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Client Alert

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Protecting Trade Secrets and Preventing Employee Raiding Gets Harder in California:

The Court of Appeal Rejects The Inevitable Disclosure Doctrine

California law governing noncompetes and trade secrets has always been different than in the rest of the country. But due to a recent court decision, protecting trade secrets and preventing employee raiding has just gotten even more difficult for California employers.

When employees leave, employers often fear for their trade secret information and the competitive damage the former employee can inflict. Yet it is often hard to prove that a former employee is actually misusing confidential or proprietary information. As an alternative to proving misappropriation, employers in many states have relied on the doctrine of "inevitable disclosure," which permits an employer to enjoin a departing employee from working for a direct competitor in a similar capacity if that employee *will inevitably use or disclose the former employer's trade secrets in the course of performing his new job*.

The California Court of Appeal recently rejected the inevitable disclosure doctrine. This recent decision, *Schlage v. Whyte*, No. G028382, 2002 Cal. App. LEXIS 4634 (Ct. App. Sept. 12, 2002), has limited the legal recourse available to California employers.

Noncompete Agreements

California law is not friendly to non-compete agreements. California Business & Professions Code section 16600 (West 2002) states, "[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." California courts have consistently interpreted this prohibition strictly, declaring the provision "an expression of public policy to ensure that every citizen . . . retain the right to pursue any lawful employment and enterprise of their choice." *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 859 (Ct. App. 1994). Courts have consistently relied on section 16600 to invalidate non-compete covenants that go beyond protection of confidential information. Narrowly tailored restraints punishable by the forfeiture of profits on stock options have been permitted, however. *I.B.M. v. Bajorek*, 191 F.3d 1033, 1040-41 (holding that IBM's covenant not to compete requiring an employee to forfeit profits made on stock options if the employee began working for a competitor within six months of exercising the options did not violate 16600 because it simply barred the employee from working one segment of his profession, **did not completely restrain him from engaging in his profession, trade, or business**, and could have been avoided had the employee exercised the options six months before he quit).

California Trade Secret Law

California's Uniform Trade Secrets Act protects an employer's confidential information, such as pricing data and client contact information, from misappropriation by a departing employee. To qualify for protection under California law, employers must first prove the matter they seek to protect "[d]erives 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(d) (West 2002). The employer must demonstrate that it intended to keep the information confidential, adopted affirmative measures to maintain its confidentiality, and conveyed the confidential nature of the information to its employees.

Once the court determines that a trade secret exists, the employer must prove "actual or threatened" misappropriation. Cal. Civ. Code § 3426.1(b) (West 2002). Establishing defendant's wrongful use of trade secret information, regardless of whether it was properly acquired, proves actual misappropriation. Actions for threatened misappropriation are typically limited to situations where the trade secret has already been taken (or disclosed) and the wrongful possession or disclosure amounts to a threat of further dissemination. Proving misappropriation is problematic when the trade secret information is not taken in a departing employee's briefcase or on a floppy disk, but instead, is taken only in his or her memory. In other states, employers have relied on the doctrine of "inevitable disclosure" as a means of proving threatened misappropriation in such a situation.

The Inevitable Disclosure Doctrine

Under the inevitable disclosure doctrine, a former employer may adequately prove misappropriation by demonstrating that defendant's new employment will inevitably require him or her to disclose or rely upon the former employer's trade secrets. The doctrine allows courts to consider the realities of the marketplace to protect trade secrets that are, by their very nature, subject to misappropriation by a hiring competitor's employee. In effect, the doctrine not only prohibits a former employee from disclosing trade secrets, but also prohibits him or her from assuming a position with a competitor that will, intentionally or otherwise, require the use of previously acquired knowledge.

In other jurisdictions adopting the doctrine, courts have considered "the degree of similarity between the employee's former and current position, the degree of competition between the former and current employers, the current employer's efforts to safeguard the former employer's trade secrets, and the former employee's 'lack of forthrightness both in his activities before accepting his job . . . and his testimony.'" *Schlage*, 2002 Cal. App. LEXIS 4634, at *28-29 (quoting *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262, 1267 (7th Cir. 1995)). Prior to the Court of Appeal's decision in *Schlage*, no published California decision had accepted or rejected the doctrine. The Court of Appeal had endorsed the doctrine in *Electro Optical Indus., Inc. v. White*, 76 Cal. App. 4th 653 (Ct. App. 1999), but the California Supreme Court subsequently depublished the case, leaving California with no binding precedent on the issue.

California Rejects the Doctrine

In *Schlage v. Whyte*, the departing employee (Whyte) was a vice president responsible for sales of locks to The Home Depot among other "big box retailers." Upon his hire, Whyte signed a confidentiality agreement to protect Schlage's proprietary information. As Schlage's vice president of sales, Whyte participated in The Home Depot's line review, which involved submitting proposals for pricing, marketing, promotions, and information about product updates and changes. Impressed by Whyte's abilities, a direct competitor of Schlage, Kwikset, offered Whyte a similar position. Whyte accepted the position and resigned nine days after participating in a confidential meeting with The Home Depot on behalf of Schlage.

