



the in-house bar association[®]

Material Type: Program Material

Title: Trade Secret Protection and Covenants Not to Compete in California

Source: Claudette G. Wilson and Aaron A. Buckley

Trade Secret Protection and Covenants Not to Compete in California

Reprinted with permission.

American Corporate Counsel Association

San Diego, California

January 27, 2000

Claudette G. Wilson

Aaron A. Buckley

Wilson, Petty, Kosmo & Turner LLP

550 West C Street, Suite 1050

San Diego, California 92101-3532

(619) 236-9600

WHAT IS A TRADE SECRET?

California has adopted the Uniform Trade Secrets Act (UTSA), which defines the term "trade secret" as follows:

"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.

Uniform Trade Secrets Act, California Civil Code § 3426.1(d).

A trade secret need not be a super-secret formula or design maintained in some sort of high-security vault with layers upon layers of security. Generally, in order to qualify as a trade secret, the information must give the owner a competitive advantage, it must have been

derived from an investment of considerable time and expense, it must be closely guarded, and it must be information not generally known to one's competitors.

Examples of trade secrets may include:

A product formula or design

A manufacturing or production method

A source of supply for ingredients or raw materials

Customer lists and customer data compiled through the investment of significant effort, time, and money

Computer software

The following are not trade secrets:

General knowledge, skill and experience acquired through employment

Information generally known within the industry

Customer lists or customer data readily ascertainable from public sources, or already known by one's competitors

SPECIFIC RULES REGARDING CUSTOMER LISTS AS TRADE SECRETS

1. The information on the list must have been compiled through a direct investment of the company's time, labor, and expense over a considerable period of time.
2. The information contained on the customer list must be information not generally known to the public or within the industry. Examples include:
 1. The identity of customers, if not generally known
 2. Product specifications of particular customers
 3. Customer preferences with regard to products or services
 4. Requirements specific to or unique to a particular customer
3. The information contained on the customer list must have been subjected to reasonable efforts to keep it confidential.

SOLICITATION OF CUSTOMERS BY DEPARTING AND FORMER EMPLOYEES

Announcing Change of Employment: A departing employee may always inform customers with whom he personally worked that he is severing his business relationship with the employer and beginning employment elsewhere or going into business for himself. The employee may use the company's rolodex or customer list in making the announcement, provided no trade secret information is used in doing so.

Soliciting Customers: An existing or former employee may NOT solicit the business of an employer's customers or otherwise compete with an employer through the use of that employer's trade secrets and confidential information. Such misuse constitutes "unfair competition" and may be enjoined pursuant to Section 17200 of the California Business and Professional Code.

Limitations on Fiduciaries: An employee who occupies a fiduciary relationship with the employer (officer, director, managing shareholder) may not take advantage of a "business opportunity" to benefit himself or others at the expense of his current employer. As a result, he may NOT solicit customers on behalf of himself or others while still employed, even if no trade secrets are used.

COVENANTS NOT TO COMPETE IN CALIFORNIA

General Rule -- Not Enforceable: Any contract which purports to restrain a person "from engaging in a lawful profession, trade, or business of any kind is to that extent void." *California Business and Professions Code*, § 16600.

Specific Statutory Exceptions:

Sale of Business: An agreement not to compete made in connection with the sale of a business is not void. *California Business and Professions Code*, § 16601.

Dissolution of Partnership: An agreement not to compete made in connection with the dissolution of a partnership is not void. *California Business and Professions Code*, § 16602.

Dissolution or Sale of Interest in Limited Liability Company: An agreement not to compete in connection with the dissolution of, or the sale of an interest in, a limited liability company is not void. *California Business and Professions Code*, § 16602.5.

Trade Secret Exception: Non-compete agreements may be enforced "where their enforcement is necessary to protect trade secrets." *Gordon Termite Control v. Terrones* (1978) 84 Cal.App.3d 176.

USING NON-COMPETE AGREEMENTS TO PROTECT TRADE SECRETS

Enforced Only to Prevent Unfair Competition: Covenants restraining competition by current and former employees may be enforced only when the competition would constitute "unfair competition." This includes circumstances such as the unauthorized use of trade secrets or confidential information. *"The applicable California law is that the employer will be able to restrain by contract only that conduct of the former employee that would have been subject to judicial restraint under the law of unfair competition, absent the contract."* *Hollingsworth Solderless Terminal Co. v. Turley* (9th Cir. 1980) 622 F.2d 1324, 1338.

Must Be Narrowly Drafted: Any restriction must be narrowly drafted to protect the proprietary interest of the employer entitled to protection. The focus should be on protecting the employers trade secrets and confidential information, not on restricting the employee's job opportunities. A blanket restriction on future employment defined by a specific geographical or time restriction will not be enforced.

Liability for Improper Use of Overly Broad Non-Compete Agreements: Use of a non-compete agreement for the improper purpose of avoiding competition may itself constitute prohibited "unfair competition" under California law. (*Application Group, Inc. v. Hunter Group, Inc.* (App. 1 Dist. 1998) 61 Cal.App.4th 881, review denied.) A party found to have engaged in unfair competition may be ordered to pay attorney fees under the "private attorney general" law, and/or to pay restitution to the injured party. *California Business and Professions Code*, § 17200.

PRACTICAL NOTE: Watch out for "national contracts" which contain non-compete agreements unenforceable in California. An overly broad non-compete agreement, even though drafted with the intent to apply it generally on a national basis, could still constitute unfair competition in the event the employer attempts to enforce it in California.

