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The Trade Secret Exception in California: Dead, Near Dead or Just Dying?

By Stephen C. Tedesco

Introduction

For many years, the drafters of California agreements clung to the so-called "trade secret exception" as a safe harbor for including restrictive covenants in agreements. Before the decision by the California Supreme Court in *Edwards v. Arthur Anderson LLP*,[1] several California courts had expressed the view that covenants not to compete are void in California, *except* to the extent needed to protect trade secrets.[2] However, no court decision ever actually defined the scope of this so-called "trade secret exception." What type of covenants, if any, were allowable under the trade secret exception was never made clear. Nonetheless, this lack of clarity did not deter the drafters of restrictive covenants in California. While no court actually held that the misappropriation of trade secrets could justify the inclusion of a covenant not to compete, practitioners justified all sorts of restrictive covenants in their agreements under the trade secret exception. Those justifications are looking increasingly tenuous since the decision in *Edwards.*

While the supreme court in *Edwards*, and lower court decisions following *Edwards*, declined to address the issue of whether the protection of trade secret information could validate post-termination restrictive

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1 44 Cal. 4th 937 (2008).

2 *See* Muggill v. Reuben H. Donnelly Corp., 62 Cal. 2d 239 (1965); Metro Traffic Control Inc. v. Shadow Network, 22 Cal. App. 4th 853 (1994).

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covenants, the reasoning and holdings of those decisions leave little doubt that the safe harbor of the trade secret exception has been all but completely washed away.

Background

In California, since the nineteenth century, with limited exceptions, any contract under which a person is prevented from engaging in his or her profession, trade or business has been considered void as against public policy, with limited exceptions.[3] California Business and Professions Code section 16600 states that "[e]very contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." The protection under Section 16600 against any restraint on employment presents a strong public policy in California: "The interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of employers."[4] For years, Section 16600 has been held to invalidate contract clauses that restrain employees from engaging in competitive employment after leaving a former employer.[5] However, until the decision in *Edwards*, it was at least debatable whether lesser restrictions, such as the trade secret exception, were valid. Much of that debate has now been settled. Whatever the trade secret exception meant before *Edwards* and its progeny, the concept is now virtually meaningless.

The *Edwards* Decision

In a long-awaited decision, the California Supreme Court in *Edwards* ruled that all restrictive covenants, except those covered by express statutory exceptions, are invalid and void as against public policy.[6] The covenants at issue in *Edwards* were drafted as follows:

> If you leave the Firm, for eighteen months after release or resignation, you agree not to perform professional services of the type you provided for any client on which you worked during the eighteen months prior to release or resignation. This does not prohibit you from accepting employment with a client.
>
> For twelve months after you leave the Firm, you agree not to solicit (to perform professional services of the type you provided) any client of the office(s) to which you were assigned during the eighteen months preceding release or resignation.[7]

Arthur Andersen LLP argued that the language of Section 16600, which uses the term "restrain," should be interpreted as synonymous with "prohibit," such that contractual limitations on an employee's post-employment conduct are allowed so long as that restraint does not "prohibit" an employee from engaging in his or her chosen business, trade or profession. The supreme court rejected this argument.

In doing so, the court also rejected the line of Ninth Circuit Court of Appeals' decisions that recognized a "narrow restraint" exception to noncompetes.[8] The court found that Section 16600 "unambiguous[ly]" dictates that even partial restraints on the ability of employees to practice their profession are prohibited.[9] Thus, the supreme court in *Edwards* not only declared the noncompete provision void, but also held—for the first time—that customer nonsolicitation clauses were also void.

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3 Cal. Bus. & Prof. Code § 16600.

4 Application Group, Inc. v. Hunter Group, 61 Cal. App. 4th 881, 900 (1998).

5 *Hunter Group*, 61 Cal. App. 4th at 900; KGB, Inc. v. Giannoulas, 104 Cal. App. 3d 844 (1980).

