

VIEWS YOU CAN USE
TAKE 5

May 2017

Employee Mobility and Trade Secret Protection in California: What Works and What Doesn't

California has always been a challenging jurisdiction for employers in terms of limiting unfair competition by former employees and protecting trade secrets. However, employers in the state can significantly enhance their ability to protect their business interests in these areas with a little planning and strategic thinking.

In this issue of *Take 5*, we look at some proactive steps that employers can take to prevent unfair competition by departed employees and protect trade secrets from misappropriation:

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- 1. Critical Importance of Realistically Identifying and Protecting Trade Secrets and Confidential Information**
 - 2. Developing a Plan for Employee Departures in California**
 - 3. California Non-Competes: Things You Can Do “Around the Edges”**
 - 4. What Will Not Work to Protect Trade Secrets or Enforce Non-Competes in California**
 - 5. View from the Courtroom: What to Expect When You Try to Get a TRO in Your Unfair Competition Case**
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1. Critical Importance of Realistically Identifying and Protecting Trade Secrets and Confidential Information

By James A. Goodman and Amy B. Messigian

California employers often face an upward battle when it comes to protecting against competitive activity by former employees. In addition to expressly precluding non-compete contracts under California Business and Professions Code (“B&P”) Section 16600, California imposes hurdles to pursuing claims against former employees for taking business information that is confidential but does not rise to the level of a trade secret. Moreover, the California Code of Civil Procedure further limits employers from bringing a trade secret claim under California’s Uniform Trade Secrets Act (“UTSA”) unless the employer can, as a threshold matter, identify the purported trade secrets with “reasonable particularity.”¹ This impedes companies from using the mechanisms of discovery to learn what an employee has taken in order to validate a claim for trade secret misappropriation; allegedly misappropriated trade secrets must be known at the outset of litigation or the case will get dismissed. Therefore, it is important for companies to identify and properly monitor for potential misappropriation so that they are well positioned to bring a claim for actual or threatened misappropriation when the circumstances arise.

In order to safeguard their trade secrets, companies doing business in California need to be on the offensive to ensure that they are properly protected at both the beginning and end of the employment relationship. At the beginning of an employment relationship, employers may set the groundwork for protecting their trade secrets by entering into confidentiality and nondisclosure agreements with their employees. These agreements will help establish one element of a claim under the UTSA,² which is that the employer took reasonable steps to identify its trade secrets and maintain their confidentiality.³

While many employers take proper measures at the onset of the employment relationship by entering into trade secret and confidentiality agreements, employers also need to make sure that they are taking similar precautions at the end of the employment relationship to prevent trade secret misappropriation. At a minimum, an employer should monitor and analyze an exiting employee’s use of electronic systems, such as his or her work computer, email, and any mobile drives or devices. An exit interview should also be conducted (see the second article of this *Take 5* for a detailed discussion of exit interviews).

In addition to proper monitoring at the end of the employment relationship, employers may also be able to spot instances of misappropriation by staying alert to warning signs—such as an employee working off-hours without authorization, taking home or

¹ Code of Civil Procedure § 2019.210.

² Civil Code § 3426, *et seq.*

³ See *Thompson v. Impaxx, Inc.*, 113 Cal. App. 4th 1425 (2003).

making unnecessary copies of proprietary or other confidential material, and conducting searches or downloading documents that appear unrelated to the employee's current projects. Tracking and keeping a record of an employee's electronic footprint may enable an employer to meet the requirements under Section 2019.210 of the California Code of Civil Procedure in the event of later trade secret litigation.

Further, even if an employer finds evidence or possible evidence of misappropriation, employers must be cautioned from proceeding with trade secret litigation where there is little evidence of damages or misappropriation. For example, in *FLIR Systems, Inc. v. Parrish*, the California Court of Appeal affirmed a \$1.6 million attorney fee award for the defendants (former employees of the plaintiff), finding that the plaintiff's UTSA action was brought in bad faith.⁴ Among other reasons, the court found bad faith because there was no evidence of economic harm to the plaintiff and no actual or threatened misappropriation. While there was evidence that the defendants downloaded confidential information onto a hard drive, the hard drive was later destroyed without being accessed. The plaintiff discovered the download only after it had already filed its complaint, which suggested that the real reason that the plaintiff filed the case was to chill competition by the defendants, who had started a rival business.