Although the Court of Appeal agreed that Whyte had acquired trade secrets during his tenure with Schlage, including knowledge of Schlage's pricing policies, profit margins, production costs, advertising and marketing strategies, and process technologies, the Court found no reversible error in the trial court's finding that Schlage failed to prove any actual or threatened misappropriation.

As an alternative to proving misappropriation, the Court considered whether the doctrine of inevitable disclosure should be adopted in California. The Court noted the striking similarity between the *Schlage* case and others in which the doctrine was adopted: the fierce competition between Schlage and Kwikset; the virtually identical job duties Whyte would be performing at Kwikset; Whyte's knowledge of Schlage's trade secrets; the signed confidentiality agreement; and Whyte's alleged lack of forthrightness with Schlage. Admitting the case could not be factually distinguished, the Court focused on the after-the-fact nature of the inevitable disclosure doctrine in affirming the lower court's decision for Whyte. The Court of Appeal held that because the effect of the doctrine "is not merely an injunction against the use of trade secrets, but an injunction restricting employment," applying the doctrine imposed a covenant not to compete after the employment contract was made. *Id.* at *36. In effect, if the Court had adopted the doctrine, it would have created a common law back door to the statutory prohibition against non-compete agreements. Moreover, applying the doctrine would convert a signed confidentiality agreement into a covenant not to compete that could be wielded by a former employer. The end result would be an employer obtaining the benefit of a non-compete provision it did not bargain for, and an employee being bound by a covenant (s)he had no choice in accepting or negotiating.

The *Schlage* Court stressed that the law governing non-compete covenants, and not the inevitable disclosure doctrine, should be used to assess the scope, meaning, and validity of contractual restrictions placed on departing employees. *Schlage* has now confirmed that California employers cannot substitute the inevitable disclosure doctrine for proving actual or threatened misappropriation of trade secrets.

Preventive Measures to Promote Trade Secret Protection

In light of *Schlage*, an enforceable agreement to protect trade secrets is more important than ever. California employers must be especially vigilant. The following are preventive measures employers should take to protect their interests in the event of employee departure and subsequent litigation.

- **Employers should require employees to sign a confidentiality agreement.**
  Requiring employees to sign a confidentiality agreement

not only communicates to the employee that information acquired in the course and scope of their employment is confidential, but also demonstrates to the court that the company took reasonable steps to ensure confidentiality.

- **Communicate the confidential nature of the data to employees.**
  Similarly, companies should convey the confidential nature of data by labeling documents and files, when appropriate, as "confidential" or "for internal use only."

- **Limit access to company trade secrets and monitor employee access.**
  Employers should restrict access to sensitive electronic information by requiring passwords. Additionally, employers should observe the frequency and duration of employees' access to, and use of, electronically stored data and information. Similarly, employers should retain control over the distribution of documents containing trade secret information. Sensitive documents should be stored in a secured room and access should be limited and monitored.

- **Be clear on what qualifies as a trade secret and what does not.**
  As previously discussed, information qualifies as a trade secret under California law if it is valuable because it is unknown to others, and the employer has attempted to keep the material confidential. However, just because material is generally known to others, and thus is unprotected, does not mean it lacks value to the company. For example, the Court in *Schlage* held that certain market research conducted by Schlage was not protected if it related to one prominent customer who is aware of its own needs. Distinguishing between what is necessarily valuable to the company and what separately qualifies as a trade secret can guide an employer in deciding who should have access to the unprotected information.

- **Conduct entrance and exit interviews.**
  Conducting entrance and exit interviews affords the employer an opportunity to stress the terms of the confidentiality agreement and any applicable non-compete provision. Furthermore, employers should require departing employees to sign a statement that they have not taken, or caused to be taken, any proprietary company information.

- **Require employees to sign narrowly tailored non-solicitation agreements.**
  In *Schlage*, the Court of Appeal acknowledged that section 16600 does not invalidate a restrictive covenant that merely prohibits solicitation of the former employer's customers. A reasonable, bargained-for agreement, which is narrowly drafted to protect trade secrets, may be upheld in California. Employers should, however, seek professional advice in determining whether a covenant should be included in an employment agreement and under what terms, as there may be legal ramifications for the employer if the covenant is subsequently deemed invalid.

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Steven M. Kayman
212.969.3430 - skayman@proskauer.com

John Siegal
212.969.3342 - jsiegal@proskauer.com

Aaron P. Allan
310.284.5662 - aallan@proskauer.com

Proskauer is an international law firm with more than 590 attorneys who handle a full spectrum of legal issues worldwide.

New York	**212.969.3000**
Los Angeles	**310.557.2193**
Washington	**202.416.6800**
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