MERITAS CAPABILITY WEBINAR NON-COMPETE CLAUSES:

California's Prohibition Against Non-Compete Agreements (B&P Code §16600), the Protection of Trade Secrets and the Practical Relationship Between the Two

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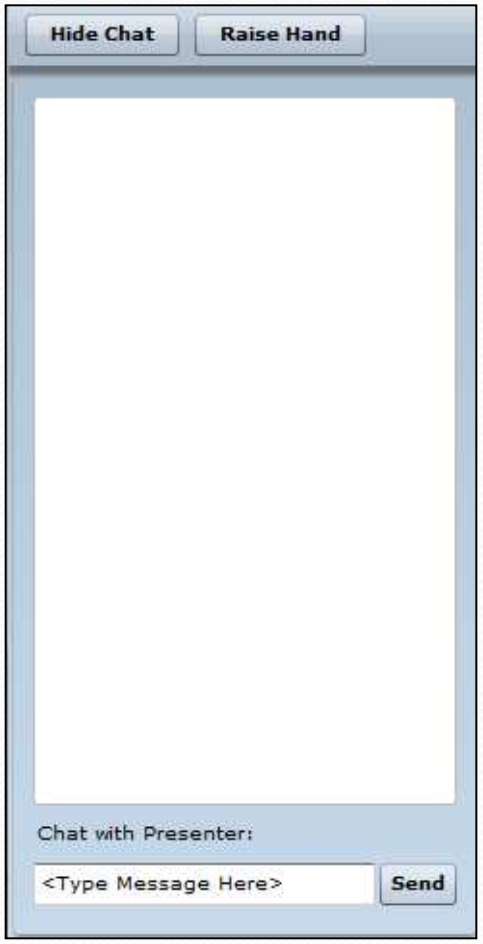

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What is a Covenant Not to Compete?

A covenant not to compete, a/k/a a non-compete clause, is an agreement in which one party agrees not to work for the other party's competition perhaps in a specified area for a certain amount of time. A covenant not to compete may be found in an employment contract or in contracts for the sale of a business.

What is a Covenant Not to Compete (contd.)

From Wikipedia:

The use of such clauses is premised on the possibility that upon their termination or resignation, an employee might begin working for a competitor or starting a business, and gain competitive advantage by exploiting confidential information about their former employer's operations or trade secrets, or sensitive information such as customer/client lists, business practices, upcoming products, and marketing plans.

Employment Agreement Not to Compete

For good and valuable consideration that is acknowledged, the undersigned, _____, "Employee", shall not engage in a business in any manner similar to, or in competition with, _____, "Company" during the term of his or her employment.

Furthermore, the Employee shall not engage in a business in any manner similar to, or in competition with, the Company's business for a period of _____ (____) years from the date of termination of his or her employment with the Company in the geographical area within a _____ (___) mile radius of any office of the Company, and the geographical area within a _____ (____) mile radius of the Employee's home address. [Sometimes add recital from employee acknowledging agreement will not preclude employee from gainful employment.]

In General Real Purpose of Covenant

(from a Freedom of Contract Jurisdiction)

A well drafted covenant not to compete can be an employer's best defense against competition from former employees. Such a covenant is a more powerful tool than a non-disclosure agreement, which prohibits the disclosure of trade secrets or proprietary information, because a valid covenant can be utilized to prevent a former employee from working in competition with the employer.

Cal. Bus. & Prof. Code § 16600. Void contracts

Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.

California Supreme Court

In sum, following the Legislature, this court generally condemns noncompetition agreements. (See, e.g., *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 123, fn. 12, 99 Cal.Rptr.2d 745, 6 P.3d 669 [such restraints on trade are "largely **illegal**"].)

Edwards v. Arthur Anderson, LLP, 44 Cal.4th 937, 946, 189 P3d 285, 291 (2008).

California Supreme Court (contd.)

In out-of-state cases in jurisdictions in which covenants not to compete are more accepted legally,[12] such restrictions are common. (See, e.g., *Central Adjustment Bureau v. Ingram* (Tenn.1984) 678 S.W.2d 28, 37; *Karlin v. Weinberg* (1978) 77 N.J. 408, 390 A.2d 1161.)

[12] Such covenants are largely illegal in this state. (Bus. & Prof. Code, § 16600.)