6 The statutory exceptions include the sale of a business and dissolution of partnerships, among others. *See* Cal. Bus. & Prof. Code §§ 16601, 16602 and 16602.5.

7 *Edwards*, 44 Cal. 4th at 942.

8 *See, e.g.*, General Commercial Packaging v. TPS Package, 126 F.3d 1131 (9th Cir. 1997); MAI Systems Corp. v. Peak Computer, Inc., 991 F.2d 511, 521–22 (9th Cir. 1993); IBM v. Bajorek, 191 F.3d 1033 (9th Cir. 1999).

9 *Edwards*, 44 Cal. 4th at 949–50.

The *Edwards* Court expressly stated that "we do not here address the applicability of the so-called trade secret exception to [S]ection 16600, as Edwards does not dispute that portion of his agreement...."[10] Does this mean that the trade secret exception is still alive and well? Alive, maybe barely. Well, not so much. The portion of the agreement not disputed was the clause that prevented the disclosure of confidential information and trade secrets.[11] This simple non-disclosure covenant is hardly the robust restrictive covenant that many practitioners attempt to include under the trade secret exception. The clauses that the court declared void under Section 16600 were typically justified as a narrow restraint necessary to protect trade secrets. That ground will no longer support a restrictive covenant. In fact, it is difficult to see what could survive *Edwards* other than a simple non-disclosure of trade secrets covenant.

The supreme court's decision in *Edwards* was not a surprise to California practitioners. Many appellate court cases had declared noncompetes void and, in the years prior to *Edwards*, several decisions found that nonsolicitation of customer clauses were also void and unenforceable under Section 16600.[12] What was slightly surprising was the absolutism of the decision in *Edwards*. The court found that Section 16600's mandate that any restraint is void "represents a strong public policy of the state which should not be diluted by judicial fiat."[13] Thus, there can be no judicial exceptions to the strong public policy of Section 16600. The trade secret exception is, in fact, a judicially-created exception. How the exception can survive *Edwards* is unclear.

Subsequent cases have also declined to directly address the issue of whether the trade secret exception is viable after *Edwards*, while they have seemingly eviscerated the trade secret exception. For example, the appellate court in *Retirement Group, Inc. v. Galante*[14] reviewed an injunction entered by the trial court to prevent the misappropriation of the Retirement Group's ("TRG") trade secrets. TRG alleged that its former employees had misappropriated trade secrets and were using them to solicit customers. The trial court entered a preliminary injunction that enjoined the former employees from several categories of conduct including "directly or indirectly soliciting any current TRG [customers] to transfer any securities account or relationship from TRG to [the former employees] or any broker-dealer or registered investment advisor other than TRG . . .."[15]

On appeal, the *Retirement Group* Court ruled that the nonsolicitation element of the injunction violated the rules established by the California Supreme Court in *Edwards* and was beyond the relief authorized by California law. The court's reasoning is curious. Traditionally, trial courts have had the authority to fashion injunctive relief to prevent harm. By its own terms, Section 16600 only applies to contracts. Orders issued by a trial court to prevent the misappropriation of trade secrets would seem to be outside the scope of Section 16600. The court, however, held that trial courts have no power to enter an injunction under California's Uniform Trade Secrets Act[16] that is inconsistent with Section 16600. Even though there was a proven misappropriation of trade secrets (otherwise the court could not have affirmed the other elements of the injunction), the injunctive remedies available to prevent the harm caused by that misappropriation were found to be limited by Section 16600.

Following the logic of the decision in *Retirement Group* to its inevitable end, this would mean there can be no injunctions under the Trade Secrets Act preventing an employee from working for a competitor, no injunctions preventing solicitation of customers, and no injunctions preventing an employee from doing business with the former employer's customers. Rather than the Trade Secrets Act being an exception to Section 16600, Section 16600 imposes a limit on the remedies available under the Trade Secrets Act for the misappropriation of trade secrets. Under this reasoning, it is difficult to see how any employer in California can obtain an injunction that is not limited to a simple prohibition against the misappropriation of trade secret information.

