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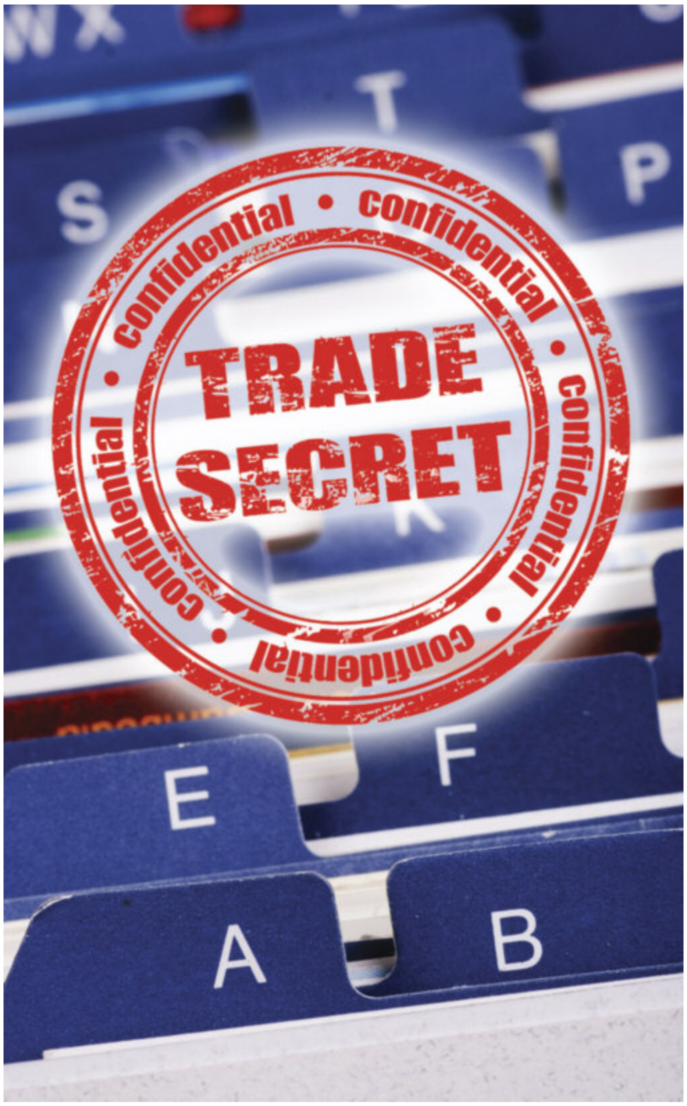

When customer lists are not trade secrets

Making the case against enforcing non-solicitation agreements

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Your client is suing her former employer for wrongful termination under FEHA. It is later discovered that she had signed the following agreement with her employer: "For a period of eighteen months after my termination, I agree not to call, solicit, or take away any of Employer's clients or prospective clients with whom I have had any dealings as a result of my employment by Employer."

It is undisputed that she has solicited customers and prospective customers from her former employer's customer list after her employment relationship terminated. As a result, her former employer has cross-complained seeking to enjoin her on the basis of this agreement. What is your client's best defense?

This article provides an overview of the general framework that applies when your client must defend against a cross-complaint in which her former employer seeks to enjoin her from soliciting its customers and prospective customers on the basis that its customer list constitutes a trade secret.

Non-Solicitation Agreements – Restraint on Trade

Agreements between employees and employers stating that the employee agrees not to solicit her former employer's customers and prospective customers have become increasingly frequent.[1] As the workforce became more knowledge-based, and employees began to move from one employer to the next more often, employers more frequently began to attempt to

protect their customer list by having their employees sign non-solicitation agreements.[2]

Non-solicitation agreements by their very nature restrict open competition and hinder employee mobility because they prescribe limits on the people and companies that an employee may work with in carrying out her trade, profession, or business. Such a restriction goes directly against California's "deeply rooted public policy favoring open competition," and employee mobility for its workers. (*Alliance Payment Systems, Inc. v. Walczer* (2007) 61 Cal.Rptr.3d 789, 800; *D'sa v. Playhut, Inc.* (2000) 85 Cal.App.4th 927.)

This policy is codified in Cal. Bus. & Prof. Code section 16600, which states: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."

