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Calif. Ruling Eases Anti-Noncompete Standard For Employers

By **Zac Cohen and Michael Geibelson** (March 11, 2020, 4:27 PM EDT)

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For years, employers seeking to break new employees' noncompete agreements with former employers moved them to California. Sometimes they get homesick and move back, disrupting the employer's strategy.

But lawyers have continued to pass along this advice to their clients in an attempt to escape the vice grip of a noncompete agreement executed in another state. The reason: California Business and Professions Code 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."

In service to Section 16600, California courts have implemented a strong public policy against the enforcement of noncompetes.[1] Indeed, many years ago, the California Court of Appeal recognized that "California courts have consistently declared [Section 16600] an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice."[2]

The California Supreme Court has likewise held that "even if narrowly drawn," noncompete agreements are invalid under Section 16600.[3] And the commonly asserted trade secret exception to this prohibition of noncompetition has proven difficult for former employers to establish.

Notwithstanding this strong public policy, the California Court of Appeal's Second District recently held in Techno Lite Inc. v. Emcod LLC,[4] that Section 16600 does not bar an employer from prohibiting employees from competing with employers during the employment. The result is a significant victory for employers for a variety of reasons, some obvious and others less so.

Of course, employers can safely prevent employees from moonlighting for a competing business during their employment, as a consultant or otherwise. More profoundly, employers can prevent employees from preparing to compete after they leave their current employment.

This has two beneficial effects. First, it enhances a current employer's ability to prevent employees from using the current employer's time and resources to create, or prepare to work for, the new business.

Second, because California has rejected the inevitable disclosure[5] doctrine as a way to prove misappropriation of trade secrets, the ruling facilitates a former employer's proof of tortious misconduct. Only the test of time will reveal whether the decision also signals the pendulum beginning to swing away from California's strict interpretation of Section 16600.

Techno Lite v. Emcod

Techno Lite sold lighting transformers. Two Techno Lite employees — while still working for Techno Lite — also ran their own company, Emcod. Techno Lite consented to its employees simultaneously

running Emcod, in exchange for the promise that the employees would only run Emcod on their own time, and that Emcod would not compete with Techno Lite.

Despite these promises, Emcod started selling to Techno Lite customers the same products Techno Lite was selling. In response to Emcod's blunt violation of its promise not to compete, Techno Lite sued Emcod for, among other things, fraud. Techno Lite alleged that while employed with Techno Lite, Emcod was "siphoning off accounts of Techno Lite's and diverting the business of their employer to their own company."

At trial, Emcod homed in on a Section 16600 defense, arguing that any promise to not to compete with Techno Lite was contrary to well-settled public policy, and void as a matter of law.

Key Findings

The court recognized that Section 16600 has consistently been interpreted as invalidating any employment agreement that unreasonably interferes with an employee's ability to compete with an employer after his or her employment ends. However, the court also opined that the statute, "does not affect limitations on an employee's conduct or duties while employed."

During the term of employment, an employer is thus entitled to its employees' — as the court puts it — undivided loyalty. The court thus found that Emcod violated its promise not to compete with Techno Lite, and that that promise was not void.

In reaching its decision, the court tackled the California Supreme Court's decision in Edwards v. Arthur Andersen LLP head on. It explained that Edwards only defined a category of agreements that could not be enforced against former employees who sought to compete with their former employers after leaving their employment. Edwards did not address, "much less invalidate," agreements by employees not to undermine their employer's business "by surreptitiously competing with it while being paid by the employer."

Duty of Undivided Loyalty Is Not Absolute

Still, the court explained that an employee's duty of undivided loyalty to its employer is not absolute, and depends on the circumstances.

For example, employees can prepare to compete with their employers so long as they do so "on their own time and with their own resources."[6] The California Court of Appeal's Sixth District's opinion in Mamou v. Trendwest Resorts Inc. recognized that "while an employee may secretly incorporate a competing business prior to departing, the employee may not use his or her principal's time, facilities or proprietary secrets to build the competing business." Solicitation of an employer's customers "likely will constitute a violation of the duty of loyalty in almost every case."[7]

However, an enforceable (and admissible) agreement prohibiting competition during the employment will cast a shadow over a former employee's claim that he or she acted properly when preparing for a new business during employment. In such disputes, debate always ensues about whether the employee in fact used any of the former employer's property or resources, but the noncompete may impugn the employee's credibility, for it is some evidence that the employee knew he or she could not compete during the employment.