The "Inevitable Disclosure Rule": Under the "inevitable disclosure rule," a former employer may obtain an injunction to prevent a former employee from working for a direct competitor where the new employment will inevitably lead the employee to rely on the former employer's trade secrets.

Standard: An injunction may be issued against the new employment where:

1. The new employment is "likely to result" in the disclosure of a former employer's trade secrets, or
2. Where it would be "impossible" for an employee to perform his or her new job without using or disclosing those secrets.

Electro Optical Industries, Inc. (App. 2 Dist. 1999) 76 Cal.App.4th 653.

OTHER WAYS TO PROTECT TRADE SECRETS FROM DISCLOSURE

Keeping the Secrets SECRET:

1. Define and identify clearly what the company considers "trade secret" information.

2. Strictly limit access to that information as appropriate ("need to know" basis).

- Designate as confidential
- Secure information
- Appropriately dispose of information
- Train employees as to confidentiality

New Employees:

Company Policies and Procedures: Put new employees on notice of their duty to safeguard trade secrets, and of the company's policies and procedures with regard to trade secret protection. Require a signed acknowledgment that they are aware of and understand the policies.

Confidentiality Agreements: A written agreement with the employee which includes language:

1. Prohibiting the employee from disclosing trade secrets acquired during the course of employment from the employer.
2. Prohibiting the employee from disclosing ideas, designs, formulas, and techniques originated or developed by the employee during the course of employment.
3. Agreeing that any inventions of the employee during the course of employment are the property of the employer.

NOTE: California Labor Code § 2870 provides that any agreement assigning the rights to any invention to the employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information, unless those inventions relate to the employer's business, research, or development; or result from any work performed by the employee for the employer.

4. Agreeing that any materials, written, stored electronically, or otherwise produced in the course of employment and existing in tangible form shall be the property of the employer and shall remain with the employer upon termination.

Non-Solicitation Agreements: "*Antisolicitation covenants are void as unlawful business restraints except where their enforcement is necessary to protect trade secrets.*" *Gordon Termite Control v. Terrones* (1978) 84 Cal.App.3d 176.

REMINDER: An attempt to enforce an overly broad non-compete or non-solicitation agreement could subject the former employer to liability under Section 17200 of the Business and Professions Code.

Departing Employees:

Exit Interviews:

1. Remind the departing employee of company policies defining and safeguarding trade secrets, and of the confidentiality agreement.

2. Collect any materials produced by or in the custody of the departing employee.
3. Obtain a signed acknowledgment from the departing employee that the obligation to protect the company's trade secrets is acknowledged and understood.

Letter to Ex-employee: Remind the ex-employee of obligations to protect trade secrets, and of the confidentiality agreement.

Letter to New Employer: Inform the new employer of the confidentiality agreement binding the employee. Inform the new employer of the types of trade secrets possessed by the employee, and putting the new employer on notice that use of those trade secrets would constitute "unfair competition" within the meaning of Section 17200 of the California Business and Professions Code.

RISK: "Interference with contract" claim.

Consulting Agreements: If a former employee is subject to a post-employment consulting agreement, the employer can prohibit the former employee/consultant from competing while the consulting agreement is in effect.

TRADE SECRET LITIGATION

Important -- Act Quickly: A business must act quickly in the event it believes its trade secrets have been or are about to be compromised. Once a trade secret becomes generally known to competitors, it is no longer a secret and the only thing left to do is to sue for damages. Failure to act quickly to protect trade secret information from disclosure could subject the holder of the trade secret to a laches or waiver defense. Trade secret litigation is usually decided at the temporary restraining order (TRO) or preliminary injunction stage.

The Problem of Public Suits About Private Things: Keep in mind the necessity to keep trade secrets and confidential information "secret" and "confidential," even when litigating the issue. Normal discovery procedures, in which both sides provide information to the opposing side, may defeat the purpose of the litigation, which is to keep secrets "secret." The courts can assist by reviewing information in camera or appointing a "referee," who can review information provided by each side, without disclosing the information to the public or the adverse party.

Attorneys Fees: Consider whether attorneys fees may be recoverable:

1. Does the non-disclosure/confidentiality agreement allow the prevailing party to recover attorneys fees? (Note: Think about this when drafting the agreement.)
2. A prevailing party may be entitled to attorneys fees under the "private attorney general doctrine," (California Code of Civil Procedure § 1021.5) if the other party is found to have committed unfair business practices under § 17200 of the California Business and Professions Code.

Misappropriation/Criminal Conduct: The scope of "unfair business practices" under Business and Professions Code ♦ 17200 is very broad. It may include not only conduct subject to civil action, but also may encompass *criminal* activity. For example, if former employees remove computer files, hard files, or actual customer lists, they could be guilty not only of misuse of trade secrets, but *theft* as well. Law enforcement authorities should be contacted, who may be able to conduct searches and seizures to recover stolen property.

Impact of the Judge: Trade secret laws are gray in many areas. The judge has a lot of discretion in handling trade secret cases. For example, some judges throw out illegal non-compete provisions, others limit them to legal restrictions.

[Back to Top](#)

American Corporate Counsel Association. 1025 Connecticut Ave, NW, Suite 200, Washington, DC 20036-5425. 202/293-4103. webmistress@acca.com. © [Copyright 1999](#) American Corporate Counsel Association. All rights reserved.