Section 16600 operates to invalidate any restraints on employee mobility, including covenants not to compete. In *Edwards v. Arthur Andersen LLP* (2008) 44 Cal.4th 937, 942, the court denounced the judicially created exception that evaluated the reasonableness of a covenant not to compete explaining that section 16600 is to be strictly construed, and therefore judicially created exceptions to this provision are impermissible. (*Ibid.)* The *Edwards* court went on to state that section 16600 "prohibits employee noncompetition agreements unless the agreement falls within statutory exception" because "[t]here exists a clear legislative declaration of public policy against covenants not to compete in Cal. Bus. & Prof. Code Section 16600." (*Ibid.)* Thus, *Edwards* makes clear that courts may not expand the prohibition against restraints on trade embodied in section 16600. (*Ibid.)*

Given that judicially created exceptions are not permitted for section 16600, courts may also not create exceptions in order to enforce non-solicitation agreements under this provision. In *The Retirement Group v. Galante* (2009) 176 Cal.App.4th 1226 the court states that section 16600 "bars a court from specifically enforcing 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." (*Id.* at 21238.)

Because non-solicitation agreements are essentially prohibited by section 16600, how is it that your client's former employer can seek to enjoin your client from soliciting its customers and prospective customers from its customer list?

There are two main ways that your client's former employer may attempt to enjoin her from soliciting its customers and prospective customers. First, the former employer can show that there exists a statutory exception to section 16600's prohibition against restraints on trade. Second, the employer can show that the solicitation is "wrongful independent of any contractual undertaking." (*Alliance Payment Systems, Inc. v. Walczer* (2007) 61 Cal.Rptr.3d 789, 800-801 (finding that "noncompetition agreements are void unless they are specifically authorized by sections 16601 or 16602, or they are necessary to protect trade secrets.").)

The language of section 16600 et seq. has listed the statutory exceptions to the general rule prohibiting restraints on trade. The proviso, "[e]xcept as otherwise provided by this chapter," expressly allows the employer to assert the statutory exceptions provided. One exception applies if your client's restraint on future work arises from the sale of a business entity or the sale of goodwill. (Bus & Prof. Code, § 16601.) The other exception applies if your client is also a partner in the business of the former employer, and there is dissolution of the partnership. (Bus & Prof. Code, § 16602.) For the hypothetical set forth above, however, we assume that none of these statutory exceptions apply for the purpose of this article.

Former employers may also request that the court grant a preliminary injunction against your client to keep her from soliciting customers when the employer can prove that the solicitation is wrongful despite the contract. (*The Retirement Group v. Galante, supra,* 176 Cal.App.4th 1226, 1233, 1238 (standing for the purpose that technically, this is not an exception to section 16600's prohibition on covenants not to compete since the court is not enforcing the contract but condemning the wrongful conduct under a tort theory of law.).)

So, although a court may not be able to enforce the non-solicitation agreement as a contract, it may nonetheless "enjoin tortious conduct by banning the former employee from using trade secret information to identify existing customers to facilitate the solicitation of such customers." (*Ibid.)*

This distinction between enjoining an employee, based on contract theory as opposed to proceeding on a tort theory, is expressed in *The Retirement Group* (*Id.* at 1226, 1233, 1238.) In that case, the court found that a former employer could enjoin a former employee from soliciting the customers on its customer list because the employee's act of soliciting the customers on that list violated the Uniform Trade Secrets Act ("UTSA"), which is embodied in Civil Code sections 3426 et seq. There, the court emphasized that a claim brought under UTSA was entirely distinguishable from a claim brought on the basis of contract breach, and it stated that "the [employee's] conduct is enjoinable not because it falls within a judicially created 'exception' to section 16600's ban on non-solicitation clauses, but is instead enjoinable because it is wrongful independent of any contractual undertaking." (*Ibid.)*

Uniform Trade Secrets Act

As mentioned above, one of the ways that the conduct could be "wrongful independent of any contractual undertaking" is under UTSA, which prohibits the misuse (or misappropriation) of trade secrets. Misuse of trade secrets includes "solicitation of an employer's customers when confidential information is employed." (*Loral Corp. v. Moyes* (1985) 174 Cal.App.3d 268; Civ. Code, §§ 3426 et seq.) So, in order for a court to enjoin your client from soliciting its former

customers based on the theory that such solicitation would be misusing a trade secret, the former employer must show two things: one, that the customer list is a trade secret, and two, that the employee has used or misappropriated the customer list. (Civ. Code, §§ 3426 et seq.) It follows, then, that if the customer list is not a trade secret, the employer is precluded from enjoining your client from soliciting its customers on the basis of trade secret misappropriation.

So, how will your client show that the customer list is not a trade secret?

