employer does not currently operate but has targeted for future potential expansion, standing alone, is reasonable.").

The *TENS Rx* case shows the risk of making the geographic limitation too abstract. There is some logic to defining the area as "the employee's sales territory," for example. What better way to comply with the Sales Territory principle? But the risk of defining the geographic area this way is that the court may say it is too indefinite. How are the employee—and the court—to know what the sales territory is if it is not stated in the contract?

On the other hand, the company may not know in advance what the employee's sales territory will be. What if the employee works for the company for over a decade and the territory changes? I don't have any foolproof solution to this problem, other than to say that the better practice is usually to include a specific geographic area that predicts, as well as the company can, what the employee's likely sales territory will be.

© Zach Wolfe (2021)

Let's say the employer tries to do that and limits the non-compete to a specific, concrete geographic area, such as "within Harris County, Texas and surrounding counties." Is that reasonable? It will probably depend on the employee's actual sales territory, which leads us to the next general rule.

10.5 Non-executive + well-defined geographic area broader than sales territory = probably unreasonable

When the employee is not a high-level executive and the non-compete has a specific geographic area, the question will be whether the geographic area is broader than the employee's actual sales territory.

This creates an obvious problem. Dozens of Texas cases say that the reasonableness of a non-compete is a question of law. But how can a judge decide the reasonableness of the non-compete's geographic area without considering extrinsic evidence regarding the facts?

Suppose the non-compete's stated geographic area is "within Harris County, Texas and surrounding counties." On a motion for summary judgment, the Employee signs a sworn affidavit stating "my sales territory was only Harris County," while the Employer's CEO signs a sworn affidavit stating "Employee's sales territory included Harris County and all the surrounding counties." In other words, conflicting evidence. How can the trial court decide that issue as a question of law?

It can't. And this illustrates why Texas courts are simply wrong when they declare that the reasonableness of a geographic limitation is always a question of law. (See the section on "question of law" above.) On the other hand, if the facts regarding the employee's sales territory are undisputed, then the reasonableness of the geographic area could present a question of law for the court.

Consider *Fomine v. Barrett*, No. 01-17-00401-CV, 2018 WL 6376500, at *1 (Tex. App.—Houston [1st Dist.] Dec. 6, 2018, no pet.), which prohibited a chiropractic case manager from competing within a 500-mile radius of the clinic's location. The former case manager, Barrett, moved for summary judgment that the geographic limitation was unreasonable, extending beyond her work responsibilities for the clinic. *Id*. at *2.

The Court of Appeals affirmed summary judgment for Barrett. The court began by citing the Sales Territory principle, i.e. "[t]he territory in which an employee worked for an employer is generally considered to be the benchmark of a reasonable geographic restriction." *Id*. at *3.

The clinic argued that a 500-mile radius was reasonable because Barrett marketed to patients throughout the State of Texas, but the court rejected this argument. Even assuming Barrett's sales territory included all of Texas, a 500-mile radius would include all of Louisiana and significant portions of Alabama, Arkansas, Mississippi, Oklahoma, and Mexico. *Id.* at *3. The geographic scope was therefore "significantly broader" than the geographic scope of Barrett's employment with the clinic, and the non-compete was therefore unenforceable as written. *Id.* at *4.

Fomine shows the importance of the employer offering evidence that an employee responsible for generating sales actually worked in the entire geographic area stated in the non-compete. Otherwise, the area will be found broader than necessary to protect the employer's goodwill.

A typical application of the Sales Territory principle can be found in *Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787 (Tex. App.—Houston [1st Dist.] 2001, no pet.). Arrow's primary business was making and installing shower stalls and mirrors for new home builders; Butler was Arrow's Operations Manager. *Id.* at 790. Butler's non-compete covered Harris and six surrounding counties. *Id.* 793. He worked in the Houston office, was the "front line" of the company's customer service, and talked to builders over the phone.

Considering the majority of customers Butler interacted with were in Harris and Fort Bend Counties, the Court of Appeals found the geographic area overbroad as written, but held that the trial court properly reformed the geographical area to include only Harris and Fort Bend Counties. *Id.* at 794. In other words, the *Butler* court enforced the Sales Territory principle.

The Sales Territory principle can also apply when the defendant is not a sales employee. *Ortega v. Abel*, 562 S.W.3d 604 (Tex. App.—Houston [1st Dist.] 2018, pet. denied), was a non-compete case involving the sale of a Hispanic-themed grocery store chain. The geographic area was a 10-mile radius from each of the five stores sold, which equated to most of the Greater Houston area. *Id.* at 611. The defendants' expert testified that a three-mile radius would be more than sufficient to protect the goodwill of each store, reasoning that people in a city like Houston rarely travel more than 10 to 12 minutes to go to the grocery store. *Id.* The plaintiff, Ortega, did not present any evidence to contradict this testimony. *Id.* at 612.

The Court of Appeals held that the evidence was sufficient to support the trial court's determination that the 10-mile radius in the non-compete was not reasonable and imposed a greater restraint than necessary to protect Ortega's goodwill and other business interests. *Id.* The court reasoned that "[t]he goal of a covenant not to compete is to establish the restraints on trade *reasonably* necessary to protect the goodwill or other business interest of the promise, not to prevent *any* competition." *Id.* The expert's testimony supported the trial court's conclusion that a 3-mile radius was sufficient. *Id.*

© Zach Wolfe (2021)

Similarly, in *TransPerfect Translations, Inc. v. Leslie*, 594 F. Supp. 2d 742, 754-55 (S.D. Tex. 2009), the court held that a large geographic area was unreasonably broad where the salesman worked nationwide but was not part of upper management.

10.6 Non-executive + geographic area basically matching sales territory = probably reasonable

The next application of the Sales Territory principle is where the employee is a sales person or other lower to mid-level employee, and it is undisputed that the geographic area matches the sales territory the employee actually worked (or is at least pretty close).

That presents a fairly easy case for the court to hold that the geographic area is reasonable.

For example, in *Gehrke v. Merritt Hawkins & Associates, LLC*, No. 05-18-001160-CV, 2020 WL 400175, at *4 (Tex. App.—Dallas Jan. 23, 2020, no pet. h.), the non-compete between a national physician recruiting firm and a salesman prohibited competition in states in which the salesman worked during his last year with the firm. The court held that the multi-state geographic restriction was enforceable because the salesman actually worked within those states. *Id. See also Curtis v. Ziff Energy Grp.,* 12 S.W.3d 114, 119 (Tex. App.—Houston [14th Dist.] 1999, no pet.) (court found six-month restriction for North America for VP of Pipelines and Energy Marketing reasonable, citing the Sales Territory principle).

But of course, not every case involves the typical sales employee who is responsible for a certain territory? What about cases where physical territory is not important, or where the employee is a high-level executive

In such cases, the Sales Territory principle may be less useful, and Texas courts may be more likely to follow what I call the Holistic Rule. The Holistic Rule considers the reasonableness of the geographic limitation not in isolation, but in combination with other factors, such as the employee's rank in the company, the employee's knowledge of high-level confidential information, the nature of the business, and perhaps most important, the scope of activity restrained by the non-compete.

This leads us to the next sub-rule.

