PAYNE & FEARS LLP

IRVINE · LAS VEGAS · LOS ANGELES · SAN FRANCISCO

# CALIFORNIA EMPLOYMENT LAW UPDATE

**SEPTEMBER 2009**

## Court of Appeal Holds Customer Non-Solicitation Agreements Only Enforceable If Limited to Prohibiting Former Employees from Using Trade Secret Information to Solicit Customers

In *The Retirement Group v. Galante*, a California Court of Appeal held that customer non-solicitation agreements are enforceable only to the extent they prohibit former employees from using trade secrets to solicit their former employer's customers. The defendants in *Galante* had informed many of the The Retirement Group's ("TRG") customers that they had left TRG for a new entity and gave them forms to transfer their business. TRG sought and obtained a preliminary injunction, which prohibited numerous categories of conduct, including directly or indirectly soliciting current TRG customers to transfer their business to defendants. The Court of Appeal held that the non-solicitation provision was not enforceable since it was not limited to restraining former employees from using or disclosing trade secret information to solicit TRG's customers.

### Background

TRG provided broker-dealer investment advice and securities sale services to customers on a fee-for-service basis. TRG's list of customers and potential customers was maintained in a secure database. As a condition to allowing access to the database, TRG required its employees and independent contractors to execute a Marketing and License Agreement ("MLA"). The MLA defined TRG's confidential information, and provided that during the term of the employment or contractor relationship and thereafter, the signing party would keep the information confidential and would not disclose or use the information, except as permitted under the MLA. The MLA also contained an express non-solicitation of customers provision.

Defendants were former principals and independent contractors of TRG who left to start their own competing business, Monarch. Defendants, all of whom had signed the MLA, allegedly contacted TRG's customers and asked them to switch their business to Monarch. TRG filed suit, alleging among other things, misappropriation of TRG's trade secret information contained on the database. TRG sought and obtained a preliminary injunction.

On appeal, the only aspect of the preliminary injunction challenged was a prohibition against the advisors from soliciting any current TRG customers to transfer their business from TRG.

## Court of Appeal's Decision

The Court of Appeal vacated the portion of the injunction that prohibited defendants from soliciting any current TRG customers to transfer their business. In its decision, the Court analyzed two trends in California law: 1) the strong public policy favoring free competition; and 2) courts' willingness to enforce restrictions on the misuse or disclosure of a company's trade secrets.

The Court noted that California courts refuse to enforce most agreements restricting competition as violative of a strong public policy favoring free competition, embodied in California Business and Professions Code Section 16600. The Court noted that in *Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937 (2008), the California Supreme Court rejected a non-statutory "narrow restraint" exception to Section 16600, affirming that non-competition agreements outside of statutorily-prescribed exceptions are unenforceable. (For a summary of the *Edwards* decision, please click here.)

However, California courts will protect an employer from the misappropriation of its trade secrets by anyone, including its former employees. The Court noted that customer lists can be trade secrets, and courts may act to protect employers from former employees who misappropriate such trade secrets.

The Court determined that an employer who seeks to prohibit a former employee from soliciting former customers to transfer their business to the employee's new business must establish a misuse of trade secrets. It is not enough to show that a former employee had access to customer lists that qualified as trade secrets, and that the former employee solicited customers once he or she left. Rather, the former employer must show that the former employee actually *used* the trade secret customer lists to identify or facilitate the solicitation of customers. As the Court stated, "it is not the *solicitation* of the former employer's customers, but is instead the *misuse of trade secret information,* that may be enjoined." Applying this reasoning to the facts before it, the Court concluded that the non-solicitation provision of the preliminary injunction violated *Edwards* and was not limited in scope to only enjoining the misappropriation of TRG's trade secrets.

## Practical Implications For Employers

Employers should consider the following important lessons from the *Galante* decision:

- The *Galante* court recognized that customer lists can be trade secrets. If a company takes reasonable measures to protect the identities of its customers and business contacts, and if the information is not publicly availably, California courts will afford it protection as a trade secret.

- Employers may still use customer non-solicitation provisions, but they must be carefully drafted to only restrain customer solicitation to the extent an employee does so by using or disclosing the employer's trade secret information.

- To the extent a former employee solicits his or her former employer's customers using publicly available information, restriction on such behavior is impermissible.

- Employers that require employees to sign employment agreements containing non-solicitation clauses of any kind should have those agreements reviewed by counsel. Requiring employees to enter into unenforceable non-solicitation provisions can create potential legal exposure.

**Rodney B. Sorensen** is a partner in the San Francisco office of Payne & Fears LLP, where he represents employers in all types of employment-related litigation, including wrongful termination, discrimination, sexual harassment, unfair competition and wage and hour class actions in state and federal court proceedings, administrative hearings, mediation and arbitration. Mr. Sorensen can be reached at (415) 277-2255.

**Leila S. Narvid** is an associate in the San Francisco office of Payne & Fears LLP, where she focuses on the representation of employers in all aspects of labor and employment law, including discrimination, sexual harassment, wrongful termination, retaliation, disability and wage and hour violations. Ms. Narvid can be reached at (415) 277-2253.

If you would like further information, please contact your Payne & Fears LLP attorney.