The *Retirement Group* Court also reiterated that under California law, customer nonsolicitation clauses are enforceable only where the customers' identities are entitled to protection as trade secrets. This seems to provide small solace to employers. As the court pointed

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10 44 Cal. 4th at 946, n4.

11 44 Cal. 4th at 943.

12 *See, e.g.*, Kolani v. Gluska, 64 Cal. App. 4th 402 (1998); Latona v. Aetna U.S. Healthcare, Inc., 82 F. Supp. 2d 1089 (C.D. Cal. 1999). Another issue not decided by the California Supreme Court was the enforceability of employee nonsolicitation clauses. Generally, a clause that prohibits solicitation of employees is enforceable, but one that prohibits hiring is unenforceable. Loral Corp. v. Moyes, 174 Cal. App. 3d 268 (1985).

13 *Edwards*, 44 Cal. 4th at 949.

14 176 Cal. App. 4th 1226 (2009).

15 176 Cal. App. 4th at 1229.

16 Cal. Civ. Code § 3426 et seq.

out, "it is not the solicitation of customers but, instead, the unfair competition or misuse of trade secret information that may be enjoined."[17] If the identities of the customers can be protected from misuse as a trade secret, then any prohibition on "solicitation" is redundant for the simple reason that solicitation is a form of misappropriation. An injunction that prohibits misappropriation of trade secrets to solicit customers may be more specific, but it provides no more protection than a simple injunction that prohibits the misappropriation of trade secrets.

So what is left, if anything, of the common law trade secret exception? California courts have already rejected the "inevitable disclosure" doctrine on the grounds that any injunction based on a presumption of a threatened misappropriation under the Trade Secrets Act is antithetical to Section 16600.[18] As the court in *Dowell v. Biosense Webster, Inc.*[19] noted post-*Edwards* and post-*Retirement Group, Inc.*, there may be nothing left to the trade secret exception.

In *Dowell*, the appellate court affirmed summary judgment on the claims that the noncompete and nonsolicitation clauses in Biosense's agreements were void as a matter of public policy under Section 16600 and under Business and Professions Code section 17200. The *Dowell* Court held:

> The broadly worded noncompete clause prevents [plaintiffs], for a period of eighteen months after termination of employment with Biosense, from rendering services, directly or indirectly, to any competitor in which the services they may provide can enhance the use or marketability of a conflicting product by application of confidential information to which the employee had access during employment. Similarly, the broadly worded nonsolicitation clause prevents the employees for a period of eighteen months post-employment from soliciting any business from, selling to, or rendering any service directly or indirectly to any of the accounts, customers or clients with whom they had contact during the last twelve months of their employment. Ultimately these provisions restrain the employees from practicing their chosen profession.[20]

Given the decision in *Edwards*, it is not surprising that the court in *Dowell* would hold that Section 16600 voids any clause that prohibits solicitation of business, selling to customers, or rendering any service for customers. However, the prohibition against using confidential information to render services for a competing product would seem to be the type of covenant specifically drafted to fall within the so-called trade secret exception. That this clause was also declared void makes it difficult for anyone drafting agreements to find language that would fall into any meaningful trade secret exception.

At this point, the recent California decisions pay lip service to restrictive covenants that are "narrowly tailored or carefully limited to the protection of trade secrets," but have emptied that exception of any meaning.[21] Obviously, there will be more court cases to test these limits. But it is hard to predict that any restrictive covenant, other than a simple covenant-not-to-disclose trade secrets, would be enforceable.

As one court observed, "any attempt to restrict competition by the former employee by contract appears likely to be doomed under [S]ection 16600. . . . [I]t seems that the employer will be able to restrain by contract only that conduct of the former employee that would have been subjected to judicial restraint under the law of unfair competition, absent the contract."[22] Unfair competition claims in California against former employees are now limited almost exclusively to the field of trade secret law, as that field has now been narrowed by recent interpretations of Section 16600.