California defines trade secret as follows: "Trade secret means information, including a formula, pattern, compilation, program, device, method, technique, or process that: (1) derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy." (Civ. Code, §§ 3426.11 (d).) Each element "must be established before a protectable trade secret can be found." (*Kovesdy v. Kovesdy*, 2010 WL 3619826 (N.D. Cal.) *6 .)

Elements of a trade secret

California courts have recognized that customer lists can constitute a trade secret when certain factors are present. In *Gordon v. Landau* (1958) 49 Cal.2d 690, the court found that when the employer's "preferred customers are a real asset to their business and the foundation upon which its success, and…its survival rests…[then] it logically follows that a list of such customers is a valuable trade secret." (*Id.* at 694) Some of the factors that courts have considered in determining the two elements of whether a customer list constitutes a trade secret are outlined below.

***Element #1:* Derives independent economic value from not being generally known to those who can obtain economic value from its disclosure**

Whether the former employer made substantial efforts to procure the customer list.

"Substantial efforts" of the employer may include circumstances evidencing that the former employer has spent a lot of time, expense, or resources in establishing the customer list. (*Kovesdy v. Kovesdy*, 2010 WL 3619826 (N.D. Cal.) *6.) Therefore, your client should seek to show that the customer list was not obtained from such efforts, but instead was built up by her own efforts and her own resources. In some cases developing personal relationships may be sufficient.

In *Gordon*, the court looked to how the employer obtained the customer information, and found that the employer did make substantial efforts to create the customer list. (*Gordon v. Landau*, *supra,* 49 Cal.2d at 690, 691) The court found it to be significant that the way that the customer list was created was by the references from the other customers and by having its employees canvass homes for "the sole purpose of…making] initial sales." (*Ibid.*)

In *Wyndham Resort Development Corp. v. Bingham* 2010 WL 2740158 (E.D. Cal.) the court expanded on the economic value prong addressed in *Gordon v. Landau* by stating that "the more difficult the information is to obtain, and the more time and resources expended by an employer in gathering it, the more likely a court will find such information constitutes a trade secret." (*Id.* at *5.) The customer list at issue in *Wyndham* consisted of 40,000 members of the employer's timeshare enterprise, called WorldMark. (*Id.* at *4.) The way that these members were obtained was by the employer's two sales forces – one team that sought out to obtain new members, and another team to strongly encourage members to upgrade. (*Id.* at *2.) Since the "majority of [the employer's] sales revenue was generated from upgrade sales" (*Ibid.*), the court found that the list was created by substantial efforts of the former employer.

In *Barney v. Burrow* (2008) 558 F.Supp.2d 1066, the court found that the customer list was not a trade secret where the former employees "built up their clientele through their [own] efforts," and where there was little evidence that such clientele had been provided by the employer or even the other previous employers of the former employees. (*Id.* at 1081) There, although the former employer had developed the customer list from "substantial expenditures," the employees had "developed and facilitated such relationships personally and established a business rapport sufficient to solicit [the customers]" after their departure. (*Id.* at 1080) This fact, along with existence of no evidence that the former employer provided customers to the employees, supported a finding that the customer was not a result of the employer's substantial efforts. (*See Barney v. Burrow* (2008) 558 F.Supp.2d 1066, 1081.)

Whether the customer list's disclosure would benefit competitors because the list contains the particular needs, preferences, or characteristics of the customers.

Your client should attempt to show that the customer list was limited to merely identities, such as names and locations of the customers and prospective customers. Hopefully, she can also testify that she did not have access to any other more personal information beyond the customer list of names and maybe locations. Making this showing will support her contention that the information from the customer list would not help her in soliciting the former employer's customers and prospective customers more selectively or more effectively.

In the recent case of *Wyndham Resort Development Corp. v. Bingham*, 2010 WL 2740158 (E.D. Cal.), the court looked to the factor of whether the customer list's "disclosure would allow a competitor to direct its sales efforts to those customers who have already shown a willingness to purchase" the employer's products or services. (*Id.* at *4.) If such a trade secret were disclosed to competitors, then it would allow access to customers who would likely use a unique type of service or product as opposed to a list of people who might only be interested." (*Id.* at *5.) As stated above, the employer in *Wyndham*

had customers who were already predisposed to the types of products that the employer provided. Therefore, the effect of a competitor having such a list would allow that competitor to "solicit both more selectively and more effectively" based on having information about customers' preferences. (*Ibid.)*

Similarly, in *American Credit Indemnity Co. v. Sacks*, the court found that the customer list was "information which has potential economic value because it allows a competitor to direct sales efforts to the elite 6.5% of those potential customers which already have evinced a predisposition to purchase credit insurance." (*American Credit Indemnity Co. v. Sacks* (1989) 213 Cal.App.3d 622.)

