

# **PROTECTING YOUR TRADE SECRETS AND ENFORCING RESTRICTIVE COVENANTS –**

## **TIPS, TRAPS & TECHNIQUES**

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# PROTECTING YOUR TRADE SECRETS AND ENFORCING RESTRICTIVE COVENANTS –

## TIPS, TRAPS & TECHNIQUES

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### **I. INTRODUCTION**

Protecting trade secrets in the current job market is more important than ever. Employees may be enticed away by competitors or laid off with little or no notice. With the high turn-over rates in today's job market, there is a significant chance that an employee a company trusts with its confidential information today will be working for its competitor tomorrow.

Improvements in information technology have made it possible for one employee to send hundreds of megabytes of confidential data to his home computer (or to his next employer) with just the click of a mouse. The internet also makes it simple for a disgruntled former employee to disclose sensitive data to a wide audience.

These situations make it more important than ever to institute a comprehensive program to protect your trade secrets and other confidential information. This article will discuss what trade secrets are, how companies can improve their procedures to protect them, and suggest other actions that companies should take in partnership with legal counsel to protect their own trade secrets and to avoid liability.

### **II. DEFINING TRADE SECRETS**

When a company's proprietary information qualifies as a "trade secret," the information is protected against misappropriation. The jurisdiction in which an employer is located will affect how a court determines what constitutes a "trade secret."

In New York, a trade secret has been defined under common law as "any formula, pattern, device or compilation of information [that] is used in one's business, and [that] gives [the owner] an opportunity to obtain an advantage over competitors who do not know or use it." Ivy Mar Co., Inc. v. C.R. Seasons, Ltd., 907 F. Supp. 547, 556 (E.D.N.Y. 1995). New York courts consider the following factors relevant in determining what information may be considered a trade secret:

- v the extent to which the information is known outside of the business;
- v the extent to which it is known by employees and others involved in the business;
- v the extent of measures taken by the business to guard the secrecy of the information;
- v the value of the information to the business and its competitors;
- v the amount of effort or money expended in developing the information; and

- ∨ the ease or difficulty with which the information could be properly acquired or duplicated by others.

EarthWeb, Inc. v. Schlack, 71 F. Supp. 2d 299, 314 (S.D.N.Y. 1999) (quoting Ashland Management Inc. v. Janien, 82 N.Y.2d 395, 407, 604 N.Y.S.2d 912, 918 (1993)); see also Ecolab, Inc. v. Paolo, 753 F. Supp. 1100, 1111-12 (E.D.N.Y. 1991).

Connecticut has adopted the Connecticut Uniform Trade Secrets Act, (“CUTSA”), which defines a trade secret as:

[I]nformation, including a formula, pattern, compilation, program, device, method, technique, process, drawing, cost data or customer list that:

1. Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, 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.

Conn. Gen. Stat. § 35-50 et seq.

Similarly, California has adopted the California Uniform Trade Secrets Act, which defines a trade secret as:

[I]nformation, 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.

Cal. Civ. Code § 3426.1(4)

In New York, Connecticut, and California, a “trade secret” is information that has independent economic value due to its secrecy and that is subject to reasonable attempts to keep it secret. The crucial characteristic of a trade secret is not novelty, but *secrecy*. Thus, a trade secret can be a device or process that is clearly anticipated in the prior art or merely a mechanical improvement that a good mechanic could make. The secrecy necessary for creating a trade secret need not be absolute. Indeed, a trade secret can be disclosed to a licensee, employee or even a stranger, as long as the disclosure is made in confidence.

#### **A. EXAMPLES OF INFORMATION THAT CAN BE PROTECTED AS TRADE SECRETS:**

- ∨ **Customer information**, including client lists, billing information, payment history, client preferences, and contacts.
- ∨ **Manufacturing processes and methods**, including machines, devices, designs, blue prints, specifications, and scientific data.
- ∨ **Business and financial information**, including pricing information, bidding practices, marketing plans and pricing policies.

- v **Computer programs and data compilations**, including databases and sourcecode, but not if the functions are “common to all programs of that type.”
- v **Employee know-how**, including special and general skills and knowledge as long as they were acquired under circumstances giving rise to a duty to maintain their secrecy or limit their use.