Armendariz v. Found. Health Psychcare Servs., Inc., 24 Cal. 4th 83, 123 fn 12, 6 P.3d 669, 696 fn 12 (2000)

California Public Policy

'The rule making void contracts in restraint of trade is not based upon any consideration for the party against whom the relief is sought, but upon considerations of sound public policy.' [Citation.]" . . . "California courts have consistently declared [section 16600] an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice." (*Metro Traffic Control, Inc. v. Shadow Traffic Network* (1994) 22 Cal.App.4th 853, 859, 27 Cal.Rptr.2d 573 . . .)

In re Marriage of Greaux & Mermin, 223 Cal. App. 4th 1242, 1250, 167 Cal. Rptr. 3d 881, 888-89 (2014)

Covenant Not to Compete Can be OK in Sale of Business (Sale of Goodwill)

[N]oncompetition clauses are expressly permitted in connection with the sale or dissolution of a corporation (§ 16601), the dissolution of a partnership (§ 16602), or the sale or dissolution of a limited liability corporation (§ 16602.5) As a general rule, the "value" being protected by a noncompetition clause is the goodwill of the business. "Where a covenant not to compete is executed as an adjunct of a sale of a business there is an inference that the business had a 'goodwill' and that it was transferred." (Monogram Industries, Inc. v. Sar Industries, Inc. (1976) 64 Cal.App.3d 692, 701, 134 Cal.Rptr. 714.)

Covenant Not to Compete Can be OK in Sale of Business (Sale of Goodwill)

"In order to restrain the seller's profession, trade, or business, there must be a clear indication that in the sales transaction, the parties valued or considered goodwill as a component of the sales price, and thus the … purchasers were entitled to protect themselves from 'competition from the seller which competition would have the effect of reducing the value of the property right that was acquired.' " . . . **Goodwill is often referred to as the expectation of continued patronage that has become an asset of the business.**

In re Marriage of Greaux & Mermin, 223 Cal. App. 4th 1242, 1250-51, 167 Cal. Rptr. 3d 881, 888-89 (2014) (emphasis added)

Choice of Law Does Not Save

We are, therefore, convinced that California has a materially greater interest than does Maryland in the application of its law to the parties' dispute, and that California's interests would be more seriously impaired if its policy were subordinated to the policy of Maryland. Accordingly, the trial court did not err when it declined to enforce the contractual conflict of law provision in Hunter's employment agreements. **To have done so would have been to allow an out-of-state employer/competitor to limit employment and business opportunities in California.** *Application Grp., Inc. v. Hunter Grp., Inc.*, 61 Cal. App. 4th 881, 902, 72 Cal. Rptr. 2d 73, 86 (1998)

Not Saved by Choice of Law

If an employment agreement contains an illegal covenant not to compete but also contains choice of law or severability provisions which would enable an employer to enforce the provisions of the agreement that are not prohibited by section 16600, can the employer lawfully condition an employee's continued employment on his signing the agreement, or does a firing of an employee for his refusal to sign the employment agreement give rise to a tort cause of action for public policy wrongful discharge?

D'sa v. Playhut, Inc., 85 Cal. App. 4th 927, 931-32, 102 Cal. Rptr. 2d 495, 498 (2000)

Choice of Law

The issue is whether defendants can make plaintiff's acceptance of the agreement a condition of his continued employment by firing him when he refused to sign it. We hold they cannot. California law would protect plaintiff if defendants sought to overreach by trying enforce the covenant not to compete, and California the law will also protect him from a termination of his employment brought on by his refusal to sign an agreement containing the illegal covenant.

D'sa v. Playhut, Inc., 85 Cal. App. 4th 927, 931-32, 102 Cal. Rptr. 2d 495, 498 (2000)

Choice of Law: May Cause "Race" to Judgment

If an employer files suit in another state and employee files suit in California, comity precludes California court from enjoining the employer from pursuing the out of state lawsuit. *Advanced bionics Corp. v. Medtronics, Inc.*, 29 Cal.4th 697 128 Cal. Rptr. 2d 172 (2003). "Full faith and credit" will make the first final judgment prevail. *Id.*

But other states should often apply California law in choice of law analysis involving California employees. *See, e.g. Ascension Insurance Holdings, LLC v. Robert Underwood* 2015 WL 356002 (Ct Chancery Del., January 28, 2015) (not for publication).

