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Restrictive Covenants in a Post-Covid Era

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Restrictive Covenants Applicable Law

Applicable Law – Federal Level

- There is no federal law directly covering **restrictive covenants**.
- But the Biden administration issued a **July 9, 2021 Executive Order** that encourages the Federal Trade Commission (FTC) to “*curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility.*”
- Non-compete agreements are increasingly considered anticompetitive restraints of trade scrutinized under federal and state antitrust laws.

Changing Landscape for Restrictive Covenants

Directives from the Top

- Obama Administration asked state governments to limit non-competes.
- Biden Administration has pushed to eliminate non-competes except those necessary to protect certain trade secrets.
- Since 2016, 16 states and Washington, D.C. passed legislation limiting restrictive covenants.
- Most reform efforts:
 - Do not target confidentiality restrictions.
 - Do not target non-solicitation restrictions.

Applicable Law – California State Level

California Law Prohibits Restrictive Covenants

- California has a strong public policy against restrictive covenants. This public policy is codified in Cal. Bus. & Prof. Code § 16600, which states “[e]xcept 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.” Cal. Bus. & Prof. Code § 16600.
- Any **covenant** that restricts a person from engaging in a lawful profession, trade, or business is generally void and unenforceable, unless it qualifies for an exception.

Applicable Law – California State Level

Three Statutory Exceptions to the Rule Prohibiting Restrictive Covenants

A non-compete agreement is generally void and unenforceable unless it falls under one of the three statutory exceptions set forth in Cal. Bus. & Prof. Code §§ 16601-16602.5.

These exceptions relate to agreements entered into in connection with:

- 1) The sale of a business entity or the goodwill of a business.
- 2) The dissolution of a partnership.
- 3) The dissolution of, or termination of an interest in, a limited liability company.

Applicable Law – California State Level

Protectable Interests Justifying Enforceable Non-compete Agreement Enforcement

- The Cal. Bus. & Prof. Code § 16601 *sale of a business* exception.
 - "serves as an important commercial purpose by **protecting the value of the business acquired by the buyer**. In the case of the sale of the goodwill of a business it is unfair for the seller to engage in competition which diminishes the value of the asset he sold."

Applicable Law – California State Level

Time Restrictions and Geographic Scope for Enforceable Non-Compete Agreements

- **Temporal limit** of non-compete for “so long as the buyer / any other member of the partnership / any other member of the LLC, or any person deriving title to the business / goodwill / ownership interest from the buyer / any such other member of the partnership / any such other member of the LLC, **carries on a like business therein.**”
- **Geographic limitation** must be:
 - “**within a specified geographic area** in which the **business** so sold has been carried on.” - *Sale of a business exception.*
 - “**within a specified geographic area** where the partnership / LLC **business has been transacted.**” - *Dissolution of a partnership or LLC exception.*

Applicable Law – California State Level

Other limited exceptions

- A **customer non-solicitation agreement** may be enforceable to the extent that it protects an employer's trade secrets.
 - However, the viability and scope of the "trade secret exemption" is uncertain.
- An **employee non-solicitation agreement** may be enforceable.
 - But see uncertainty of "trade secret exemption."
- **Confidentiality agreements** are enforceable to the extent they prevent the misappropriation of trade secrets and unfair competition.

Applicable Law – California State Level

Non-compete Agreements Permitted during Employment

- An employer may restrict employees from competing with the employer **during their employment** because an employee may not transfer his loyalty to a competitor.
- **During the term of employment**, an employer is entitled to its employees' undivided loyalty.

California Law - Customer Non-Solicitation Covenants

Customer Non-Solicitation Covenants

- Like non-compete agreements, **customer non-solicitation agreements** are generally void and unenforceable, **unless they are subject to a statutory exception.**
 - Some California courts have held that a **customer non-solicitation agreement** is enforceable to the extent that it protects an employer's trade secrets.
- Even if a **customer non-solicitation agreement** falls under an exception, an employer must ensure that its **customer non-solicitation agreements** are not overbroad so as to restrain an employee's ability to work.
- The statutory exceptions to Cal. Bus. & Prof. Code § 16600 require employers to limit the geographic scope of a **customer non-solicitation agreement.**

California Law - Customer Non-Solicitation Covenants

Protectable Interests

Two protectable interests for customer non-solicitation agreements include:

1) Goodwill

- One of the primary goals of Section 16601 is to protect the buyer's interest in preserving the goodwill of the acquired corporation
 - *However, a customer non-solicitation that bars the seller from soliciting all customers of the buyer, including those who were not former customers of the sold business, is unenforceable.*

2) Trade Secrets

- *Courts are split.* some California courts have held that a customer non-solicitation agreement is enforceable to the extent that it protects an employer's trade secrets
 - However, the agreement must be narrowly tailored or carefully limited to the protection of trade secrets.

