



Non-compete Restrictions in Texas Severance Agreements

Insights

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One of the most frequent Texas non-compete questions I am asked is whether an employee and employer can enter an enforceable non-compete agreement at the time of termination.

From the employee's perspective, this seems like an ideal time to negotiate a non-compete agreement because there is no disparity in bargaining power. Employees will not feel pressured to sign a non-compete agreement just because they want a job. Rather, they will simply make a rational economic decision about whether they prefer to accept a severance payment and temporarily limit their future job options, or instead forego the severance payment and keep their job options wide open. The employer, of course, wishes it would have secured a non-compete agreement earlier in the employment relationship (for free), but paying for a non-compete agreement now is better than having nothing at all. Plus, by the end of employment, the employer should have a better sense as to whether this particular employee would pose a competitive threat and therefore should be subject to restrictive covenants. So if a non-compete agreement at the termination stage would be a "win-win" situation for the employee and employer, it should be enforceable, right?

Not in Texas. Under Texas law, the consideration that the employer gives in the non-compete agreement must have a "reasonable relationship" to the employer's interest in restraining the employee from competing. This consideration requirement also applies to provisions restricting the solicitation of customers or employees. Although in recent years Texas has broadened the types of consideration that can create an enforceable non-compete agreement, a monetary payment at the time of termination still won't suffice.

But there may be another option. The agreement at issue in *Exxon Mobil Corp. v. Drennen*, 452 S.W.3d 319 [Tex. 2014], did not prohibit the employee from competing, but created significant incentives for the employee to decide (on his own) not to compete. Specifically, if the employee engaged in certain competitive activities, he forfeited restricted stock that had been awarded to him during his employment. The Texas Supreme Court did not view this arrangement as a non-compete agreement because the employee could choose to compete and forfeit the stock.

Unfortunately, *Drennen* left an important question unanswered: Even if the agreement is not strictly a non-compete agreement, is it still considered a restraint on trade that must meet the statutory requirements of a non-compete agreement (including Texas's consideration requirement)? Twenty-five years ago, in a case that predated the Covenants Not to Compete Act, the Texas Supreme Court

nine years ago, in a case that predated the Covenants Not to Compete Act, the Texas Supreme Court held that an agreement that did not prohibit a former employee from soliciting the employer's customers, but required the employee to pay liquidated damages if he secured business from those customers, was a restraint on trade that must meet the reasonableness requirements of a non-compete agreement. *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381 [Tex. 1991]. Although *Peat Marwick* seems on point to the issue presented in *Drennen*, the *Drennen* Court shrewdly sidestepped *Peat Marwick*, stating that whether forfeiture provisions are unenforceable restraints of trade "is a separate question and one which we reserve for another day." This is far from a resounding endorsement of *Peat Marwick*'s holding and continuing viability, but technically *Peat Marwick* remains good law for now.

While we've seen tremendous judicial developments in Texas over the past ten years that enhance an employer's ability to enforce non-compete agreements, there is still no fail-safe way to obtain an enforceable non-compete agreement at the time of termination. The best arrangement - and one that is still somewhat untested in the courts - is to encourage the employee to decide on his own not to compete. For those employers that want to attempt to secure post-employment restrictions at the severance stage, here are the keys that will enhance the enforceability of the agreement:

- Rather than a lump sum severance payment when the employee signs the agreement, the employee receives incremental severance payouts over a period of time.
- During that period of time, the employee may compete if he chooses, but he forfeits future severance payments if he does. The employee is not liable for liquidated damages and does not forfeit money already received should he choose to compete (this helps differentiate the agreement from *Peat Marwick*).
- Structure a "balloon payment" at the end of the period to encourage the employee to refrain from competing during the entire period.

With Texas's quirky consideration requirements for non-compete agreements, this arrangement is the most robust "non-compete" agreement an employer can secure at the time of termination.