Crucial Arthur Anderson fn

[4] We do not here address the applicability of the so-called trade secret exception to section 16600, as Edwards does not dispute that portion of his agreement or contend that the provision of the noncompetition agreement prohibiting him from recruiting Andersen's employees violated section 16600.

Edwards v. Arthur Andersen LLP, 44 Cal. 4th 937, 946, 189 P.3d 285, 291 (2008)

Restated Public Policy of California

Sixty years ago our Supreme Court in *Continental Car–Na–Var Corp. v. Moseley, supra,* 24 Cal.2d at page 110, 148 P.2d 9, stated: "A former employee has the right to engage in a competitive business for himself and to enter into competition with his former employer, even for the business of those who had formerly been the customers of his former employer, **provided such competition is fairly and legally conducted.** [Citation.]"

FLIR Sys., Inc. v. Parrish, 174 Cal. App. 4th 1270, 1277, 95 Cal. Rptr. 3d 307, 314-15 (2009)

Uniform Trade Secrets Act

(d) “Trade secret” means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

(1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and

(2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Cal. Civ. Code § 3426.1

Misappropriation of Trade Secrets

Misappropriation of trade secrets is proscribed and may be enjoined (Cal. Civ. Code §3426.2) or compensated by damages/royalties. Exemplary damages (if misappropriation is willful and malicious) (up to twice actual damages) Cal. Civ. Code §3426.3 and attorney fees (willful and malicious) Cal. Civ. Code §3426.4 may be awarded.

Public Policy Restated

Thus, under *Edwards*, Business and Professions Code section 16600 generally prohibits the enforcement of a nonsolicitation agreement in all cases in which the trade secret exception does not apply.

Wanke, Indus., Commercial, Residential, Inc. v. Superior Court, 209 Cal. App. 4th 1151, 1177, 147 Cal. Rptr. 3d 651, 670 (2012), as modified on denial of reh'g (Oct. 29, 2012)

Customer List as Trade Secret

Numerous courts have concluded customer lists can qualify for trade secret protection.

Ret. Grp. v. Galante, 176 Cal. App. 4th 1226, 1237-38, 98 Cal. Rptr. 3d 585, 593 (2009)

Customer List as Trade Secret (contd.)

A former employee may be barred from soliciting existing customers to redirect their business away from the former employer and to the employee's new business *if the employee is utilizing trade secret information* to solicit those customers. (See *American Credit Indemnity Co. v. Sacks* (1989) 213 Cal.App.3d 622, 634, 262 Cal.Rptr. 92 ["in the absence of a protectable trade secret, the right to compete fairly outweighs the employer's right to protect [customers] against competition from former employees"] . . . . Thus, it is not the *solicitation* of the former employer's customers, but is instead the *misuse of trade secret information,* that may be enjoined.

Ret. Grp. v. Galante, 176 Cal. App. 4th 1226, 1237-38, 98 Cal. Rptr. 3d 585, 593 (2009)

Customer Lists

Sunbelt appears to use the term "customer lists" generically to include the identity of the customer, the name of the customer's decision-maker and customer-specific information, such as its equipment needs, order history and equipment pricing. . . . Courts have found this type of information worthy of trade secret protection. Nonetheless, determining whether a particular customer list is protectable under the UTSA is fact-specific. To that end, the plaintiff must show that the information it seeks to protect "is the product of a substantial amount of time, expense and effort on the part of the employer, has commercial value, and is not readily ascertainable to other competitors[.]" [citations] *Morlife, Inc. v. Perry,* 56 Cal.App.4th 1514, 1521 (1997) ("As a general principle, the more difficult information is to obtain, and the more time and resources expended by an employer in gathering it, the more likely a court will find such information constitutes a trade secret.").

Sunbelt Rentals, Inc. v. Victor, No. C 13-4240 SBA, 2014 WL 492364, at *5 (N.D. Cal. Feb. 5, 2014)

Customer Lists as Trade Secret (contd.)

[C]ourts are reluctant to protect customer lists to the extent they embody information which is "readily available" through public sources, such as business directories. On the other hand, where the employer has expended time and effort identifying customers with particular needs or characteristics, courts will prohibit former employees from using this information to capture a share of the market.

Such lists are to be distinguished from mere identities and locations of customers where anyone could easily identify the entities as potential customers. As a general principle, the more difficult the information is to obtain, and the more time and resources expended by an employer in gathering it, the more likely a court will find such information constitutes a trade secret.