The *Parrish* case serves as a cautionary tale for employers that are keen to utilize trade secret protections as a means of circumventing California's restraints against competition. Because California strongly favors employee mobility, simply downloading confidential information may not be enough, particularly if an employer is not aware of that taking at the outset of litigation. In addition to monitoring for employee misappropriations, employers are well advised to assess potential economic harm prior to filing litigation. If the court views the litigation as an effort to restrain employees from competing—as opposed to curing an actual or threatened misappropriation—an employer may find itself not only losing the litigation but also paying attorneys' fees to its former employees under UTSA.

2. Developing a Plan for Employee Departures in California

By Peter A. Steinmeyer

As discussed elsewhere in this *Take 5*, although California employers generally cannot restrict an employee's ability to work elsewhere, California employers can protect their trade secrets and confidential information. One pillar of a successful plan to do so is having an employee departure protocol.

The foundation of a solid employee departure protocol is the exit interview. Employers should know *who* will conduct it, *when* it will be held, and *what* will be covered.

There should be a written checklist for the exit interview, and it should cover threshold topics, such as reminding the departing employee of his or her continuing confidentiality

⁴ 174 Cal. App. 4th 1270 (2009).

obligations, the return of company property and information stored on-site (e.g., access cards, laptops, and iPhones), and arrangements for the return and/or destruction of company property stored off-site.

The discussion of possible company property stored off-site should cover specific locations that a departing employee might not think of unless specifically asked, including thumb drives, personally owned computers, and personal email or cloud storage accounts. Many a lawsuit has been filed over forgotten thumb drives in employee backpacks.

The departing employee should also be asked to sign a certification that he or she has or will return all of the employer's property by a date certain, and someone needs to follow up to make sure this is done. The signing of such a certification reiterates the importance of the employee's confidentiality obligation. Additionally, should that certification later prove false (i.e., if it is later determined that the employee, in fact, misappropriated trade secrets), the false certification will be a critical piece of evidence in showing the reasonableness of the employer's efforts to protect itself—and maliciousness by the former employee.

If an employee is departing under suspicious circumstances, or if there is other reason to suspect possible misappropriation of trade secrets, records of the employee's computer activity in the days and weeks leading up to his or her termination should be preserved (e.g., by saving the employee's e-mails and making a forensic image of the employee's hard drive, rather than simply wiping it and reissuing it). Litigation over trade secret misappropriation frequently turns on evidence of unusual computer activity shortly before a departure. The employer should have a plan for accomplishing this, whether it be an internal resource, such as its information technology department, or an outside forensic computer firm.

Finally, depending on the facts of a particular situation, a formal "cease and desist" letter to a departed employee and/or a less threatening "reminder" letter can be a valuable tool. Such letters can come from the human resources or legal department, and not only serve as useful written reminders to the departed employee, but may also resolve a dispute without proceeding to litigation. Depending on the situation, an employer may also decide to send a copy of the "cease and desist" or reminder letter to the employee's new employer.

In conclusion, different employers have different needs with respect to the protection of their trade secrets and confidential information, and reasonable precautions for one employer might be completely unreasonable for another. However, regardless of the size or nature of the business, every employer should develop and maintain an employee departure protocol.

3. California Non-Competes: Things You Can Do “Around the Edges”

By James A. Goodman and Amy B. Messigian

There are not many things an employer can do to prevent unfettered competition by a former employee. B&P Section 16600 states that “every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.” The statute provides three exceptions, none of which apply to the typical employer/employee relationship: (1) a person who sells the goodwill of a business or sells substantially all of its operating assets may lawfully agree to refrain from carrying on a similar business;⁵ (2) a partner may, upon the anticipation of the partnership dissolution or disassociation from the partnership, lawfully agree not to carry on a similar business;⁶ and (3) any member of a limited liability company may lawfully agree not to carry on a similar business.⁷

Those exceptions are not realistic business models for most companies. California courts will carefully scrutinize business structures that ostensibly fall within one of the exceptions to determine whether structures are shams created to circumvent B&P Section 16600.⁸

Outside of the three limited exceptions, one option to prevent an employee from leaving to work for a competitor is to enter into a term agreement for employment with the employee, though such an agreement may not be desirable. Employment in California is generally “at will,” which means that employment may be terminated by an employer for any lawful reason, at any time. However, an employee who has a specified term agreement is less likely to be recruited by a competitor because doing so may lead to liability against the competitor for interference with, or inducing a breach of, a contract.⁹ Moreover, if the employee breaches his or her employment agreement by leaving before the term has ended, the employer would have a claim against the employee for breach of contract unless the employee can show willful or permanent breach by the employer.¹⁰ But even with a term agreement, unless the employee has unique talents (such as a professional athlete or entertainer), the employer would still be unable to enjoin the employee from working for a competitor.¹¹ Although the contract for a specified term provides more security for the employer against an employee leaving and competing, it also means that the employee may be terminated only if the employee

⁵ Bus. & Prof. Code § 16601.