California Law - Employee Non-Solicitation Covenants

Employee Non-Solicitation Covenants

- The California Supreme Court has yet to rule on the legality of **employee non-solicitation agreements** under Cal. Bus. & Prof. Code § 16600, although recent trends suggest that such agreements could be heavily scrutinized. See:
 - *Loral Corp. v. Moyes*
 - *AMN Healthcare, Inc. v. Aya Healthcare Services*
- More courts may follow AMN Healthcare and find that **employee non-solicitation** provisions may be void and unenforceable unless a statutory exception applies.

California Law - Employee Non-Solicitation Covenants

Protectable Interests

- To the extent employee non-solicitation covenants remain enforceable, they should not prohibit former employees from hiring the company's employees - but merely from soliciting them.
 - In *Loral Corp.*, the purpose of the restriction was to maintain a stable work force and enable the employer to remain in business.
- Recommend tying employee non-solicitation covenants to the protection of trade secrets.

California Most Recent Case Law

California Most Recent Case Law

Blue Mountain Enterprises, LLC v. Owen - California Court of Appeal – First Appellate District

- The California Court of Appeal affirmed the trial court ruling granting plaintiff Blue Mountain a preliminary and permanent injunctive relief prohibiting defendant seller Owen from soliciting Blue Mountain's current customers. Defendant Owen breached the customer-non solicitation covenant because the letter Owner sent to Blue Mountain's customers was a solicitation, not merely an announcement.

LGCY Power, LLC v. Superior Court

- California Labor Code Section 925 provides an exception to California's compulsory cross-complaint statute (Code Civ. Proc., § 426.30) such that an employee who comes within section 925's purview may file a complaint in California alleging claims that are related to the causes of action their employer has filed against them in a pending action in a sister state.
- If a related action is filed first and is still pending in a sister state (here, Utah), the Full Faith and Credit Clause of the United States Constitution does not compel a state court (here, California) to extend credit to and apply the sister state's compulsory cross-complaint statute.

Trade Secrets Audits

Conducting a Trade Secret Audit

Protect Against Unfair Competition

- Defend Trade Secrets Act
- California Uniform Trade Secrets Act
- Importance of Protecting Trade Secrets
- Conducting a Trade Secret Audit
 - Identify and Define
 - Implement Protective Mechanisms
 - Manage Your Employees

Defend Trade Secrets Act

What exactly is a trade secret?

- Federal Defend Trade Secrets Act
 - Federal cause of action for trade-secret misappropriation .
 - Defines “trade secret” broadly to include “all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes...” if
 - (1) The owner has taken the reasonable measures to keep such information secret; **and**
 - (2) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.

Examples: the formula for Coca-Cola; computer software; plans, designs, and patterns for specialized equipment; cost/pricing information; internal marketing analyses, etc.

Defend Trade Secrets Act

- **What does it mean to “misappropriate” a trade secret?**
 - The acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by “improper means;” or
 - The disclosure or use of a trade secret of another without express or implied consent.
- **What are “improper means?”**
 - “Improper means” includes theft, bribery, misrepresentation, breach or inducement of breach of a duty to maintain secrecy, or espionage through electronic or other means.
 - “Improper means” does **not** include reverse engineering, independent derivation, or any other lawful means of acquisition.
- **What remedies are available?**
 - Injunction;
 - Actual Damages;
 - Unjust Enrichment;
 - Royalties;
 - *Civil Seizure – But Only In Exceptional Circumstances.*
- **Exception – The DTSA provides immunity to “whistleblowers” who misappropriate trade secrets solely for the purpose of reporting, investigating, or seeking legal relief for a suspected violation of the law.**

California Uniform Trade Secrets Act

- Uniform Trade Secrets Act
 - Provides parameters to protect trade secrets and flexibility to meet local needs.
 - Protects only certain information from disclosure or use: Derives independent economic value from not being generally known or ascertainable by others who can obtain economic value from its disclosure or use; and Subject to reasonable efforts to maintain its secrecy.
- **Differences between the DTSA and CUTSA**
 1. CUTSA does not require that a “trade secret” not be readily ascertainable by the public. However, it still must not be generally known to the public.
 2. CUTSA does not allow for civil seizure as a remedy.
 3. CUTSA does not provide whistleblower immunity.
- Under both the DTSA and CUTSA, a trade secret owner who is suing for misappropriation must identify the trade secret(s) with reasonable particularity at the beginning of the case.

The Importance of Protecting Trade Secrets

- Lost value.
- Difficulties recovering value through successful legal action.
- Diminished chances of judicial success.
 - In Art and Cook, Inc. v. Haber, No. 17-cv-1634 (E.D.N.Y. Oct. 3, 2017), the court held that while product designs and branding/marketing strategies would normally qualify as trade secrets, it would not enjoin the former employee's alleged actions, as the employer did not do enough to protect them.
 - The employer did: (a) password protect the materials; and (b) engage a third party contractor to protect against outside hacking.
 - The employer did **not** require the employee to sign a non-compete or non-disclosure agreement as a condition for access.
 - Lesson: If you don't protect your trade secrets, neither will the courts.