Morlife, Inc. v. Perry, 56 Cal.App.4th 1514, 1521–22, 66 Cal.Rptr.2d 731 (1997), quoted in *Farmers Ins. Exch. v. Steele Ins. Agency, Inc.*, No. 2:13-CV-00784-MCE, 2013 WL 3872950, at *14 (E.D. Cal. July 25, 2013)

Protection for Employees

- Overbroad Claim of Trade Secrets
- No inevitable disclosure
- B&P § 17200 (affirmative claim)
- Labor Code violation?
- Trade Secret Act: Claim of misappropriations made in bad faith allows award of attorney fees to defendant. Civil Code §3426.4
- Antitrust claim?

Overbroad Trade Secret Provisions

The trial court here properly concluded that it should not rewrite the broad covenant not to compete into a narrow bar on theft of confidential information. There was no allegation of any mistake justifying reformation. The "savings" clause in the Agreement authorizes a court to revise the non-compete covenant if it is "unfair" or "commercially unreasonable," not if it is illegal. No case we have found approves of the rewriting of an illegal covenant not to compete in the manner proposed here.

Kolani v. Gluska, 64 Cal. App. 4th 402, 408, 75 Cal. Rptr. 2d 257, 260 (1998)

Overbroad Trade Secret Provision (contd.)

The policy of section 16600 would be undermined by rewriting overbroad covenants. Employers could insert broad, facially illegal covenants not to compete in their employment contracts. Many, perhaps most, employees would honor these clauses without consulting counsel or challenging the clause in court, thus directly undermining the statutory policy favoring competition. Employers would have no disincentive to use the broad, illegal clauses if permitted to retreat to a narrow, lawful construction in the event of litigation.

Kolani v. Gluska, 64 Cal. App. 4th 402, 408, 75 Cal. Rptr. 2d 257, 260 (1998)

Covenant Not to Compete With Overbroad Trade Secret Provision

Potential for bringing serious mischief to the work place: We cannot expect workers generally to be cognizant of [their section 16600 rights]. We reject the concept that a worker, compelled by economic necessity to secure employment, can be thus coerced into signing sweeping agreements [to not compete with their employers upon leaving the employment] in the uninformed hope the agreement will not be enforced by the courts. We foresee situations where the uninformed … employee will forego legitimate [employment] rather than assume the risk of expensive, time-consuming litigation [by the former employer]."

D'sa v. Playhut, Inc., 85 Cal. App. 4th 927, 935, 102 Cal. Rptr. 2d 495, 500-01 (2000)

Query: Does an illegally overbroad Covenant not to Compete Allow a former employee to compete tortiously? (i.e., what if the ex-employee has taken real trade secrets but was required to sign an overbroad, unenforceable non-competition agreement?)

- Breach of contract vs. tort dichotomy
- Does voiding overbroad covenants really remedy the in terrorem effect?

§ 2019.210. Misappropriation of Trade Secrets: Discovery Limitation

In any action alleging the misappropriation of a trade secret under the Uniform Trade Secrets Act (Title 5 (commencing with Section 3426) of Part 1 of Division 4 of the Civil Code), before commencing discovery relating to the trade secret, the party alleging the misappropriation **shall identify the trade secret with reasonable particularity subject** to any orders that may be appropriate under Section 3426.5 of the Civil Code.

Cal. Civ. Proc. Code § 2019.210

§ 2019.210. Misappropriation of Trade Secrets

The rule requiring a plaintiff to describe its trade secrets before the commencement of discovery serves several purposes: it discourages the filing of meritless claims, prevents plaintiffs from using the discovery process to uncover the defendant's trade secrets, assists the trial court in framing the scope of discovery, and "enables defendants to form complete and well-reasoned defenses, ensuring that they need not wait until the eve of trial to effectively defend against charges."

Altavion, Inc. v. Konica Minolta Sys. Lab. Inc., 226 Cal. App. 4th 26, 44, 171 Cal. Rptr. 3d 714, 728 (2014), review denied (Aug. 20, 2014)

No Inevitable Disclosure

The decisions rejecting the inevitable disclosure doctrine correctly balance competing public policies of employee mobility and protection of trade secrets. The inevitable disclosure doctrine permits an employer to enjoin the former employee without proof of the employee's actual or threatened use of trade secrets based upon an inference (based in turn upon circumstantial evidence) that the employee inevitably will use his or her knowledge of those trade secrets in the new employment. The result is not merely an injunction against the use of trade secrets, but an injunction restricting employment.