⁶ *Id.* at § 16602.

⁷ *Id.* at § 16602.5.

⁸ *Bosley Medical Group v. Abramson*, 161 Cal. App. 3d 284 (1984).

⁹ See, e.g., California Civil Jury Instructions Series 2200; *Diodes, Inc. v. Franzen*, 260 Cal. App. 2d 244 (1968). Conversely, under California law, competitors are generally free to solicit at-will employees unless they commit an independently wrongful act. *Reeves v. Hanlon*, 33 Cal. 4th 1140 (2004).

¹⁰ See Cal. Labor Code § 2925.

¹¹ *Id.* at § 2855.

commits a willful breach of duty, engages in habitual neglect of duty, or is incapacitated and cannot perform.¹²

If an employer is not interested in divesting itself from the at-will nature of employment, another option to induce continued employment is to provide deferred compensation as an incentive to remain employed over a number of years. An employer may offer stock with strings attached, such that an employee who resigns may be required to forfeit his or her unvested restricted stock.¹³ Another alternative for high-level employees is to provide deferred compensation in a retirement plan that is subject to the Employee Retirement Income Security Act (“ERISA”) and to include noncompetition or restrictive covenant language in the plan. Because ERISA preempts state law, it may be another means of avoiding California’s restrictive covenant restrictions.¹⁴ This issue has not been tested under California law.

Covenants not to solicit employees may offer some protection against competition, but the protection *actually* provided is uncertain at best. Prior to the seminal California Supreme Court decision *Edwards v. Arthur Anderson*, employee non-solicit provisions were generally considered enforceable.¹⁵ *Edwards* established a broad interpretation of B&P Section 16600, but the issue of employee non-solicits was not before the Court and the Court stated in a footnote that it would not address the issue.¹⁶ No California appellate court decision has addressed employee non-solicits since 2008, but many practitioners believe that, following *Edwards*’s expansive view of Section 16600, there is a reasonably good chance that employee non-solicits will be unenforceable as well. Presently, there is appellate court authority holding that employee non-solicits are valid; thus, it is unlikely that terminating an employee for refusing to sign such a covenant (or declining to hire an employee for refusing to do so) would create the same litigation risk as terminating or refusing to hire an employee for not signing an agreement that contained an unenforceable non-competition provision. Nonetheless, employee non-solicit provisions still carry some risk and have limited upsides.

As discussed in the fourth article of this *Take 5*, while an employer may not compel the enforcement of a choice-of-law or choice-of-forum provision in an agreement with an unrepresented employee, Labor Code Section 925 expressly excludes agreements with employees who are “in fact individually represented” if the employee’s lawyer is involved in negotiating the terms of the forum selection or choice-of-law clause applicable to employment disputes. This carve-out means that high-level employees, who are often represented in negotiating their employment agreements, may be validly bound to choice-of-law or forum selection provisions that open the door to restrictive covenants if they are represented in the negotiation of their employment agreements.

¹² *Id.* at § 2924.

¹³ *Schachter v. Citigroup, Inc.*, No. S161385 (Cal. Nov. 2, 2009).

¹⁴ *Lojeck v. Thomas*, 716 F.2d 675 (9th Cir. 1983).

¹⁵ *Loral Corp. v. Moyes*, 174 Cal. App. 3d 268 (1985).

¹⁶ *Edwards v. Arthur Anderson*, 44 Cal. 4th 937 (2008).

In summary, there is very little that an employer can do contractually to limit competition in California; however, there are mechanisms that an employer may utilize to strengthen the longevity of its relationship with its employees. Nevertheless, an employer's focus should be on ensuring that proper measures are taken to protect trade secrets, as discussed in the first article of this *Take 5*.

4. What Will Not Work to Protect Trade Secrets or Enforce Non-Competes in California

By James A. Goodman and Amy B. Messigian

B&P Section 16600 invalidates contractual restraints on a person's ability to engage in a profession, trade, or business.¹⁷ This statute, which has been interpreted expansively,¹⁸ expresses a strong California public policy and contains only the three limited exceptions set forth in the third article of this *Take 5*.¹⁹

Employers have tried to utilize various contractual provisions and constructs to circumvent this policy without success. Out-of-state employers routinely include choice-of-law provisions in employment contracts to specify that these agreements should be interpreted under the laws of a state that is generally more amenable to restrictive covenants. Even though choice-of-forum provisions that have a reasonable relationship to one or more of the parties to the contract are presumed enforceable in California,²⁰ that presumption does not apply when the choice-of-law provision is used to circumvent the public policy against non-competes.²¹