Trade Secret Audit

- Identify a point-person to assist with the audit process.
- Arrange interviews with the heads of departments.
- Verify compliance with trade secret protection measures.
 - Are your trade secrets identified and defined?
 - Have you implemented mechanisms for protection of trade secrets?
 - Manage your employees to protect trade secrets?

Trade Secret Audit

Identifying and Defining Trade Secrets

- Have you identified and documented trade secrets?
 - In consultation with relevant departments (R&D, Manufacturing, Sales, Marketing, Human Resources, etc.):
 - Assess the importance of protecting the information.
 - Consider receiving a request from a competitor for information about the way your company does business.
 - The information about your company's business that would give the competitor an advantage is the information to protect.
- Have you verified ownership of trade secrets?
 - In consultation with counsel and Human Resources.
- Have you reviewed published company information (e.g., company website, marketing materials, etc.) to ensure confidential-designed information is not publicly accessible?

Implement Protective Mechanisms in California

Implement Protective Mechanisms in California

Restrictive Covenants

- Confidentiality and Non-Disclosure Agreements.
- Customer & Employee Non-solicitation Covenants by Use of Trade Secrets.

Implement Protective Mechanisms in Other States

Restrictive Covenants

- Many jurisdictions carefully scrutinize restrictive covenants.
 - Must be justified by a “legitimate business interest.”
 - Must be only as broad as necessary to protect legitimate interest.
 - Legislatures are increasingly attempting to reform restrictive covenants laws.
- Industry-specific limitations.
- Ethical considerations.

Implement Protective Mechanisms Cont'd

Questions to ask yourself in implementing protections:

- Do you label confidential materials?
- Do you segregate confidential materials?
- Do you limit access to confidential materials?
 - With respect to employees?
 - With respect to third parties (e.g., vendors, contractors, visitors, etc.)?
- Do you log access to confidential materials (i.e., maintain an electronic record of who/what/when)?
- Do you restrict the removal of confidential materials from company property?
- Do you condition access to confidential materials on written, executed agreements (e.g., confidentiality, non-disclosure, return of property, etc.)?

Implement Protective Mechanisms Cont'd

- Do you regulate offsite access to electronic confidential materials?
- Have you implemented anti-hacking initiatives (e.g., firewalls, anti-virus/ anti-malware software, encryption software, etc.)?
- Have you developed a protocol for responding to inadvertent disclosures of confidential materials?
- Have you implemented a data loss protection system?
- Do you protect against data loss through mobile devices?
 - Have you established a mobile device management system?
 - Do you employ a “bring your own device” (BYOD) policy? If so, have you considered the associated risks?
- Do you have written policies and procedures regarding confidentiality and non-disclosure?

Managing Employees in California

Managing Employees

Managing the Departure of Employees

- Consider Confidentiality Agreements
- Consider Restrictive Covenants
- Protect Computer Information
- Identify and Limit Access to Trade Secrets
- Use Exit Interviews
- Investigate Theft or Proprietary Information

Managing Employees

Managing the Onboarding of Employees

- Implement Interview Protocols and Training
- Recruiting and Offer Process
- Implement a Step-By-Step Checklist

Remedies for Breach in California

Remedies for Breach

- Remedies for Breach:
 - Of Non-Competes under the Statutory Exceptions to Prohibitions on Non-compete Agreements.
 - Of Customer Non-Solicitation.
 - Of Employee Non-Solicitation.
- Injunctive Relief.
- Compensatory damages (in breach of contract actions).
- Monetary damages (in common law unfair competition claims).
- Injunctive Relief and Restitution under the California Unfair Competition Law (UCL).

Remedies for Breach

- Remedies for Breach:
 - Of Confidentiality Agreements.
- Injunctive Relief.
- Compensatory damages (in breach of contract actions).

Note: a liquidated damages provision in a contract is valid unless the provision was unreasonable under the circumstances existing at the time the contract was made.

Enforcement of Restrictive Covenants

Whether to file

- Is there a good faith basis for the claims?
- Has there been harm, or is irreparable harm threatened?
- Is there a rule permitting the commencement of litigation without the need to file?
- Litigation costs vs. potential benefit?
- Downside risks?
- Potential counterclaims?

Where to file

- Is there a forum selection clause?
- Is there a basis to file in federal court?
- Is federal court a better forum for the particular case?

Potential ramifications

- Comfortable with likelihood of outcome that restrictive covenant is enforceable?
- Comfortable with potential publicity?
- Comfortable with public disclosure of business activities?
- Comfortable with impact of unsuccessful enforcement on existing agreements with other employees?
- Prepare for potential bond costs?

Takeaways

Takeaways

- Landscape regarding restrictive covenants is changing.
 - State legislatures are increasing efforts to reign in restrictive covenant use.
 - The tone on the national level is changing.
- Employers can protect legitimate business interests.
 - Confidentiality agreements.
 - Carefully drawn non-solicitation and non-compete agreements that comply with law.
- Consult competent and experienced counsel at drafting and potential enforcement stages.

Questions?

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Thank you.