**B. EXAMPLES OF INFORMATION THAT CANNOT BE PROTECTED AS TRADE SECRETS:**

- v **General knowledge.** The information need not be available to the public at large to prevent trade secret protection; knowledge of the information by the participants in the relevant industry is sufficient. If the information is generally known in the trade and already used in good faith by competitors, it cannot be protected as a trade secret.
- v **Skills and abilities necessary to perform a job.** Courts have articulated the principle that an individual has the right to change employment for whatever reason and the right to utilize general skills, knowledge and experience for the benefit of his new employer. The courts will not deprive an employee of the right to use general skills developed through the years.
- v **Publicly available information.** While information generally available to the public cannot be protected as a trade secret, a combination of various elements in the public domain can be protected as long as the combination is itself a secret. An example is KFC’s chicken recipe involving 11 herbs and spices – while the ingredients are commonly known, the combination is a carefully guarded trade secret.
- v **Information that is a result of reverse engineering.** Information about a product obtained through inspection or analysis of the product itself is permitted by the trade secret laws if the product was obtained by honest and legitimate means.
- v **Information obtained by independent invention.** Independent discovery by a large number of entities may lead to the loss of trade secret protection on the grounds that the information is generally known, even if each entity continues to take affirmative steps to maintain the confidentiality of the information.

**III. PRACTICAL STEPS YOU CAN TAKE TO PROTECT TRADE SECRETS**

Given the significant energy and resources companies expend in developing the trade secrets that give them a competitive edge in their respective industries, it makes sense that they should also undertake to protect the confidentiality of those trade secrets and impose reasonable restrictions on the competitive activities of departing employees who had access to those trade secrets. The following steps should be taken to protect your company’s confidential information:

- v **Create a confidentiality policy.** The policy should clearly state the consequences of improper use or disclosure of confidential information, including that such use or disclosures may be grounds for discharge. Set out what information the company deems confidential. State how employees are to treat confidential information, such as refraining from discussing it in public, and returning copies to locked filing cabinets at the end of each day. The policy should also require employees to check with designated personnel prior to disclosing any information if the employee is uncertain if the data is confidential.
- v **Educate employees about your confidentiality policy.** Include the confidentiality policy in your company’s employee handbook, and explain your confidentiality policy to your employees. Do not assume that your employees know what information is confidential and

what is not. Have each employee sign a written acknowledgement that the employee has received a copy of the policy, understands its terms, and agrees to abide by it.

- v **Enforce the policy.** Whatever policy you create, make sure that it is actually followed. If you do not enforce your confidentiality policy, your confidential information may not receive protection as a trade secret. Therefore, make sure that your policy is reasonable and workable while still protecting the information. Spot check employees to make sure they are following the policy, conduct training for your managers, and provide periodic reminders of the company's policy to employees.
- v **Restrict access to the information.** Trade secrets should not be readily available to all employees, but rather only those who have a need to know. Keep confidential information in restricted areas that are clearly marked. Do not disclose confidential information to agents, consultants, customers, joint venturers, or licensees until after they have signed a confidentiality agreement.
- v **Label confidential documents.** By stamping documents "CONFIDENTIAL TRADE SECRET. DO NOT COPY. DO NOT DISTRIBUTE," the appropriate message is sent to those who view the documents. While such a statement, without actual enforcement, will not alone establish that the information is a trade secret, it can be very helpful. Do not overuse the "confidential trade secret" characterization, however, since overuse may diminish the protection given to truly confidential information.
- v **Store trade secrets in secured areas.** Trade secrets should not be left in the open where customers or unauthorized employees can see the information. Proprietary or confidential documents should be stored in secured areas, such as locked file cabinets, drawers, safes, secured databases, password protected files, or in saferooms with alarm systems. Consider a log system for checking out documents.
- v **Have employees use only designated notebooks.** Providing special notebooks for employees to use while working with trade secrets is a good way to contain secret information and protect against accidental disclosure. When the employment relationship ends, such notebooks can make collecting confidential information easier.
- v **Consider formal copyright or patent protection.**
- v **Shred Documents.** Creating and enforcing a policy for shredding confidential documents prior to disposal and removing documents from electronic data storage is an important part of protecting confidential information. If your company is involved in litigation, however, check with counsel before destroying any documents that could potentially be evidence in the case.
- v **Use exit interviews.** Exit interviews are important for reminding employees of the confidential nature of certain information. Remove the departing employee's password from your computer system, and consider inspecting all materials to be removed from the premises by the former employee.

#### **IV. REMEDIES AVAILABLE TO EMPLOYERS**

##### **A. INJUNCTION**

Employers may seek injunctive relief in the courts to enjoin the actual or threatened misappropriation of their confidential information. This means that you can go to court to stop someone from disclosing or using your trade secrets. Courts are generally empowered to impose an injunction that remains in force until the information no longer has value, and the injunction can be extended to eliminate any commercial advantage that otherwise would be derived from the misappropriation. You may be able

to obtain an injunction that would stop a key employee from working for a competitor by using the "Inevitable Disclosure Doctrine."