Employers have had better luck in the past with choice-of-forum provisions, and federal courts in California have enforced those provisions in some instances.²² When the choice-of-forum provision is enforced, it can make it difficult on an employee who may have to defend a non-compete lawsuit in another jurisdiction, where those courts may be less inclined to apply California law to the dispute. This "loophole" was substantially closed on January 1, 2017, with new legislation that prohibits employers from requiring, as a condition of employment, that employees who primarily reside and work in California agree to litigate claims outside of California that arise in California or otherwise deprive the employee of the substantive protections of California law.²³ While an employee may nevertheless sign such agreements, they are voidable at the employee's option unless he or she was individually represented by counsel to negotiate the venue or choice-of-law provisions. The law applies to litigation and arbitration, and to any contract entered into, modified, or extended on or after January

¹⁷ Bus. & Prof. Code § 16600.

¹⁸ Edwards, *supra* note 16.

¹⁹ Bus. & Prof. Code §§ 16601, 16602 and 16602.5.

²⁰ *Smith, Valentino & Smith, Inc. v. Superior Court*, 17 Cal. 3d 491 (1976).

²¹ *Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998).

²² See, e.g., *Hartstein v. Rembrandt IP Solutions, LLC*, No. 12-2270, 2012 U.S. Dist. LEXIS 105984 (N.D. Cal. July 30, 2012), and *Hegwer v. American Hearing Aid Associates*, No. C 11-04942, 2012 U.S. Dist. LEXIS 24313 (N. D. Cal. Feb. 24, 2012).

²³ Cal. Labor Code § 925.

1, 2017. With respect to agreements after such date, employers will be unable to rely on choice-of-law provisions unless the employee is represented by counsel.

In addition, “narrow restraints” in contracts will not be enforced. In 2008, the California Supreme Court rejected the narrow restraint exception²⁴ and held that a covenant not to solicit customers was unenforceable.²⁵ A covenant that prohibits hiring employees²⁶ or penalizes an employee for competing will likewise not be enforced.²⁷ As discussed in the third article of this *Take 5*, it is unclear whether contractual provisions prohibiting solicitation or other conduct by a former employee will be enforced.

The creation of sham agreements that require an employee to purchase stock or other bogus constructs that attempt to come within the scope of one of the exceptions to B&P Section 16600 by suggesting that there has been a “sale of a business” will not be enforced.²⁸ California courts will examine the realities of the agreement to determine if the agreement complies with the statute’s intent.

Employers should think twice before including the unenforceable provisions in employment contracts merely for their deterrent effect. Such a practice is risky. If an employer terminates an employee who refuses to sign an agreement that contains an unenforceable non-compete provision, such action would constitute a wrongful termination in violation of public policy and would entitle the employee to recover tort damages, including punitive damages, as well as economic damages.²⁹ We are not aware of any case that expressly holds that the refusal to hire an employee who refuses to sign an agreement that contains an unlawful non-compete as a condition of employment would likewise constitute tortious conduct under California law, yet strong arguments can be made that it would. Moreover, a clause that is void under Section 16600 may also violate the provisions of the California Unfair Practices Act,³⁰ which could subject an employer to liability for committing an unfair business practice.³¹

Given the strong protections against non-competes in California, it is too risky to require employees to sign employment agreements that contain these provisions. All employment agreements entered into with employees who live or work in California should be carefully reviewed to ensure compliance.

²⁴ Edwards, *supra* note 16.

²⁵ *Id.*

²⁶ *VL Systems, Inc. v. Unisen, Inc.*, 152 Cal. App. 4th 708 (2007).

²⁷ *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239 (1965).

²⁸ *Bosley Medical Group v. Abramson*, 161 Cal. App. 3d 284 (1984).

²⁹ *D’Sa v. Playhut, Inc.*, 85 Cal. App. 4th 927 (2000).

³⁰ Bus. & Prof. Code § 17200, *et seq.*

³¹ *Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998).

5. View from the Courtroom: What to Expect When You Try to Get a TRO in Your Unfair Competition Case

By Steven R. Blackburn

Experience shows that most unfair competition or trade secret theft issues can be resolved without the need for litigation; often, an exchange of letters between the parties' respective attorneys is sufficient to resolve the matter. However, litigation is sometimes unavoidable, and when it occurs, the employers involved are often surprised by how fast an unfair competition case can move to a practical conclusion, and how little time there might be to prepare for the crucial court hearing.