© Zach Wolfe (2021)

10.7 No geographic limitation or broad geographic limitation + non-compete limited to existing customers = probably reasonable

The Sales Territory principle was rooted in the idea that customer goodwill is usually tied to a certain geographic territory. This idea goes back at least as far as the *City Ice Delivery* case in the 1920s. But Texas courts also recognized decades ago that even a non-compete with no geographic limitation at all can be reasonably limited to protecting customer goodwill, if the scope of activity it restrains is narrow.

Consider *Stocks v. Banner American Corp.*, 599 S.W.2d 665 (Tex. Civ. App.—Texarkana 1980, no writ). Stocks sold his stock in Banner and agreed not to compete with Banner for three years. Banner's business included manufacturing selling blank cassette tapes, selling blank labels for cassette tapes, and custom duplication of cassette tapes. Banner's customers included Tandy Corporation and Apple Computers. *Id*. at 666.

Stocks apparently could not leave the cassette game behind, because he somehow became an owner of Xalon Corporation. Despite the lack of any geographic limitation in the non-compete, the trial court enjoined Stocks and Xalon Corporation from doing business with Tandy, Apple, or a list of other Banner customers. *Id*. at 666-67.

The Court of Appeals found that the lack of a geographic area was not fatal to the non-compete. *See id*. at 667 ("Failure to include a territorial limitation will not void a covenant to compete"). The court cited *Justin Belt Company, Inc. v. Yost*, 502 S.W.2d 681 (Tex. 1973), where the court held that a non-compete that was "unlimited both as to time and to space" could be enforced to a reasonable extent. *Id*. The court also reasoned that non-competes may be construed more broadly in the sale of a business than in an employment relationship. *Id*. (citing *Seline v. Baker*, 536 S.W.2d 631 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ)).

Thus, the non-compete could be enforced *to some extent*, despite the lack of a geographic limitation. But to what extent? The *Stocks* court cited two cases approving injunctions limited to prohibiting a former employee from contacting certain listed customers. *Id*. at 667-68 (citing *Toch v. Eric Schuster Corp.*, 490 S.W.2d 618 (Tex. Civ. App.—Dallas 1972, writ ref'd n.r.e.), and *Arrow Chem. Corp. v. Anderson*, 386 S.W.2d 309 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.)). The takeaway was that "[t]he use of a customer list as an alternative to setting a specific geographical limit is a reasonable means of enforcing a covenant not to compete." *Id*. at 668.

From the *Stocks* rule we can deduce this common-law principle of Texas non-compete law: a non-compete that is limited to prohibiting a former employee or owner from doing business with the company's existing customers may be reasonable and enforceable even if it lacks a geographic limitation. *See also Investors Diversified*

Servs., Inc. v. McElroy, 645 S.W.2d 338, 339 (Tex. App.—Corpus Christi 1982, no writ) (non-compete limited to clients securities salesmen contacted or learned about while working for company was enforceable despite lack of defined territory).

The logic of the rule is that the point of the geographic limitation was to protect customer goodwill. If the non-compete is otherwise limited to protecting customer goodwill—because it is limited to the company's existing customers—then a geographic limitation may not be necessary. This is the most basic formulation of the Holistic Rule.

But this was a common-law rule. Did the *Stocks* rule survive the enactment of the Texas non-compete in 1989?

Even though the statute expressly requires a geographical limitation, Texas courts continued to hold that a geographic limitation may be unnecessary if the scope of activity restrained is sufficiently narrow.

In *Totino v. Alexander & Associates, Inc.*, No. 01-97-01204-CV, 1998 WL 552818 (Tex. App.—Dallas Aug. 20, 1998), former employees of an insurance brokerage argued that the their non-competes violated the statute because they contained no geographic limitation, but the court rejected this argument. *Id.* at *3. The statute's reasonable geographic restriction parallels a similar common-law requirement, the court reasoned, and Texas courts had held that a geographic limitation was not necessary where the non-compete was limited to clients the former employee had contact with. *Id.* at *3-4 (citing *McElroy* and *Stocks*). The non-compete "implicitly" contained a reasonable geographic restriction because it was limited to clients of the brokerage. *Id.* at *4.

The First Court of Appeals followed the same approach in *Gallagher Healthcare Insurance Services v. Vogelsang*, 312 S.W.3d 640 (Tex. App.—Houston [1st Dist.] 2009, pet. denied). The non-compete in *Gallagher* had no geographic limitation, but it was limited to clients the employee had worked with in her last two years at the company. *Id.* at 654. "A number of courts have held that a non-compete covenant that is limited to the employee's clients is a reasonable alternative to a geographical limit," the court said, citing *Stocks*, *Totino*, and *McElroy*. *Id.* at 654-55. The court held the limitation to clients the employee worked with while employed by the company was a "reasonable alternative to geographical area." *Id.* at 655.

As these cases illustrate, the scope of activity restrained is usually a more important factor than geographic area. Even a non-compete that has a reasonable geographic area will be unenforceable if the scope of activity restrained is too broad.

The employee's position in the company is also an important factor, which leads to the next sub-rule.

© Zach Wolfe (2021)

10.8 No geographic limitation or broad geographic limitation + non-compete *not* limited to specified customers + high-level executive = It depends

We have seen that a broad geographic area—or even the lack of any geographic area—may be found reasonable if the non-compete is limited to existing clients or customers. But what if the non-compete is *not* limited to existing clients or customers?

This is where it gets hard. In a case like this, other factors, such as the employee's rank in the company and knowledge of the company's confidential information, become more important.

Judge Ellison considered the issue in detail in *M-I LLC v. Stelly*, 733 F. Supp. 2d 759 (S.D. Tex. 2010). In that case, Knobloch resigned from his position as Manager of Sales for the Americas at M-I, an oilfield services company. He started his own oilfield services company and allegedly started "raiding" employees from M-I. *Id*. at 769-70.

Knobloch's non-compete restricted doing business with existing M-I customers, but it did not end there. Like many non-competes, it also prohibited Knobloch from engaging in any business "involving oilfield displacement tools or services or any other businesses then conducted by Employer." *Id*. at 794. These restrictions applied "in any geographic area" where the company did business, which effectively meant North America, South America, and the Caribbean. *Id*. at 797.

Knobloch argued that his non-compete was unenforceable because the geographic area was too broad, but Judge Ellison disagreed, citing his own formulation of the Holistic Rule. "[N]on-compete covenants with restrictions covering a wide geographic area may be reasonable if they are limited in scope to a firm's current or prospective clients such that they do not pose a greater restraint than necessary to protect the firm's goodwill," he said, citing his own opinion in *TransPerfect Translations*. *Id*. at 797-98.

He also cited a version of the Sales Territory principle: "Covenants with wide geographic areas have been upheld frequently in Texas courts, especially when the area covered constitutes the employee's actual sales or work territory." *Id*. at 798.

Applying these rules, Judge Ellison acknowledged that "a geographic area covering the Western hemisphere is broad, reaching to the outer limits of a restriction." But he ruled that this broad geographic area was reasonable, even where the non-compete was not limited to existing customers, where:

- Knobloch had "extensive job responsibilities" and held a position in "upper management" (Manager of Sales for the Americas). He was "much more than

© Zach Wolfe (2021)

a manager and salesman for his former employer." He oversaw the company's "relationships with major international clients."

- His actual territory did span the Americas.