## **B. INEVITABLE DISCLOSURE DOCTRINE**

Generally, to obtain an injunction, an employer must show that a defendant has actually used or disclosed its trade secrets to a competitor, unless the defendant has violated a covenant not to compete. Thus, unless there is evidence of wrongdoing on the part of the defendant employee, the court will usually deny a request for an injunction. However, employers have increasingly had some success arguing that an employee who has been exposed to an employer's trade secrets will inevitably disclose or use those secrets in the course of the new employment, and therefore the former employee should be enjoined from working for a competitor. Although this doctrine is still considered controversial, such injunctions have been occasionally granted. Courts have enjoined former employees from working for a competitor, at least for a limited time, based on a finding that there was virtually no way the defendant could perform his current job for a competing employer without utilizing or disclosing the trade secrets the employee learned from his former employer. See, e.g., Lumex, Inc. v. Highsmith, 919 F. Supp. 624, 631 (E.D.N.Y. 1996) (enforcing six-month restriction based on conclusion that "there will inevitably be immediate disclosure of trade secrets when [the employee] commences his employment with [a competitor]."); DoubleClick, Inc. v. Henderson, No 116914/97, 1997 WL 731413 at \*5 (Sup. Ct. N.Y. Co., Nov. 5, 1997) (enjoining two former employees for six months from forming a new business that would compete directly with former employer because of the "high probability of 'inevitable disclosure' of [the former employer's] trade secrets.").

In applying the inevitable disclosure doctrine, the courts will first determine whether misappropriation is inevitable, and if so, they will craft an injunction to prevent it. Four factors will generally be considered when evaluating if misappropriation is inevitable: (1) the degree of competition in the industry; (2) the new employer's efforts to safeguard from disclosure the secrets of the old employer; (3) the forthrightness of the employee; and (4) the degree of similarity of the new and old employment. Because the third factor, "forthrightness," is only one of several conditions, the former employer does not necessarily need to prove intent to misappropriate as a requirement for applying the doctrine. Therefore, the doctrine can potentially stop an apparently well-meaning or neutral former employee from working for a competitor, even when the former employee consciously intends to protect her former employer's trade secrets.

The courts may also consider whether the employee in question has highly technical skills or will be required to use technical information in the new position. The idea is that highly technical employment requires the use of all of an employee's specialized knowledge and skills acquired from the former employer, including those that are considered trade secrets. In such a highly technical field, the reasoning goes, even a conscientious former employee will inevitably use or disclose technical trade secrets in the course of the new job. This consideration can give extra protection to high tech companies that properly classify and protect their trade secrets.

The inevitable disclosure doctrine primarily focuses on protecting trade secrets, not balancing employee and employer interests or evaluating relative value. Even so, courts are reluctant to grant injunctions that will prevent a former employee from acquiring any sort of employment in the same field. Courts are more likely to grant an injunction that is limited to protecting specifically defined trade secrets where the trade secret has been clearly identified and is of significant value. In such a situation, a showing of bad faith or underhanded dealing by the former employee or new employer would not necessarily be required. To support a broad injunction effectively precluding competitive employment, however, most courts would probably require a showing of bad faith or underhanded dealing by the former employee or new employer, and/or a showing that the new employer lacks comparable levels of knowledge and achievement.

The inevitable disclosure doctrine effectively prevents an employee from working for a competitor in the same way as a noncompete agreement. Even without signing such an agreement, an employee

could be prevented from taking a new job if the court believes the new job would require the employee to use or disclose trade secrets. While still controversial, in the hands of an experienced labor and employment attorney, the inevitable disclosure doctrine can be a powerful tool to help protect your trade secrets.

### **C. DAMAGES**

Companies may also recover damages suffered from the misappropriation of trade secrets. These damages can include both the actual loss caused by misappropriation and the competitor's unjust enrichment it received as a result of the misappropriation. If the injured party cannot prove the amount of unjust enrichment, the damages can be awarded by imposing a reasonable royalty for the unauthorized disclosure or use of the trade secrets.

Under CUTSA, punitive damages and the recovery of attorneys' fees may be available to the injured party if the misappropriation was willful and malicious. Attorneys' fees may also be recoverable under CUTSA if the claim of misappropriation is made in bad faith.

## **V. DUE DILIGENCE IN HIRING EMPLOYEES AND LOSING EMPLOYEES TO COMPETITORS**

Skilled employees are often scarce. Moreover, unlike in the past, the current labor pool is highly mobile -- employees sometimes change jobs many times over short periods. Employers therefore compete aggressively to recruit and retain top employees. Employers should conduct "due diligence" both when hiring new employees, and when their current employees depart to be employed by competitors. Indeed, it is often vital that human resources professionals be involved throughout the hiring and exit interview process to protect the company's interests. We discuss below potential liabilities and necessary concerns for employers in New York and Connecticut, as well as broader issues on the topic nationally.