The most important event in a trade secret or unfair competition litigation is the hearing when the court grants or denies a temporary restraining order, or "TRO." A TRO is essentially an emergency injunction to prevent the wrongdoing party from taking advantage of his or her illegal activities. The process begins with the filing of a complaint that looks essentially no different than any other lawsuit. The claims are usually pleaded under theories like "conversion" (i.e., theft), fraud, breach of contract, or violations of state and federal trade secret statutes. The difference is that the parties will typically find themselves before a judge in only days, or perhaps only hours, after the lawsuit is filed for a hearing that will, for all practical purposes, resolve the case. This is the TRO hearing.

Before a TRO can be granted, the court must be satisfied that the actions of the alleged wrongdoer will cause "irreparable injury" to the party seeking the TRO—in essence, that the harm being done cannot later be remedied by an award of money damages. In the unfair competition context, a TRO is typically sought to require the immediate return of misappropriated trade secret information or to enjoin the alleged wrongdoer from soliciting the other party's customers or employees. It can be challenging to prove "irreparable injury" because most wrongs can be righted at a later time with an award of money damages. For a TRO to be issued, it truly must be a situation where "the bell cannot be un-rung."

Another requirement for a TRO is that the moving party show a high likelihood that it would prevail on the merits of its claims if the case was resolved through the ordinary litigation process, ultimately culminating in a trial. In other words, the party seeking a TRO must be prepared to demonstrate to the court that there is very clear and strong evidence of actionable bad behaviors on the part of the alleged wrongdoer.

A risk of irreparable injury and a high likelihood of eventual success on the merits are typically proven to the court by declarations filed with the complaint and TRO papers. Conclusory or vague accusations of illegal conduct will not suffice; the declarations must precisely describe what, when, and how the wrongdoer engaged in unfair competition activities. The challenge of marshalling this information in a very short period of time is further complicated by the fact that unfair competition activities almost by definition are undertaken by the guilty party in secret, and, obviously, he or she is not interested in cooperating with the victims' attorneys in putting together their case.

Very commonly, the critical evidence in an unfair competition matter comes from forensic examination of IT systems, including email, phone records, and word-processing systems. With surprising regularity, the persons who engage in these sorts of activities do not-so-smart things that leave a clear trail of their wrongdoing, often committed in the final days of their employment with their former employer.

Attempting to get a TRO in an unfair competition case can require a very large amount of work and result in the accrual of significant legal fees in only a matter of days. Before initiating the litigation process, it is critical that the employer accurately assess the viability of its case. Many employers that have thought themselves to be a victim of unfair competition have been disappointed when their case simply did not hold together well enough to justify the issuance of a TRO.

The TRO hearing is often the be-all and end-all of unfair competition litigation because, if it is granted, the unfair competitive activities are immediately stopped, any stolen trade secrets are returned, and the competitive damage to the plaintiff-employer is contained or stopped. The case is usually thereafter resolved by a settlement. Essentially, if the TRO is granted, there typically is not much else of consequence to litigate between the parties.

Conversely, if a TRO is denied, the court's ruling can effectively take the wind out of the sails of the plaintiff-employer's case. The court has essentially said, "I don't see anything wrong going on here," which means that the employee or person who has allegedly engaged in unfair competition can keep doing what he or she is doing. Here again, it is a rare unfair competition case where a TRO is denied and it makes sense for the plaintiff-employer to continue pressing on with litigation against the supposed wrongdoer. In other words, if you can't prove to the judge in the context of a TRO hearing that you have a valid claim, it's probably not going to be any easier to do so later on in the litigation. And it is a very rare situation where an unfair competition claim presents the possibility of a big award of money damages that would make continuing on with protracted litigation worthwhile.

A TRO is deemed to be an "extraordinary remedy," and an employer seeking one in an unfair competition claim should expect the judge to be cautious and conservative in deciding whether to grant one. Another factor is the often surprisingly small amount of time that the applicant gets in front of the judge to prove its case. Essentially, this is a situation where the TRO applicant is trying to push its way to the head of the line in the court's crowded docket and saying, "My case can't wait ... I need a court order now." Skepticism on the part of the judge should be expected.

In California, an employer pursuing a legal claim for redress of unfair competition activities should also recognize that judges in the state superior courts are often suspicious that an unfair competition claim brought by an employer against departed employees may really be a disguised attempt to restrain legitimate competition by the former employees, which, of course, the law of the state strictly prohibits.

In short, an employer going into court to address a possible unfair competition issue is an employer that really needs a good lawyer. The law is there to stop and remedy real unfair competition, but an employer that is asking a court to intervene in what may look like just a business dispute must be realistic about the merits of its case, well prepared, and well represented.

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