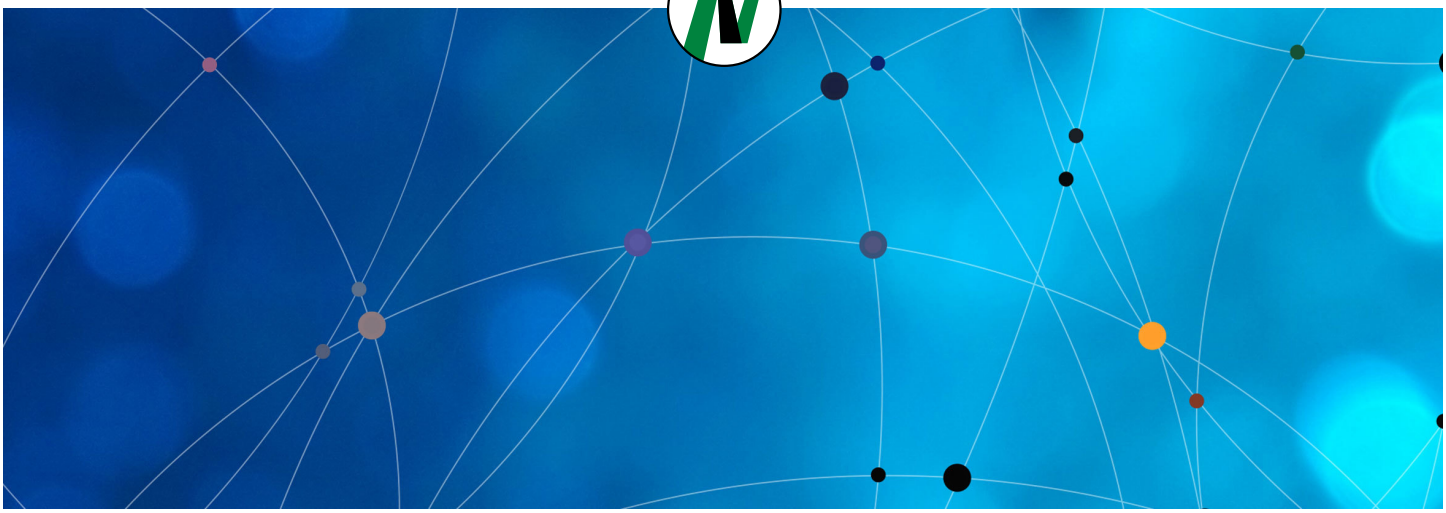

# Reconciling Covenants Not to Compete and Trade Secret Protection

**01.07.2010 | By Veronica M. Gray**

In a recent decision, the California Court of Appeal addressed a specific trade secret issue which the California Supreme Court previously left undecided , with significant implications for employers whose employees leave to become competitors. In 2008, the California Supreme Court held that California's statutory ban on covenants not to compete contained in section 16600 of the Business and Professions Code was **not** subject to a "reasonable restriction on competition" exception. (*Edwards v. Anderson*; see previous E-alert, *California Supreme Court Rejects Employer Effort To Limit Statutory Ban On Noncompetition Agreements*.) However, the Court In *Edwards* expressly stated that it was not deciding whether protecting against misappropriation of trade secrets constituted a "so-called trade secret exception" to the statutory ban on covenants not to compete.

Last year, in *The Retirement Group v. Galante*, the Court of Appeal addressed the very issue the Supreme Court left unresolved in *Edwards*. In short, the Court of Appeal ruled that protecting against a misappropriation of trade secrets, for example by way of injunctive relief, is not inconsistent with the statutory proscription against covenants not to compete.

*The Retirement Group v. Galante* involved a dispute between former business associates who operated a brokerage and financial adviser business – The Retirement Group ("TRG"). The defendants left TRG and commenced work with a competing firm. TRG sued the defendants asserting, among other things, that the defendants were misappropriating trade secrets related to the identities of TRG's customers and soliciting their business. The defendants had also executed confidentiality agreements with respect to customer information in a TRG database. The trial court issued a preliminary injunction that enjoined the defendants from (a) using information found solely and exclusively on TRG's databases (i.e., not otherwise available publicly) and (b) soliciting any current TRG customers to transfer their accounts to anyone other than TRG. The defendants appealed the preliminary injunction.

The Court of Appeal reviewed the Supreme Court's opinion in *Edwards v. Anderson*, noting that the Court left open the question that now faced the Court of Appeal, namely, whether the terms of the injunction were consistent with the statutory bar against covenants not to compete. Based upon a reading of *Edwards* and a number of trade secret cases, the Court of Appeal distilled the following rules:

First, "section 16600 bars a court from specifically enforcing (by way of injunctive relief) a *contractual* clause purporting to ban a former employee from soliciting former customers to transfer their business away from the former employer to the employee's new business." (Original italics.)

Second, notwithstanding section 16600, a court may enjoin "*tortious* conduct (as violative of either the Uniform Trade Secrets Act and/or the Unfair Competition Law)" by preventing a former employee from using trade secret information "to identify existing customers, to facilitate the solicitation of such customers, or to otherwise unfairly compete with the former employer." (Original italics.) According to the court, such conduct is subject to injunctive relief "*not* because it falls within a judicially-created ‘exception' to *section 16600's* ban on contractual nonsolicitation clauses, but is instead enjoinable because it is wrongful independent of any contractual undertaking." (Original italics.)

Applying these rules as to the TRG injunction and that portion enjoining use of information found solely and exclusively on TRG's databases (i.e., not otherwise available publicly), the court concluded that this effectively enjoined misappropriation of TRG's trade secrets – namely, the provision enjoined *tortious* misconduct. According to the court, such a provision was not inconsistent with the proscription of section 16600 as to covenants not to compete and was valid.

Regarding that portion of the TRG injunction that enjoined defendants' solicitation of any current TRG customers to transfer their accounts to anyone other than TRG, the Court of Appeal concluded that the provision was not limited to tortious misappropriation of trade secrets. Rather, it barred solicitation of TRG customers whether or not any TRG trade secrets were used in the solicitation. As a result, the provision was invalid.

In sum, employers will be entitled to injunctive relief to prevent former employees from misappropriating **trade secrets** without running afoul of the statutory bar on covenants not to compete. Employers will not be entitled to injunctive relief to prevent former employees from using information that is **not a trade secret** but which the employer has simply denominated, for example, as "confidential" or "proprietary," under an employment agreement.

**What This Means for Employers**
For employers, there are a number of takeaways from *The Retirement Group v. Galante*:

1. Make a written inventory of all information and materials you consider to be trade secrets.

2. Make sure that you have taken steps to secure the confidentiality of information and material you consider to be trade secrets. Review these steps with your legal counsel. Simply denominating material as a trade secret in an employee agreement will not, in view of *The Retirement Group v. Galante*, be enough.

3. Review your employment and/or proprietary information agreements as to provisions concerning confidentiality of proprietary information. In view of *The Retirement Group v. Galante*, any provisions that

seek to protect the confidentiality of information or material that is not a trade secret are unlikely to be enforceable. Discuss with your legal counsel as to whether it is advisable to modify such agreements to be directed specifically to trade secret information and material. Provisions that exceed protection of trade secrets could be susceptible to affirmative employee suits that challenge the potential *in terrorem* effect the provisions may have on employee mobility.