Moreover, while California has rejected the inevitable disclosure doctrine as a means of proving misappropriation of trade secrets,[8] the continuing viability of the inevitable disclosure doctrine after the adoption of the federal Defend Trade Secrets Act remains a topic of intense interest.[9]

Willful misappropriation also carries enhanced remedies. A noncompete covering the period of employment serves as a surrogate for or enhanced consciousness of an obligation to dutifully serve the then-current employer and to refrain from using trade secrets learned while in that employment.

Additional insights include that if the employee is an officer of the employer corporation, there is no requirement that the employee officer disclose his or her preparations to compete with the corporation unless failure to disclose would be harmful to the corporation.[10] Furthermore, the

court explained that the ban on noncompetition clauses outlined in Edwards is limited to employment agreements, and does not apply to noncompetes between corporations.[11]

While California has been a standout in its disfavor of noncompetes,[12] Techno Lite has created some leeway in the area, even if just to those that limit competition during employment.

As a result of the decision (and unless reviewed and reversed by the California Supreme Court), businesses will consider whether to introduce noncompete clauses restricting competition during employment as a staple in their employment contracts. This is especially so in those businesses with sensitive intellectual property or trade secret concerns, where employees might start a competing company on their employer's time and resources, or on their own time during their employment.

Thus, Techno Lite is a decision that should be on the radar of in-house counsel for all businesses, large and small, who would be wise to review or draft employment agreements to include noncompete clauses covering the period of their employment.

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[1] Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc. (1971) 20 Cal.App.3d 668, 673.

[2] Metro Traffic Control, Inc. v. Shadow Traffic Network (1994) 22 Cal.App.4th 853, 859.

[3] Edwards v. Arthur Andersen LLP (2008) 44 Cal.4th 937, 955.

[4] (2020) Cal.App.5th 462.

[5] The "inevitable disclosure" doctrine provides that a plaintiff may prove a claim of trade secret misappropriation by demonstrating that defendant's new employment will inevitably lead him or her to rely on the plaintiff's trade secrets. It is not the law in California, in part because it creates a de facto covenant not to compete and runs counter to the public policy favoring employee mobility. See Whyte v. Schlage Lock Co. (2002) 101 Cal.App.4th 1443, 1463.

[6] Mamou v. Trendwest Resorts, Inc. (2008) 165 Cal.App.4th 686, 719.

[7] Mamou, 165 Cal.App.4th at 719., quoting Futch v. McAllister Towing of Gerogetown (1999) 335 S.C. 598, 609-610.

[8] See Whyte, supra, 101 Cal. App. 4th at 1458.

[9] For a discussion of the issue, see D. Prange and A. Lukoff, "Inevitable Disclosure and the DTSA" https://www.robinskaplan.com/-/media/pdfs/inevitable-disclosure-and-the-dtsa-intellectual-property-magazine.pdf; see also UCAR Technology (USA) Inc. v. Yan Li , 17-cv-1704, 2017 WL 6405620 (N.D. Cal. 2017).

[10] Bancroft-Whitney Co. v. Glen (1966) 64 Cal.2d 327, 347.

[11] Quidel Corp. v. Superior Court (2019) 39 Cal.App.5th 530, 538.

[12] See, e.g. Raimonde v. Van Vlerah , 325 N.E.2d 544 (Ohio 1975) (enforcing three-year restriction on competition in practice of veterinary medicine within 30-mile radius); New River Media Group Inc. v. Knighton , 429 S.E.2d 25 (Va. 1993) (upholding noncompete agreement prohibiting former radio personality from competing with employer within 60 air miles of the station, which was strength of the station's signal, because employer had protectable interest within "earshot" of station); Business Intelligence Systems Inc. v. Hudson , 580 F.Supp. 1068 (S.D. N.Y. 1984)

(enforcing one-year non-compete agreement with unlimited geographic scope for senior computer consultant because company's business was worldwide); Continental Group Inc. v. Kinsley, 422 F.Supp. 838 (D. Conn. 1976) (enforcing 18-month non-compete agreement covering United States, Canada, Western Europe, and Japan because company's products were being developed in each locale).