- Knobloch knew the company's technical confidential information: "An engineer by training, Knobloch participated in the design of [the company's] tools and in facilitating wellbore completions. He delivered technical presentations internationally, formulated company growth strategies, and discussed product development with engineers."

Id. at 798-99.

In short, in *M-I v. Stelly* the geographic area covering the entire Western hemisphere was reasonable where the employee was a high-level executive, he was actually responsible for that territory, and he had knowledge of the company's confidential technical information.

Texas cases since *M-I v. Stelly* have tended to find broad geographic areas reasonable when the former employee was a high-level executive.

Consider *Daily Instruments Corp. v. Heidt*, 998 F. Supp. 2d 553 (S.D. Tex. 2014). In that case, the non-compete broadly applied to the United States and any country in which Daily Instruments did business. *Id*. at 567. Daily Instruments specialized in the narrow field of reactor thermometry, which involved electrical temperature measurement devices used in reactors for the refining, chemical, and petrochemical industries. *Id*. at 557.

The court found the non-compete reasonable for three reasons. First, the employee was a high-level sales manager with responsibility for a very large territory and with access to the company's confidential information regarding worldwide clients and sales. *Id*. at 567-68. Second, the field of reactor thermometry was very narrow, with a narrow customer base, few competitors, and a global scale. *Id*. at 568. Third, the non-compete had a reasonable limitation on scope because it did not bar the employee from working in the industry, but only from performing the kind of work he had performed in his last two years of employment in the narrow field of reactor thermometry products, and from disclosing confidential information. *Id*.

Similarly, in *Ameripath, Inc. v. Hebert*, 447 S.W.3d 319, 335 (Tex. App.—Dallas 2014, pet. denied), the court found a broad geographic area reasonable considering the employee was a member of employer's "highest level management team." The employee cited the Sales Territory Rule and argued that he only worked in two counties, while the geographic scope of the non-compete was much broader. *Id*.

© Zach Wolfe (2021)

But the court said "the breadth of enforceable geographical restrictions in covenants not to compete must depend on the nature and extent of the employer's business and the degree of the employee's involvement in that business." *Id.* (citing *Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 793 (Tex. App.—Houston [1st Dist.] 2001, no pet.). The restriction on working anywhere for a company that operated in the Dallas-Fort Worth area was reasonable, the court reasoned, because the employee's "management knowledge of and experience with [the company's] Dallas-area operations would be valuable to his new employer."

And in *McKissock, LLC v. Martin*, 267 F. Supp. 3d 841, 856-57 (W.D. Tex. 2016), the court found a nationwide geographic area reasonable, where the company had a national customer base, the employee taught online courses available to the national customer base, and the employee held an upper-level position as Senior Appraisal Instructor.

10.9 Does a restriction on soliciting employees require a geographic limitation?

Does a restriction on soliciting *employees*, as opposed to customers, require a geographic limitation? In *Smith v. Nerium Int'l, LLC*, No. 05-18-00617-CV, 2019 WL 3543583, at *7 (Tex. App.—Dallas Aug. 5, 2019, no pet. h.) (mem. op.), the court said no. The court acknowledged cases holding that a non-compete with no geographic limitation is unenforceable but distinguished such cases as involving typical covenants not to compete for the former employer's *customers or clients*. *Id.* at *9. Given the company's interest in protecting its salesforce and goodwill, the court held that the restriction on soliciting the company's employees was a "reasonable alternative" to a geographic limitation. *Id.*

11. The reasonable scope requirement for non-competes

The non-compete statute requires that the non-compete contain limitations on scope of activity restrained that are "reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee." Tex. Bus. & Com. Code § 15.50(a). Texas courts have interpreted this to mean that a non-compete may not prohibit an employee from working in the company's industry in any capacity, i.e. an "industry-wide exclusion" is generally considered unreasonable.

11.1 The industry-wide exclusion rule

The post-statute industry-wide exclusion rule comes from *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381 (Tex. 1991), which arose from a suit that was already being litigated when the 1989 statute was adopted.

© Zach Wolfe (2021)

In *Haass* the Texas Supreme Court cited the Texas common-law rule that a non-compete must not be greater than necessary to protect the employer's legitimate interests such as goodwill and confidential information. *Id.* at 386. The court reasoned that the "fundamental legitimate business interest" protected by a non-compete is "preventing employees or departing partners from using the business contacts and rapport established during the relationship . . . to take the firm's customers with him." *Id.* The court also approvingly cited a Wisconsin case stating that "the restrictive covenant must bear some relation to the activities of the employee." *Id.* at 387.

The *Haass* court held that the non-compete was overbroad unreasonable because it inhibited departing partners from providing accounting services to clients acquired after the partner left, or with whom the accountant had no contact while associated with the firm, which was not reasonably necessary to protect the firm's goodwill. *Id.* at 388.

Haass did not use the term "industry-wide exclusion," but the Fourteenth Court of Appeals later cited *Haass* for the proposition that "[t]he Texas Supreme Court has held that an industry-wide exclusion is unreasonable." *John R. Ray & Sons, Inc. v. Stroman*, 923 S.W.2d 80, 85 (Tex. App.—Houston [14th Dist.] 1996, writ denied) "In the case of covenants applied to a personal services occupation, such as that of a salesman," the court said, "a restraint on client solicitation is overbroad and unreasonable when it extends to clients with whom the employee had no dealings during his employment." *Id.*

Applying both parts of the rule, the *Stroman* court held that the non-compete was unenforceable because it imposed an industry-wide exclusion on the employee's ability to work in the insurance business in and around Harris County and extended to customers the employee had no association with while working for the employer. *Id*.

The First Court of Appeals applied *Haass* and *Stroman* to the oilfield services industry in *Brown Services, Inc. v. Brown*, No. 01-98-00304-CV, 1999 WL 681964 (Tex. App.—Houston [1st Dist.] Sept. 2, 1999, pet. denied). First, the court held that a clause barring the employee from being connected to any oilfield services business was an overbroad industry-wide exclusion. *Id.* at *6. Second, the court held that a clause barring the employee from soliciting or selling products or services to anyone who was a customer of the employer during his employment was overbroad, because it was not limited to customers he had contact with. *Id.* at *7.

Similarly, in *Wright v. Sport Supply Group, Inc.*, 137 S.W.3d 289, 298 (Tex. App.—Beaumont 2004, no pet.), the court cited *Haas* and *Stroman* for the propositions that "[a] covenant not to compete that contains an industry-wide exclusion from subsequent employment is unenforceable," and "a covenant not to

© Zach Wolfe (2021)

compete that extends to clients with whom a salesman had no dealings during his employment is unenforceable." The court held that the agreement at issue was overbroad and unenforceable because it was not limited to customers the employee had dealings with while employed by the company. *Id.*

Wright also cited *Haass* for the principle that "[a] restrictive covenant is unreasonable unless it bears some relation to the activities of the employee." *Id.* You might call this the "janitor corollary" of the industry-wide exclusion rule. The idea is that a non-compete that would bar a salesman from working for a competitor as a janitor would be unreasonably broad.