Whyte v. Schlage Lock Co., 101 Cal. App. 4th 1443, 1461-62, 125 Cal. Rptr. 2d 277, 292 (2002)

No Inevitable Disclosure

Lest there be any doubt about our holding, our rejection of the inevitable disclosure doctrine is complete. If a covenant not to compete (which would include, for example, a nonsolicitation clause), is part of the employment agreement, the inevitable disclosure doctrine cannot be invoked to supplement the covenant, alter its meaning, or make an otherwise unenforceable covenant enforceable. California law concerning enforcement of noncompetition agreements, not the inevitable disclosure doctrine, would measure the covenant's scope, meaning, and validity.

Whyte v. Schlage Lock Co., 101 Cal. App. 4th 1443, 1463-64, 125 Cal. Rptr. 2d 277, 293-94 (2002)

No Inevitable Disclosure Doctrine

The mere fact that Victor had access to Sunbelt's confidential information prior to his separation does not ipso facto establish that he later misappropriated such information. *See Central Valley Gen. Hosp. v. Smith*, 162 Cal.App.4th 501, 528–29 (2008) (mere possession of a trade secret does not constitute misappropriation); *see also FLIR Sys., Inc. v. Parrish*, 174 Cal.App.4th 1270, 1279 (2009) ("Mere possession of trade secrets by a departing employee is not enough for an injunction."). *Sunbelt Rentals, Inc. v. Victor*, No. C 13-4240 SBA, 2014 WL 492364, at *6 (N.D. Cal. Feb. 5, 2014)

Unfair Competition B&P §17200

Unfair competition includes "any unlawful, unfair or fraudulent business act or practice." (Bus. & Prof. Code, § 17200.) The Legislature intentionally used "sweeping language" and empowered the court to issue injunctions to curb any such business practice "in whatever context such activity might occur." (*Barquis v. Merchants Collection Assn.* (1972) 7 Cal.3d 94, 111.) Because Section 17200 "is written in the disjunctive, it establishes three varieties of unfair competition - acts or practices which are unlawful, or unfair, or fraudulent. In other words, a practice is prohibited as unfair or deceptive even if it is not unlawful and vice versa." *Cel-Tech Communications v. Los Angeles Cellular Telephone Company* (1999) 20 Cal.4th 163, 180.

B&P §17200 Violation

An employer's use of an illegal noncompete agreement also violates the UCL (§ 17200 ["unfair competition shall mean and include any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising"].) (*Application Group, Inc. v. Hunter Group, Inc.* (1998) 61 Cal.App.4th 881, 906–908, 72 Cal.Rptr.2d 73 [section 17200 "borrows" violations of other laws and treats them as unlawful practices independently actionable under section 17200].)

Dowell v. Biosense Webster, Inc., 179 Cal. App. 4th 564, 575, 102 Cal. Rptr. 3d 1, 8-9 (2009)

§432.5 Unlawful Terms and Conditions

No employer, or agent, manager, superintendent, or officer thereof, shall require any employee or applicant for employment to agree, in writing, to any term or condition which is known by such employer, or agent, manager, superintendent, or officer thereof to be prohibited by law.

Cal. Lab. Code § 432.5 (West)

See Cal. Labor Code §2699 providing for attorney fees for successful employee.

Civil Code §3426.4 (Trade Secrets)

Section 3426.4 authorizes the trial court to award attorney fees as a deterrent to specious trade secret claims. . . . Because the award is a sanction, a trial court has broad discretion in awarding fees. (*Id.*, at p. 1262, 116 Cal.Rptr.2d 358.)

FLIR Sys., Inc. v. Parrish, 174 Cal. App. 4th 1270, 1275, 95 Cal. Rptr. 3d 307, 313 (2009)

Potential Antitrust Violation

Agreements by competitors not to solicit ("pirate") each others employees as an unlawful restraint of trade.

In re High Tech Employee Antitrust Litigation, No. 11-cv-02509 (N.D. Cal); *e.g.*, 856 F. Supp 2d 1103 (N.D. Cal. 2012) (denying in pertinent part motion to dismiss) (noting federal DOJ investigation).