



## Legal Risk Management Tip September 2011

### THE EFFECT OF NONCOMPETITION AND NON-SOLICITATION AGREEMENTS IN CALIFORNIA

Many investment advisers, broker-dealers and other employers commonly place non-compete or other similar contractual provisions in their employment agreements in the hope that a departing employee will be precluded from taking clients or other valuable resources to a competitor at the end of the employment relationship. While some states uphold noncompetition agreements if they are subject to reasonable time and geographic constraints, California views noncompetition agreements as a barrier to the right to engage in lawful employment. Accordingly, California courts find noncompetition agreements void and contrary to public policy. This legal tip explores the cross section between noncompetition agreements, and how laws which govern trade secrets may be able to afford employers with some protection when a departing employee attempts to take client information to their next employer.

#### A. Noncompetition Agreements

##### 1. Generally Void Under California Law

When challenged in court, California judges almost invariably begin their analysis of noncompetition agreements with Section 16600 of the California Business and Professions Code.<sup>1</sup> 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.”<sup>2</sup> While seemingly straight forward, this one sentence has been interpreted to strongly favor a policy of open competition and employee mobility regardless of whether a noncompetition agreement has been executed.

A recent example of California’s hostile view toward noncompetition agreements is illustrated by the California Supreme Court case *Edwards v. Arthur Anderson*.<sup>3</sup> In the *Edwards* case, the plaintiff’s division within Arthur Anderson was sold to HSBC after the Enron scandal. However, Edwards had signed a noncompetition agreement while working at Arthur Anderson and HSBC asked Edwards to sign a termination of noncompetition agreement so that he could work for HSBC.<sup>4</sup> Edwards refused to sign the termination of noncompetition agreement and was fired by HSBC.<sup>5</sup> The California Supreme Court concluded that “noncompetition agreements are invalid under section 16600 in California, even if narrowly drawn, unless they fall within the applicable statutory exceptions.”<sup>6</sup>

---

<sup>1</sup> See generally, *D’sa v. Playhut, Inc.*, 85 Cal.App.4th 927 (2000); (*Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal.App.4th 853 (1994); *Morlife, Inc. v. Perry* (1997) 56 Cal.App.4th 1514, 1520.

<sup>2</sup> California Bus. & Prof. Code, §16600.

<sup>3</sup> *Edwards v. Arthur Anderson*, 44 Cal.4th 937 (2008).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> While void under §16600, there are statutory exceptions to this general prohibition. For instance, California law allows for and upholds noncompetition agreements in the sale or dissolution of corporations (§16601), partnerships, and limited liability corporations (§16602.5).

## **B. Trade Secrets: How to Protect Client Lists and Information from Misappropriation**

With California courts generally finding noncompetition agreements to be void, how is an employer to reduce the risk that today's loyal employee is not tomorrow's business rival, or that a departing employee will take clients with them to a competitor? The answer may lie in the laws governing trade secrets and the California Uniform Trade Secret Act.<sup>7</sup>

In an attempt to maintain the delicate balance between promoting unfettered competition and protecting business from a former employee's unfair conduct, numerous California courts have concluded client lists can qualify for trade secret protection.<sup>8</sup> However, and in order to be afforded such protection, the client list must first be deemed to satisfy the two-part definition of what constitutes a "trade secret."

Under California law, trade secrets are defined as "information that (i) derives independent economic value, actual or potential, from not being generally known to the public [...]; and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."<sup>9</sup> As for the requirement that a client list have "economic value" to qualify as a trade secret, California courts have interpreted this to mean that the secrecy of this information provides a business with a "substantial business advantage."<sup>10</sup> In this respect, a client list can be found to have economic value because its disclosure would allow a competitor to direct its sales efforts to those clients who have already shown a willingness to use a unique type of service or product as opposed to a list of people who only might be interested. In other words, the former employee's use of a misappropriated client list enables him or her to solicit the employer's clients more selectively and more effectively.

To satisfy the requirement that the client list be subject to reasonable efforts to maintain its secrecy, labeling information "trade secret" or "confidential information" does not conclusively establish that the information satisfies this second requirement. It is, nonetheless, an important factor in establishing the value which was placed on the information and that it could not be readily derived from publicly-available sources.

To that end, and to help ensure that a client list will be treated as a trade secret by a court, private funds, investment advisers, broker-dealers and other employers may wish to consider the following policies and procedures:

1. Establish and maintain policies about the use of confidential business information;
2. Clearly label client lists as a "Trade Secret" or "Confidential";
3. Have employees sign nondisclosure and confidentiality agreements;
4. Limit access to the client list to select employees; and

---

<sup>7</sup> California Civil Code §§ 3426-3426.11.

<sup>8</sup> See generally, *Gordon v. Landau*, 49 Cal.2d 690 (1958); *Gordon v. Schwartz*, 147 Cal.App.2d 213(1956); *Gordon v. Wasserman*, 153 Cal.App.2d 328 (1957).

<sup>9</sup> *Id.*

<sup>10</sup> *Klamath-Orleans Lumber, Inc. v. Miller*, 87 Cal.App.3d 458 (1978).

5. Password protect or maintain the client list and other confidential information in locked filing cabinets.

While these policies and procedures may not guarantee that a client list or other important information be classified as a “trade secret,” they may help a court in classifying them as such.

**For more information about this topic and other legal services, please contact us at (619) 298-2880, [info@jackolg.com](mailto:info@jackolg.com) or visit [www.jackolg.com](http://www.jackolg.com). Thank you.**

**Authors: Co-Authors: Brent M. Cunningham, Esq., Associate, Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters.**

*This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.*