Four years later the Beaumont Court of Appeals considered whether the Texas Supreme Court's intervening decision in *Sheshunoff* changed the industry-wide exclusion rule applied in *Poole v. U.S. Money Reserve, Inc.*, No. 09-08-137CV, 2008 WL 4735602, at *8 (Tex. App.—Beaumont 2008, no pet.) (mem. op.). The *Poole* court said that *Sheshunoff* was distinguishable because it only prevented the employee from soliciting prior clients with whom he had personal contact or any previously identified prospective client. Thus, the court reasoned, *Sheshunoff* did not change the industry-wide exclusion rule. *Id.*

In another post-*Sheshunoff* case, *CDX Holdings, Inc. v. Heddon*, No. 3:12-CV-126-N, 2012 WL 11019355, at *10 (N.D. Tex. March 2, 2012), the court held that the scope of activity restrained was overbroad, where the non-compete applied to all anatomic pathology work performed by the employer, even though the employee's work exclusively involved dermatopathology.

In *Weber Aircraft, L.L.C. v. Krishnamurthy*, No. 4:12-CV-666, 2014 WL 12521297 (E.D. Tex. Jan. 27, 2014), the non-compete barred the employees from working for a company providing the same products (seating products and components) as the employer or working for five specific competitors in any capacity. Citing *Wright*, the court held that a restriction barring the employees from working for five competitors, "even in a position that would not require [the employees] to use any of [the employer's] confidential information, such as a janitor position," was unreasonably broad. *Id.* at *8.

The Fifth Circuit weighed in on the industry-wide exclusion rule in *D'Onofrio v. Vacation Publications, Inc.*, 888 F.3d 197, 211-12 (5th Cir. 2018), where it applied *Haass* and *Stroman* to a non-compete involving the travel industry. The court held that the non-compete as written was unenforceable because the covenants "amount to an industry-wide restriction—preventing former employees from working in any job related to the sales or marketing of not just cruises, but also a host of other travel products—and are not limited as to either geography or clients with whom former employees actually worked during their employment." *Id.* at 212.

© Zach Wolfe (2021)

Thus, the industry-wide exclusion rule appears to be alive and well in Texas today—in several forms. But the rule has its limits.

11.2 Limits to the industry-wide exclusion rule

The industry-wide exclusion rule can provide a powerful argument for the party seeking to avoid enforcement of a non-compete, but it has its limits, as the cases discussed below illustrate.

11.2.1. When the non-compete does not prohibit working in the industry

A non-compete that *is* limited to customers the employee did business with does not run afoul of the industry-wide exclusion rule. In *Gallagher Healthcare Insurance Services v. Vogelsang*, 312 S.W.3d 640 (Tex. App.—Houston [1st Dist.] 2009, pet. denied), the court approvingly cited the industry-wide exclusion rule of *Haas* and *Stroman*, *id*. at 654, but the court held that the non-compete at issue did not violate the rule, because "[u]nlike some covenants not to compete that preclude the employee from working in the same industry, the agreement here does not limit [the employee] from working in the insurance business." *Id*. at 655.

Similarly, in *Stone v. Griffin Communications & Security Systems, Inc.*, 53 S.W.3d 687, 694 (Tex. App.—Tyler 2001, no writ), the court held that a non-solicitation clause limited only to customers the employees had contact with while employed by the employer was reasonable.

11.2.2 When the "industry" is broader than the company's niche

What exactly is the "industry" for purposes of the industry-wide exclusion rule? In *M-I LLC v. Stelly*, 733 F.Supp.2d 759, 794 (S.D. Tex. 2010), the non-compete applied to any customer or potential customer of the employer in the business of oilfield displacement tools or services. The employee argued this was an impermissible industry-wide exclusion. *Id*. The company argued the non-compete only applied to well completion services, not the oil and gas industry generally, and therefore was not an "industry-wide" ban. *Id*. at 796.

The court sided with the employer. The court distinguished Stroman as involving a bar on the insurance business generally, while the non-compete in *Stelly* did not apply to the entire oil and gas industry. *Id*. at 796. Considering the "industry" to be the oil and gas industry, not the "niche" services offered by the employer, the court held that the non-compete did not impose an impermissible industry-wide exclusion, but instead limited its scope to a reasonably narrow business area that correlated to the employee's work for the company. *Id*. at 797.

© Zach Wolfe (2021)

In *Salas v. Chris Christensen Systems, Inc.*, No. 10-11-00107-CV, 2011 WL 4089999, at *20 (Tex. App.—Waco Sept. 14, 2011, no pet.), the court held that a non-compete that applied to the "pet supply manufacturing and distribution industry" did not apply to "the entire industry pertaining to pets or pet products, where the employee was free to return to his previous work as a dog handler and groomer."

And in *Merritt Hawkins & Associates, LLC v. Gresham*, 79 F.Supp.3d 625, 641 (N.D. Tex. 2015), the court held that a non-compete applying to permanent and temporary medical staffing was not an industry-wide exclusion, where it did not prohibit the employee from working in "other sections of the staffing industry or the medical industry."

11.2.3. When the evidence does not show the restriction amounts to an industry-wide exclusion

The industry-wide exclusion rule may not apply if the employee fails to offer evidence that a prohibition of being associated with any "competitor" of the company actually amounts to an industry-wide exclusion. That was the problem for the employee in *Republic Services, Inc. v. Rodriguez*, No. 14-12-01054-CV, 2014 WL 2936172 (Tex. App.—Houston [14th Dist.] 2014, no pet.) (mem. op.).

In that case, the court held that *Stroman* did not apply absent evidence that the "competitor" scope of the non-compete was "tantamount to an industry-wide prohibition." *Id.* at *8. The employee offered no evidence about the industry at issue, the court said, and the employer offered evidence that there were companies in the legal services or legal support services industry that were not competitors of the employer. *Id.* "On this record, we cannot determine as a matter of law that the covenant imposed an unreasonable industry-wide exclusion."

In contrast, in *McKissock, LLC v. Martin*, 267 F.Supp.3d 841, 855-56 (W.D. Tex. 2016), the court said a non-compete barring employee from being "connected in any manner with any business or practice which is in competition with [employer]" was overbroad as written.

11.2.4. When the employer's interest is not just its goodwill, but also protecting confidential information

The industry-wide exclusion rule as stated in *Haas* and *Stroman* is incomplete because it does not address confidential information. The limitation to customers the employee had dealings with may not be required when there is a danger of the employee using knowledge of the company's confidential information to compete for other customers.

© Zach Wolfe (2021)

For example, in *Accruent v. Short*, 1:17-CV-858-RP, 2018 WL 297614, at *1 (W.D. Tex. Jan. 4, 2018), the employee served as a director of client services and a senior engineer for a software services company and had access to a wide range of confidential proprietary information. The non-compete prohibited competing with the company in "Business," which was defined as the portions of the company's business in which the employee actively participated or received confidential company information.

The employee in *Accruent* argued that the non-compete violated the *Haass* rule because it was not limited customers and prospects the employee worked with at the company, but the court did not read *Haass* so broadly. *Id.* at *5. The court said that *Haass* applies more narrowly to cases where the employer's interest "derives from the employee's relationship with his or her clients."

But in *Accruent*, the employee's role gave him access to confidential proprietary information concerning the company's product functionality, development plans, sales pipeline, sales process, customer preferences, and market research. Thus, the concern animating the non-compete was not just that the employee would "use his rapport with his customers to take them with him to a competitor," but principally the concern that the employee would use the confidential information he learned at the company to help a competitor compete with the company. Thus, the court found that *Haass* did not compel finding the non-compete's scope unreasonable. *Id.* at *6.

