SUBJECT: Enforcing covenants not to compete

COMMITTEE: Business and Industry— favorable, without amendment

VOTE: 7 ayes — Brimer, Corte, Elkins, Giddings, Janek, Solomons, Woolley

2 nays — Rhodes, Dukes

SENATE VOTE: On final passage, April 15 — voice vote

WITNESSES: (*On House companion bill, HB 2988*):
For — Christopher Knepp, Texas Employment Law Council; Stewart Greenlee, Texas Business Law Foundation

Against — None

BACKGROUND: Texas law allows covenants not to compete to be enforced if made ancillary to or part of an otherwise enforceable agreement, so long as the restrictions of the covenant related to time, geographical area, and scope of activity are reasonable. In Texas, most employment is considered employment at will. Texas courts have determined that employment at will agreements are not enforceable agreements for purposes of enforcing covenants not to compete, *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642 (Tex. 1994). The Texas Supreme Court in the *Light* case held that a covenant not to compete made ancillary or part of an agreement of employment at will is an illegal restraint of trade.

DIGEST: SB 885 would allow the enforceability of covenants not to compete when made ancillary to or part of an otherwise enforceable agreement or otherwise valid transaction or relationship.

SB 885 would also prohibit the enforcement of a covenant not to compete made after the commencement of the underlying agreement unless such a covenant was supported by consideration other than the continuation of the agreement, transaction or relationship.

SB 885 would take effect September 1, 1997.

SUPPORTERS SAY:

Covenants not to compete are permissible under common law so long as the covenant is considered reasonable as to time, geographically area and scope of the activity restrained. Such covenants are extremely useful in certain employment situations when employers give employees specialized knowledge or specialized training that without such a covenant those employees could use to transfer to another job. In order to protect the employer's investment in the employee, an employer can make a covenant not to compete a condition of starting employment. At that time, the employee is free to enter into the covenant or refuse to take the job.

The Texas Supreme Court, however, refused to enforce an otherwise valid common law covenant not to compete in 1987 in *Hill v. Mobile Auto Trim, Inc.*, 725 S.W.2d 168 (Tex. 1987), overturning a long-standing precedent of enforcement. The Legislature in 1989 enacted SB 946 by Whitmire, allowing the enforceability of covenants not to compete made ancillary or part of otherwise enforceable agreements. However, the court has continued to limit the enforceability of such covenants by holding that employment at will agreements are not enforceable agreements allowing covenants not to compete.

SB 885 would allow Texas to return to the common law doctrine of enforceability of covenants not to compete and the original intent of the Legislature in enacting the statute allowing for the enforceability of such covenants. Essentially, covenants not to compete would be allowed to be included in an agreement beginning an employment at will. Such a situation would allow employers to protect their investment in a new employee and ensure that the knowledge the employer passed on the employee would not be used against the employer. Such agreements are especially important in the growing high-tech industry in Texas where knowledge given about the inner workings of a technologically intensive device or program can be very valuable to a competitor of the company.

SB 885 would also strengthen employee's protections against having such covenants not to compete forced on them after they have been working with a company. The enforceability of a covenant not to compete is based on the idea that the employee can refuse to enter the agreement ancillary to such a covenant and, therefore, not be subject to the covenant. However, if such covenants were applied to employment at will, employers could force

employees to enter into such covenants as a condition of continuing their employment. To avoid this pitfall, any covenant not to compete made after employment had begun would have to be supported by consideration other than the continuation of employment. In other words, the employee would have to be offered something that the employee could refuse in order for the covenant to be enforceable. SB 885 would, therefore, allow employers to make covenants with their existing employees so long as the employee freely chose to enter into such an agreement.

Covenants not to compete are not a restriction on an employee's rights, but merely a reasonable part of life in a competitive, free market economy. Without such agreements, employers would be forced to keep trade secrets and other competitively vital information from employees unless the employer was certain about that employee's loyalty. Without allowing for the enforceability of such covenants in Texas, many high-tech and other extremely competitive industries would likely be forced to leave Texas because they could not be sure of safeguarding any competitive advantage they may have from competitors who might hire away employees in order to gain knowledge to that advantage.

OPPONENTS SAY:

Covenants not to compete limit the ability of an employee to find a job should they ever decide to leave the employer with whom they were forced to enter into such a covenant. With the difficulty of finding good jobs and the competition for high-paying jobs in the high-tech industry, employees must often take whatever job they are offered; they do not have the luxury of declining a job because they would be required to sign a covenant not to compete. When employees are forced to sign such covenants, they have a much more difficult time subsequently moving to a better job. Many of the industries in which such covenants are used are highly specialized, and employees trained in those areas must either continue to work for the company with whom they have signed a covenant or look for a completely different line of work.

The so-called protection that would be given to covenants made after employment had begun would really just be a way to allow employers to force such covenants onto their current employees. For example, an employer could offer an employee a $200 bonus for signing a covenant not to compete, and such an offer would be consideration allowable under SB

885. But an employee who refused to enter the agreement could be subject to retribution for not signing the agreement and could be denied promotions or the ability to work on certain projects because the employer would have questions about the loyalty of that employee. No offer made by an employer to an employee concerning the conditions of employment is truly up to the free choice of the employee.