What is an Employer to Do?

The essential question becomes how do employers respond to the inhospitable California legal landscape. Employers must recognize that their standard nondisclosure agreement, which may include restrictive covenants, simply will not work in California. Those willing to assume the risk may still take an aggressive position in the hope of finding what may turn out to be the mythical covenant that is enforceable in California. Employers should not assume, simply because they do not use noncompetes, that their nonsolicitation covenants are enforceable. Such agreements should be carefully vetted for specific California issues. Clauses prohibiting the solicitation of employees still appear to

17 *The Retirement Group*, 176 Cal. App. 4th at 1239–40.

18 Whyte v. Schlage Lock Company, 101 Cal. App. 4th 1443, 1462 (2002).

19 179 Cal. App. 4th 564 (2009).

20 179 Cal. App. 4th at 575.

21 *See, e.g., Dowell*, 179 Cal. App. 4th at 575; Retirement Group, Inc. v. Galante, 176 Cal. App. 4th 1226.

22 Metro Traffic Control v. Shadow Traffic Network, 22 Cal. App. 4th 853, 861 (1994).

be viable. However, customer non-solicitation clauses would have to be narrowly drafted to prohibit the use of trade secrets in the solicitation of customers.

Employers headquartered outside of California may wish to include choice of law and forum selection clauses in all of their agreements. While California courts will generally not enforce such provisions,[23] the employer may be able to enforce such claims in their home state, as California courts do not have the authority to enjoin or in any way interfere with litigation on the same subject matter occurring in other states.[24] However, this may lead to messy—and expensive—litigation in two states. While an employer may be able to obtain a favorable result in its home state, this strategy may not be viable in all cases, nor will it be worth the cost for all employees.

There are other alternatives that are generally better suited for higher level employees, particularly those whose authority may encompass a larger territory than just California. If the company already has certain types of deferred compensation in a retirement plan for its executives, an employer may be able to treat such a plan as a benefit plan subject to the Employee Retirement Income Security Act ("ERISA").[25] Thus far, such plans, including any noncompetes or restrictive covenants in the plan, have been held to be enforceable under ERISA. Because ERISA is a federal law, it preempts state laws, including California's non-restrictive covenant laws.[26] An injunction against working for a competitor would not be viable, but the forfeiture of benefits under the plan may be an effective deterrent.

If a company uses executive employment agreements, it may wish to include severance or other types of arrangements that are paid only so long as the employee does not obtain comparable employment. This type of agreement, which is in essence a "garden leave" plan, is yet untested in California. It can be argued, however, that the garden leave clauses are not restraints on someone's profession, but merely agreements to compensate someone so long as they are not employed in that particular profession. The employee is free to forego the severance-based compensation to pursue their chosen profession. It is, in essence, an incentive as opposed to a restriction. Any such arrangements must be structured carefully so as to comply with applicable tax rules, including Section 409A of the Internal Revenue Code, which establishes rules for forms of "nonqualified deferred compensation" that can include arrangements of this type.

While most management-side employment lawyers recommend at-will agreements, a fixed term contract may provide some stability and can provide some advance notice of a departing employee.

None of these alternatives are without risk. However, an employer can plan and implement a strategy that can help it get the maximum amount of protection with the least amount of risk. Conversely, implementing agreements without taking into consideration the current state of California law can only lead to disaster.

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[23] *See Application Group*, 61 Cal. App. 4th at 881 (California public policy overrides foreign states' interests in having its own law apply to noncompetes in California).

[24] *See* Advanced Bionic Corp. v. Medtronic, Inc., 29 Cal. 4th 697 (2002).

[25] 29 U.S.C. § 1001 et seq.

[26] *See* Lojek v. Thomas, 716 F.2d 675 (9th Cir. 1983).