But there was another problem with the non-compete in *Accruent*. Recall the "janitor corollary" from *Haass* and *Wright*, i.e. the principle that a non-compete must bear some relation to the activities of the employee. The non-compete in *Accruent* arguably prohibited the employee for working for a competitor regardless of his role, i.e. even if he was "emptying trash cans" for a competitor. The court agreed that a non-compete barring an employee for working for a competitor in *any* capacity is invalid, but to address this defect the court reformed the non-compete such that it would only prohibit the employee from working for a competitor in the same or substantially similar role that he performed for his previous employer. *Id.* at *6-7.

11.2.5. When the restriction applies to solicitation of employees, not customers

The industry-wide exclusion rule may not apply to solicitation of *employees*, as opposed to customers. In *Smith v. Nerium Int'l, LLC*, No. 05-18-00617-CV, 2019 WL 3543583, at *8-9 (Tex. App.—Dallas Aug. 5, 2019, no pet. h.) (mem. op.), the court held that the industry-wide exclusion rule did not apply to a clause barring a former employee from soliciting the company's other employees, reasoning that the clause did not bar the employee from working for the company's competitors, but only from soliciting the company's employees. *Id.* at *9.

© Zach Wolfe (2021)

11.3 Practice tips concerning the industry-wide exclusion rule

First, don't draft your non-compete with an industry-wide exclusion. That should be obvious by now, but you'd be surprised how many non-competes still have this.

Second, when drafting the non-compete, consider limiting it to customers the employee had contact with while employed by the company. Alternatively, you can add customers that the employee received confidential information about.

The practice tip suggested by *Republic Services* is that if the non-compete is not an industry-wide exclusion on its face, the employee should offer evidence that the scope of the non-compete would effectively prevent the employee from working in any capacity in the industry at issue.

12. Tortious interference with a non-compete

Typically, the company seeking to enforce the non-compete will sue the competitor that hires the employee, claiming tortious interference with contract. But unenforceability of a non-compete is a defense to a claim for tortious interference. *Nguyen v. Able Commc'ns, Inc.*, No. 020-19-00069-CV, 2020 WL 2071757, at *10 (Tex. App.—Fort Worth Apr. 30, 2020, no pet. h.) (citing *Lazer Spot, Inc. v. Hiring Partners, Inc.*, 387 S.W.3d 40, 49 (Tex. App.—Texarkana 2012, pet. denied)).

Under Texas law, "justification" is a defense to a claim for damages for tortious interference. In a non-compete case, the competitor can prove justification by showing either (1) the non-compete is legally unenforceable, or (2) the competitor had a *good faith belief*—even if mistaken—that the non-compete was legally unenforceable. *See Texas Beef Cattle Co. v. Green*, 921 S.W.2d 203, 210-11 (Tex. 1996).

Unenforceability is the same defense that the mployee would raise on the breach of contract claim. If the judge rules that the non-compete is unenforceable, then there can be no liability for *tortious interference* with the non-compete. *Juliette Fowler Homes, Inc. v. Welch Associates, Inc.*, 793 S.W.2d 660, 665 (Tex. 1990); *Lazer Spot, Inc. v. Hiring Partners, Inc.*, 387 S.W.3d 40, 49-50 (Tex. App.—Texarkana 2012, pet. denied); *Zep Mfg. Co. v. Harthcock*, 824 S.W.2d 654, 663-64 (Tex. App.—Dallas 1992, no writ).

The second defense is different. To prove this "good faith" defense, the competitor must first persuade the judge that it had a "colorable" legal right to interfere with the non-compete. *See Texas Beef Cattle*, 921 S.W.2d at 211. This means arguing there was a reasonable, plausible, or at least *non-frivolous* basis for the competitor to believe that the non-compete was legally unenforceable.

© Zach Wolfe (2021)

Usually, the competitor will argue that it reasonably believed that the company did not actually provide confidential information to the employee, that the non-compete is unreasonably broad, or both. Remember, the argument does not have to be *correct*—otherwise there would be no point to having the second defense. It just has to be "colorable."

If the competitor can clear the "colorable" hurdle, then it will be up to the jury to answer this question: "did Competitor have a good-faith belief that Employee's non-compete was unenforceable?" Texas Pattern Jury Charge 106-2. The commentary to PJC 106.2 says it "is derived from *Texas Beef Cattle Co.*, 921 S.W.2d at 211, and *Southwestern Bell Telephone Co. v. John Carlo Texas, Inc.*, 843 S.W.2d 470, 472 (Tex. 1992)."

What a can of worms this opens! Not only must the jury determine what the competitor *believed* (as opposed to what it *did*), the jury must determine what the competitor believed *about a legal issue*. Here are just a few of the thorny issues raised:

- How will jury members know whether Competitor's view of the enforceability of the non-compete was reasonable?

- Will there be a battle of experts on what is required for a non-compete to be enforceable under Texas law and why Competitor's belief was or was not reasonable?

- What does "good faith" mean here? Is it a subjective standard, essentially a question of Competitor's *sincerity* in believing the non-compete unenforceable? Or is it an objective standard, a question of whether the alleged belief was *reasonable*? Or a combination? (The comment to the Pattern Jury Charge notes that the Texas Supreme Court has not defined "good faith" in this context.)

- What if Competitor relied on a legal opinion from its lawyer that the non-compete was unenforceable? Is that fact admissible as evidence of good faith? If Competitor offers this evidence does it waive attorney-client privilege?

- What if Competitor offers the legal opinion itself as evidence? Is it inadmissible hearsay? What if Competitor offers the legal opinion not for its truth (which is a legal issue for the judge anyway), but for the limited purpose of showing that Competitor had a good faith—even if mistaken—view that the non-Compete was unenforceable?

© Zach Wolfe (2021)

- Does it matter whether the facts the lawyer assumed to render the opinion were accurate? Does it matter how competent or experienced the lawyer was in Texas non-compete law?

Considering the Pandora's Box the "good faith" jury question opens, the judge may instinctively resist submitting the question at all. But as long as the competitor's argument is *colorable*, refusal to submit the good faith question to the jury would result in built-in reversible error. And who wants that?

13. Temporary injunctions in non-compete cases

The judge's decision on a temporary injunction is often the key event in a non-compete case. (In federal court it is called a "preliminary" injunction, but for simplicity I'll just use "temporary.") So, the rules that apply to temporary injunctions are just as important as the case law on enforceability, if not more so.

Texas state courts require three elements for a temporary injunction:

(1) a cause of action against the defendant;

(2) a probable right to the relief sought; and

(3) "probable, imminent, and irreparable injury in the interim"

Butnaru v. Ford Motor Co., 84 S.W.3d 198, 204 (Tex. 2002).