The court found that the fact that the customer list was exclusive and unique went to support that the competitors could directly benefit if they had this list.

In *Hanger Prosthetics & Orthopedics, Inc. v. Capstone Orthopedic, Inc.* (2008) 556 F.Supp.2d 1122, the court found that substantial efforts were made where the customer list consisted of extensive customer data, and not just names and locations of customers. (*Id.* at 1135) There, the customers were patients, and the customer list had additional information, including "prescriptions/referral source information, treatment records, [and] addresses." (*Id.* at 1135.) The court found that the presence of this additional information exhibited that the employer spent significant time, effort, and resources in developing the list. (*Ibid.*)

Whether the customer list is readily ascertainable by competitors or easily identifiable from public directories.

Your client should also attempt to show that the customers can be discovered by the general public or by competitors. For instance, it helps if your client can point to the fact that the identities of the customers are easily accessible online just by viewing the employer's Web page. Your client may also set forth facts that show that the customers do not consistently use only the employer's services or products, but instead, they often use the services or products of one or more competitors of the former employer at one time.

In finding that the customer list was a trade secret, the *Gordon* Court pointed to the fact that "some [customers] continue to buy, and these form the hard core of steady customers who have bought merchandise from [the employer] for many years…[employer's] regular customers can be counted on to buy month after month and year after year." (*Gordon v. Landau* (1958) 49 Cal.2d 690, 692.)

The court also found that the customers would not use the employer's services and a competitor's service, and this supported the claim that competitors could not readily ascertain the identities on the customer list. (*Ibid.)*

For instance, in *Kovesdy v. Kovesdy*, the court found that the plaintiff failed to show that the customer list was not already readily ascertainable by competitors in the tax preparation business, and this lack of showing went against the employer's claim that the list had an independent economic value. (*Kovesdy v. Kovesdy,* 2010 WL 3619826 (N.D. Cal.) *6 Also, in *Dowell v. Biosense* (2009) 179 Cal.App.4th 564.) The court also found that the customer list was not a trade secret because, "it appears that the customers (e.g., physicians and hospitals) are easily identified from any number of publicly available directories and resources." (*Id.* at 571.) The ease of accessibility for others to obtain the employer's customer list completely defeated its claim that the customer list was a trade secret.

***Element #2:* Reasonable efforts to maintain secrecy.**

The other element required before a court will find that a customer list is a trade secret, is whether the employer has made reasonable efforts to maintain the secrecy of its list. In California, reasonable efforts to maintain secrecy are found when the employer had its employees sign a confidentiality agreement that states that the customer list is confidential, and when the employer utilizes security measures to protect the list. (*Whyte v. Schlage Lock Company* (2002) 101 Cal.App.4th 443, 1454.)

In *Whyte v. Schlage Lock Company*, (*Ibid.*) the court found that adequate efforts to maintain secrecy existed where the former employer had in place a "password protection system," and had its employees sign a confidentiality agreement. However, in evaluating confidentiality agreements, keep in mind that courts may not find it legally significant that the employee signed an agreement that the customer list was confidential or a trade secret when that information was accessible to competitors or the public. (*Loral Corp. v. Moyes* (1985) 174 Cal.App.3d 268, 219 Cal.Rptr. 836) ("An agreement between employer and employee defining a trade secret may not be decisive in determining whether court will so regard it.") For instance, in *Thompson v. Impaxx* (2003) 113 Cal.App.4th 1425 the court stated that the "recitals alone do not establish anything. Labeling information as a trade secret or as confidential information does not conclusively establish that the information fits this description. (*Id.* at 1430) citing *Morlife, Inc. v. Perry* (1997) 56 Cal.App.4th 1514, 1522).

Conclusion

When your client brings a claim against her former employer for wrongful termination, her employer may cross-complain, seeking to enforce the non-solicitation agreement that she signed. Although enforcement of this contract will likely fail due to California's strong public policy against restraints on trade, the employer may alternatively seek an injunction under UTSA. Under these circumstances, your client's best defense is to establish that the employer's customer list is not a trade secret.

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Endnotes

[1] For a further discussion regarding how covenants not to compete are prevalent amongst today's modern workers, *see* Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment,* 27 Berkeley J. Emp. & Lab. L. 287 (2006).

[2] Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment,* 27 Berkeley J. Emp. & Lab. L. 287 (2006).