Some Texas opinions add that in deciding whether to grant an injunction, the trial court "balances the equities" and considers the resulting conveniences and hardships on the parties. *Computek Computer & Office Supplies, Inc. v. Walton*, 156 S.W.3d 217, 220 (Tex. App.—Dallas 2005, no pet.); *Universal Health Services, Inc. v. Thompson*, 24 S.W.3d 570, 578 (Tex. App.—Austin 2000, no pet.); *Surko Enterprises, Inc. v. Borg-Warner Acceptance Corp.*, 782 S.W.2d 223, 225 (Tex. App.—Houston [1st Dist.] 1989, no writ). *See also Reliant Hosp. Partners, LLC v. Cornerstone Healthcare Group Holdings, Inc.*, 374 S.W.3d 488, 503 (Tex. App.—Dallas 2012, pet. denied) ("While rule 683 does not specifically require a balancing of equities and public interest, numerous courts have consider[ed] them when deciding if a trial court properly granted or denied an injunction"); *NMTC Corp. v. Conarroe*, 99 S.W.3d 865, 868 (Tex. App.—Beaumont 2003, no pet.) ("An application for injunction is a request that a court exercise its equitable jurisdiction, and in exercising that power the court balances competing equities").

In other words, the trial court considers the extent of the injury that would result from either erroneously granting or erroneously denying an injunction. *O'Brien v. Rattikin Title Co.*, No. 2-05-238-CV, 2006 WL 417237, at *5 (Tex. App.—Fort Worth

© Zach Wolfe (2021)

2006, pet. dism'd w.o.j.) (mem. op.) (citing *T.F.W. Mgmt., Inc. v. Westwood Shores Prop. Owners Assoc.*, 162 S.W.3d 564, 575 (Tex. App.—Houston [14th Dist.] 2004, no pet.).

The requirements for a preliminary injunction in federal court are similar but not identical:

(1) substantial likelihood of success on the merits;

(2) substantial threat of irreparable harm;

(3) balance of hardships in plaintiff's favor; and

(4) no disservice to the public interest.

Daniels Health Sciences, L.L.C. v. Vascular Health Sciences, L.L.C., 710 F.3d 579, 582-85 (5th Cir. 2013).

13.1 Does the breach or threatened breach of a non-compete establish "irreparable injury"?

Irreparable injury—or "no adequate remedy at law"—is the key element required for a temporary injunction. And on this element there are the Paper Rules and the Real Rule. The Paper Rules are almost hopelessly muddled. You can find cases saying that the imminent violation of a non-compete establishes irreparable injury, but you can find other cases that say it doesn't.

The Real Rule is that loss of customers establishes "irreparable injury" if the trial court judge wants it to. Otherwise, it doesn't. You can sum up the reason for this answer in three words: standard of review.

Let's break it down in ten simple steps:

1. The Texas non-compete statute authorizes judges to award "injunctive relief" for the breach of a non-compete. Tex. Bus. & Com. Code § 15.51(a). Injunctive relief includes a temporary injunction.

2. A temporary injunction is an order from the trial court judge that says, for example, "Salesman may not do business with Former Employer's Customers until this court renders a final judgment after trial."

3. A temporary injunction is a common-law remedy. That means that judges, through case law, have established the requirements for a temporary injunction through decades, even centuries, of case law.

© Zach Wolfe (2021)

4. The common-law requirements for obtaining a temporary injunction include "irreparable injury," or irreparable harm, and "no adequate remedy at law." These requirements apply to non-compete cases.

5. Irreparable injury and no adequate remedy at law mean essentially the same thing: money damages would be inadequate to compensate for the lost sales.

6. If the trial court rules against you on a temporary injunction, you get an interlocutory appeal, which is an appeal taken before the trial court has rendered a final judgment. Tex. Civ. Prac. & Rem. Code § 51.014(a)(4) (state court); 28 U.S.C. § 1292(a)(1) (federal court).

7. The "standard of review" for an interlocutory appeal of a temporary injunction ruling is "abuse of discretion." *See, e.g., Argo Group US, Inc. v. Levinson*, 468 S.W.3d 698, 700 (Tex. App.—San Antonio 2015, no pet.) ("In this interlocutory appeal, our review is limited to determining whether the trial court abused its discretion in denying Argo's request for a temporary injunction"); *Cardoni v. Prosperity Bank*, 805 F.3d 573, 579 (5th Cir. 2015) ("We review a district court's assessment of these factors [that a party seeking an injunction must show] for abuse of discretion. Conclusions of fact that affect that analysis are left undisturbed unless clearly erroneous, whereas conclusions of law are reviewed de novo.")

8. Abuse of discretion means even if the Court of Appeals thinks the trial court judge got it wrong, it will affirm the ruling as long as there was a reasonable basis for it.

9. There are cases saying that the loss of customer sales establishes irreparable injury. *See, e.g., Cardinal Health Staffing Network, Inc. v. Bowen*, 106 S.W.3d 230, 236 (Tex. App.—Houston [1st Dist.] 2003, no pet.) ("proof that a highly trained employee is continuing to breach a non-competition covenant gives rise to a rebuttable presumption that the applicant is suffering irreparable injury"); *Tranter Inc. v. Liss*, No. 02-13-00167-CV, 2014 WL 1257278, at *7 (Tex. App.—Fort Worth Mar. 27, 2014) ("A highly trained employee's continued breach of a noncompete agreement creates a rebuttable presumption that the employer is suffering an irreparable injury").

10. There are other cases saying it doesn't. *See, e.g., Argo Group US, Inc. v. Levinson*, 468 S.W.3d 698, 704-5 (Tex. App.—San Antonio 2015, no pet.) (affirming trial court's denial of temporary injunction where trial court could have reasonably found no threat of irreparable injury); *Midstate Environmental Services LP v. Atkinson*, No. 13-17-00190-CV, 2017 WL 6379796, at *4 (Tex. App.—Corpus Christi 2017, no pet.) (mem. op.) (affirming trial court's denial of a temporary injunction to enforce a non-compete based on lack of irreparable injury, where damages could be calculated based on the proceeds plaintiff would have received for customers that

© Zach Wolfe (2021)

switched to the competitor); *Am. Mortgage & Equity Consultants, Inc. v. Bowersock*, No. 1:19-CV-492-RP, 2019 WL 2250170, at *5 (W.D. Tex. May 24, 2019) (denying TRO for misappropriation of customer information where the court would be able to calculate damages for resulting from the "converted" customers); *BMC Software, Inc. v. Int'l Business Machines Corp.*, No. H-17-2254, 2018 WL 4520020, at *4-5 (S.D. Tex. Sept. 21, 2018) (denying preliminary injunction where alleged loss of customer could be compensated by money damages).

Thus, in the vast majority of cases, the trial court judge's ruling on a temporary injunction will be upheld on appeal. If the trial court judge *denies* a temporary injunction, it is usually easy for the court of appeals to affirm on the ground that there was no showing of irreparable injury, i.e. that damages would be inadequate. If the trial court *grants* an injunction, it is just as easy for the court of appeals to hold that the evidence adequately supported a finding of threatened irreparable injury.

Still, lawyers handling temporary injunctions in non-compete cases should be prepared to address the irreparable injury requirement, as the case examples below illustrate

13.2 Illustrative examples of cases on temporary injunctions

Let's look at a few case studies and the lessons they offer to lawyers handling temporary injunctions in Texas non-compete cases.

13.2.1 A temporary injunction should be denied if the employee has not competed in the geographic area he was responsible for at the first company.

In *Cameron International v. Abbiss*, the judge denied a temporary injunction because the employee had not breached the non-compete *as limited* to a reasonable geographic area. *Cameron Int'l Corp. v. Abbiss*, No. H-16-2117, 2016 WL 6216667 (S.D. Tex. Oct. 25, 2016).

Abbiss signed a one-year non-compete with his employer, Cameron. He later went to work for a competitor, FMC, as its General Manager for the Middle East. Cameron sued Abbiss in federal court and sought a preliminary injunction.

The court found the non-compete as written was overbroad. A reasonable geographic limit would be Oman and Yemen, the court said, because (1) those were the countries Abbiss was responsible for during his last two years of employment, and (2) the evidence did not support Cameron's claim that Abbiss received confidential Cameron information regarding the entire Middle East. The court found that much of the information Abbiss received at the meeting at issue was either publicly available or was available to employees who did not have non-competes.

© Zach Wolfe (2021)

The question, then, was whether to enter a preliminary injunction barring Abiss from competing in Oman and Yemen, the reasonable geographic area. The court said no, because (1) there was no evidence Abbiss had competed or intended to compete in Oman or Yemen, and (2) the confidential information Abbiss obtained regarding bids in other Middle East countries was more than six months old and likely stale.

In short, the court in *Abbiss* denied a temporary injunction because there was no evidence the employee breached or intended to breach the non-compete within the geographic area the court found was reasonable.

13.2.2 Judges are not always strict about the "irreparable injury" requirement.

In *Fantastic Sams v. Mosley*, Mosley opened a competing hair salon in violation of his two-year non-compete, which covered a five-mile radius from a Fantastic Sams franchise in Cypress (the Houston suburb, not the Mediterranean island). *Fantastic Sams Franchise Corp. v. Mosley*, No. H-16-2318, 2016 WL 7426403 (S.D. Tex. Dec. 23, 2016).

After finding the non-compete was reasonable, the judge found that Mosley's violation of the non-compete was likely to cause irreparable injury:

> Fantastic Sams . . . argued the existence of Mosley's nearby salon, which offers nearly identical hair care services to Fantastic Sams, prevents Fantastic Sams from licensing a new franchise in the area. The court also notes that the Agreement actually contains a provision that requires Mosley to concede that violations of the Agreement constitute irreparable harm to Fantastic Sams. The court agrees with Fantastic Sams that Mosley's continued operations of a nearby salon, in violation of the Agreement, hurts other franchisees, poses a risk of loss of goodwill, and inhibits the opening of new Fantastic Sams franchises in the area. All of these injuries cause irreparable harm to Fantastic Sams as a whole, and that harm cannot be fully remedied with damages.

"Identical hair care services." I love that part. I can only assume there was testimony that both salons offered a unique proprietary combination of shampooing, cutting, and blow drying. But I digress.

The passage above from *Fantastic Sams* is typical of cases granting a temporary injunction to enforce a non-compete. Judges often apply the "irreparable injury" requirement loosely, especially when there is a clear violation of the non-compete.

© Zach Wolfe (2021)

Yes, there was a contractual stipulation to irreparable harm, but surely that can't be dispositive. Almost every non-compete has a clause like this, so allowing it to substitute for actual evidence of irreparable injury would effectively abolish the irreparable injury requirement in non-compete cases.

And I don't read *Fantastic Sams* as saying that a contractual stipulation, by itself, is sufficient. My practical takeaway from the case, and others like it, is that it's easier to clear the "irreparable injury" hurdle when the judge sees that the defendant is behaving badly by blatantly breaching a reasonably limited non-compete.

13.2.3 Companies should present *evidence* of imminent harm, not just an argument about "inevitable disclosure"

While courts don't always apply the "irreparable injury" requirement strictly, *DGM Services v. Figueroa* shows that the company trying to obtain a temporary injunction still needs to offer evidence that harm has already happened or is about to happen. *DGM Servs., Inc. v. Figueroa*, No. 01-16-00186-CV, 2016 WL 7473947 (Tex. App.—Houston [1st Dist.] Dec. 29, 2016, no pet.) (mem. op.).

In that case, DGM's president, Petillon, testified that Figueroa received confidential financial information on budgets, revenues, and costs while working for DGM. He expressed concern that Figueroa would use his knowledge to undercut DGM's prices and gain an unfair advantage. But Petillon did not know if Figueroa had actually provided confidential information to his new employer, GCC, or whether DGM had lost any customers to GCC since Figueroa had left.

The trial court denied a temporary injunction, stating that DGM did not prove imminent harm. On appeal, DGM argued that proof of violation of a non-compete creates a *presumption* of probable, imminent, and irreparable harm.

The Houston Court of Appeals disagreed. Under recent Texas Supreme Court cases, the applicant for a temporary injunction has the burden to prove these elements to obtain a temporary injunction. Therefore, the Court of Appeals declined to hold that breach of a non-compete creates a presumption of harm that relieves the plaintiff of its burden to offer evidence. DGM only established a "fear of possible injury," so the trial court was within its discretion to deny the injunction.

DGM also argued that the **"inevitable disclosure doctrine"** relieved it of the burden of offering evidence of imminent harm, citing state and federal cases applying various versions of it. The Court of Appeals disagreed, finding that Texas courts have not adopted the doctrine, and that it is not a blanket rule applicable to all nondisclosure agreements. DGM was still required to offer evidence of imminent harm.

You can find a lot of articles on the inevitable disclosure doctrine, so I won't go into great detail. Essentially, it is the idea that a court can enjoin a company's former employee from working for a competitor, even if the employee hasn't done anything wrong yet, on the theory that the employee will "inevitably" disclose his knowledge of the company's confidential information to the competitor.

I don't like the idea of an inevitable disclosure "doctrine." These are fact-intensive cases that should be decided based on the evidence in each case. Talking about some general "doctrine" distracts from the real issues, which should be imminent harm and irreparable injury.

If the inevitable disclosure doctrine is merely the common-sense notion that a former employee who is working for a competitor is in a position to use the company's confidential information, then it's fine. But if the inevitable disclosure doctrine means that the company doesn't have to offer any evidence of imminent harm, then it is wrong. The *DGM* case got this point right.

The recent *BM Medical* case was similar. *BM Med. Mgmt. Serv., LLC v. Turner*, No. 05-16-00670-CV, 2017 WL 85423 (Tex. App.—Dallas Jan. 10, 2017, no pet. h.) (mem. op.). BM Medical argued that its former employee, Turner, had access to its confidential information such as client lists and prices, and that Turner would be able to use his knowledge to "undersell" BM Medical. But Turner testified that he did not access any confidential information after his termination, that he did not solicit any BM Medical clients, and that the only BM Medical client who became a client of his new company was a friend he knew before going to work for BM Medical.

Like the plaintiff in *DGM Services*, BM Medical argued that Turner had its confidential information, was working for a direct competitor, and intended to use the information. But like the court in *DGM Services*, the court in *BM Medical* disagreed. It held that the trial court was within its discretion to deny a temporary injunction based on the evidence that Turner had not used any confidential information and was not soliciting BM Medical clients.

13.3 Does an "ipso facto" clause in a non-compete establish the elements required for a temporary injunction?

Most non-competes contain some kind of stipulation that a breach will cause the company irreparable injury, and the company is therefore entitled to an injunction in the event of a breach. Let's call this an "ipso facto" clause.

There are essentially four ways courts can approach an ipso facto clause:

1. Find it enforceable and dispositive.
2. Consider it as a factor favoring an injunction.

© Zach Wolfe (2021)

3. Cite it as a factor, but without really giving it any weight.
4. Disregard it entirely.

In my opinion, no. 4 is the correct approach. I don't see this kind of stipulation between two private parties as binding on a judge. We wouldn't let private parties stipulate to their own rules of evidence or procedure. And it seems especially inappropriate for a temporary injunction, which is both an "extraordinary" remedy and, traditionally, an "equitable" remedy left to the discretion of the judge.

You might cite "freedom of contract." Ok, but would you enforce a clause that says "in the event of any litigation between Company and Employee, Company wins"?

No, I don't think this is not the kind of decision we leave to private parties, and that may explain why you won't find many Texas cases saying an ipso facto clause is dispositive and binding on the court.

In *Wright v. Sport Supply Group, Inc.*, 137 S.W.3d 289, 293-94 (Tex. App.—Beaumont 2004, no pet.), the court said it was unaware of any Texas case holding that an ipso facto clause alone establishes, for injunction purposes, that remedies at law will be inadequate. And in *Shoreline Gas, Inc. v. McGaughey*, No. 13-07-364-CV, 2008 WL 1747624, *11 (Tex. App.—Corpus Christi 2008, no pet.) (mem. op.), the court, citing *Wright*, said the employer cited no Texas case holding that an ipso facto clause proves there is irreparable injury or no adequate remedy at law.

But Texas courts have sometimes cited ipso facto clauses as a factor to consider. In *Wright*, the court held that an ipso facto clause provided some "substantive and probative evidence" to support the trial court's temporary injunction, citing the strong public policy of Texas favoring freedom of contract. *Wright*, 137 S.W.3d at 294.

This seems to be the most common approach. *See South Plains Sno, Inc. v. Eskimo Hut Worldwide, Ltd.*, No. 07-19-00003-CV, 2019 WL 1591994, at *6 (Tex. App.—Amarillo April 12, 2019, no pet.) (mem. op.) (citing ipso facto clause, in addition to evidence of irreparable injury, in support of affirming trial court's temporary injunction); *Poole v. U.S. Money Reserve, Inc.*, No. 09-08-137CV, 2008 WL 4735602, at *8 (Tex. App.—Beaumont Oct. 30, 2008, no pet.) (mem. op.) (citing ipso facto clause as "but one consideration in our analysis").

Citing the ipso facto clause as a factor is kind of an easy way out, so I get why courts would say that. But I wonder. In these cases where the ipso facto clause was cited as a factor, did the clause actually make a difference? In other words, would the case have come out the same way if the agreement had no such clause?

I suspect the answer is yes, but of course there is no way to be sure.

© Zach Wolfe (2021)

I do know of at least one Texas case that seemed to find an ipso facto clause conclusive. In *Henderson v. KRTS, Inc.*, 822 S.W.2d 769 (Tex. App.—Houston [1st Dist.] 1992, no writ), the buyer of a radio station obtained a temporary injunction prohibiting the seller from interfering with the buyer's efforts to move the station. *Id.* at 771-73. On appeal, the seller argued the temporary injunction was improper because damages would be an adequate remedy. The Court of Appeals disagreed, citing the ipso facto clause. The court held that the seller, "by agreement, stipulated that [the buyer] could seek injunctive relief without the necessity of proof of actual damages." *Id.* at 776. But the opinion simply decreed this without any analysis.

In a more recent case, the First Court of Appeals reached the opposite conclusion, without citing *Henderson*.

In *Malone v. PLH Group, Inc.*, No. 01-19-00016-CV, 2020 WL 1680058 (Tex. App.—Houston [1st Dist.] Apr. 7, 2020, no pet. h.), the court said an ipso clause had no effect. The employment agreement contained restrictive covenants prohibiting the employee from competing against the company, soliciting the company's employees, and using or disclosing the company's confidential information. *Id.* at *1. The agreement also contained an ipso facto clause, stating any breach of the restrictive covenants would cause "irreparable damage" to the company, and the company "will be entitled as a matter of right to equitable relief, including temporary or permanent injunction, to restrain such breach." *Id.*

After a bench trial, the trial court found that the employee breached the confidentiality clause by forwarding a bid log report to his private email account, but the trial court also found the company failed to prove a "continuing violation" of the confidentiality provision, and it therefore denied equitable relief. *Id.* at *6.

On appeal, the company argued that it was entitled to an injunction under the ipso facto clause based on the breach of the confidentiality requirement. The Court of Appeals disagreed, for two reasons. First, there was sufficient evidence to support the trial court's finding of no continuing violation. Second, the court said "a contracting party's acknowledgment that the other contracting party has a right to equitable relief does not bind judicial actors or require a court to grant the equitable relief ultimately requested." "Trial courts are afforded discretion in granting equitable relief," the court explained, and the company "cannot remove that discretion by eliciting a contractual term from Malone authorizing injunctive relief." *Id.* at *6 (citing *Shoreline Gas*).

So the same Court of Appeals has reached the opposite conclusion on this issue? What gives?

Here's a hint. In both cases, the Court of Appeals affirmed the trial court's ruling. In *Henderson*, the trial court granted an injunction, and the Court of Appeals

© Zach Wolfe (2021)

affirmed. In *Malone*, the trial court denied an injunction, and the Court of Appeals affirmed.

Similarly, in *Shoreline Gas*, the case cited in *Malone*, the trial court denied a temporary injunction, and the Court of Appeals affirmed.

You might deduce that the rule in non-compete injunction cases is that the party who wins in the trial court wins. That would be pretty close to accurate, but the truth is a little more complicated. Here's what I think the "real" rules are:

1. If the trial court <u>grants</u> a temporary injunction to enforce a non-compete, and there is *some* evidence to support it, the Court of Appeals will affirm the injunction and might cite the ipso facto clause as a factor supporting it (although it wouldn't be necessary, because there would be some evidence to support it anyway).

2. If the trial court <u>denies</u> a temporary injunction, and had *some* reasonable basis to do so, the Court of Appeals will affirm the denial and either say the ipso facto clause had no effect (as in *Malone*), or say that it was just one factor to consider (as in *Wright*).

These two rules will apply in the vast majority of cases. And in both scenarios, the Court of Appeals doesn't really have to decide whether an ipso facto clause is dispositive.

In the rare case where the trial court grants an injunction and there is really *zero* evidence of irreparable injury, then the Court of Appeals might have to bite the bullet and decide whether the ipso facto clause establishes irreparable injury, despite the lack of any evidence. But that will be rare.

So, should employers continue to include ipso facto clauses in their non-competes? Well, as much as I hate to include something that I personally think should have no effect, I do include an ipso facto clause in my form non-compete. For one thing, it doesn't really cause any harm to include it. And some judges might consider the clause as a factor, or even find it dispositive, although that would be a mistake.

14. Conclusion

I hope you have found this paper helpful. I plan to publish an updated version soon. If you have comments, suggestions on additional topics, a good case to add, etc., please email me at zwolfe@fleckman.com. I would love to hear from you.

Keep the nerve.

© Zach Wolfe (2021)