### **A. DEFINING "DUE DILIGENCE"**

Due diligence is a term of art to describe the level of investigation that should attend certain decisions. Due diligence can best be defined as a reasonable investigation prior to making a decision or otherwise committing to an action which may give rise to legal or commercial liability. Obviously, the intensity of investigation should be based on the risk. In the human resources context, due diligence in the hiring and exit process includes the following:

- v gathering information about each potential employee before hiring;
- v conferring with counsel and management regarding potential employment related issues for job candidates;
- v enforcing personnel policies designed to protect the company, including written agreements with prospective and departing employees;
- v fulfilling obligations to competitors from which employees are recruited regarding trade secret protection;
- v preventing raiding of the company's employees and customers through use of non-competition and non-solicitation agreements;
- v using exit interviews to ensure that all company property, including intellectual property, is returned before the employee departs;

- v monitoring any employees who are subject to restrictive agreements with former employers, including maintaining the secrecy of the former employer's trade secrets; and
- v keeping management and counsel apprised of potential theft of trade secrets or confidential information and/or violations of any law or company policies by employees.

There may be varying levels of diligence necessary for each employee or issue concerned. For example, hiring a senior executive or senior engineer would generally require greater scrutiny than hiring a new computer programmer. However, if the due diligence in hiring a junior employee leads to the discovery of certain risk factors, it is important to exercise additional care, perhaps treating the junior employee as if he or she were being considered for a senior management position. For example, a junior employee candidate for a chemist position with one company who was previously a chemist for another in the same industry would be of significantly higher risk than a senior manager in insurance sales who went to work in car sales.

## **B. WHICH WORKERS SHOULD BE INCLUDED IN DUE DILIGENCE?**

An ever-increasing number of companies use temporary workers, independent contractors, and/or partnerships with other companies instead of regular employees. This is often done because outsourcing, temporary workers, and using short-term independent contractors may cost less and be more efficient. For these alternative employment arrangements, many companies may not use the same due diligence procedures. However, it is imperative that these non-traditional employment relationships receive an appropriate level of scrutiny. The hiring and departure of independent contractors and temporary employees may give rise to liabilities or risks similar to those encountered with traditional employees.

## **C. WHAT ISSUES SHOULD BE CONCERNS?**

### **1. Inevitable Disclosure Doctrine**

As noted above, former employees who routinely use trade secrets to do their jobs may not be allowed to work for a competitor because the employee will inevitably disclose those secrets to the new employer. The Inevitable Disclosure Doctrine can thus affect your hiring decisions since hiring a highly skilled employee with trade secrets from a competitor may result in that competitor filing a lawsuit to enjoin the employee from working for your company. The Doctrine conversely allows you an opportunity to attempt to stop a key employee from working for a competitor. Even if such a suit were unsuccessful, it could be used to obtain a more favorable severance agreement or noncompete agreement.

### **2. Other Potential Legal Actions**

#### **a. Tortious Interference With Contract**

A claim for tortious interference with contract can arise when an organization hires an employee who is subject to a written agreement with a competitor such as a covenant not to compete or a non-disclosure agreement. Often it is difficult to enforce such agreements against the employee, and so former employers may prefer to bring a tortious interference claim against the competitor instead of (or in addition to) a contract action against the employee. See, e.g., Whittaker General Medical Corp. v. Daniel, 379 S.E.2d 824 (N.C. 1989) (\$93,551 in compensatory damages and \$12,898.00 in punitive damages awarded to former employer of salesperson who was subject to covenant not to compete). The desire to bring this action against competitors is particularly strong in jurisdictions like California which generally do not enforce non-competition agreements against individual employees.

In New York, a plaintiff alleging tortious interference with an employment contract must show "(1) the existence of a valid contract between plaintiff and its employees, (2) defendants' knowledge of that contract, (3) defendants' intentional inducement of employees to breach that contract, and (4) damages."

Lockheed Martin Corp. v. Atlas Commerce, Inc., No. 88042, 2001 N.Y. App. Div. LEXIS 5183, \*4 (3d Dep't 2001); Murray v. SYSCO Corp., 273 A.D.2d 760, 761, 710 N.Y.S.2d 179, 181 (3d Dep't 2000). If there is no covenant not to compete between the former employee and the plaintiff, and the employment is at-will, then the plaintiff must also show that the "defendant employed wrongful means, such as fraud, misrepresentation or threats to effect the termination of the employment." Murray, 710 N.Y.S.2d at 181; Headquarters Buick-Nissan, Inc. v. Michael Oldsmobile, 539 N.Y.S.2d 355, 357, 149 A.D.2d 302, 304 (1st Dep't 1989).

"Under Connecticut law, a claim for tortious interference with contractual relations requires a plaintiff to establish the following: (1) the existence of a contractual relationship; (2) the defendant's knowledge of that relationship; (3) the defendant's intent to interfere with that relationship; (4) a tortious interference; and (5) damages caused by the defendant's conduct." Brown v. Northeast Nuclear Energy Co., 118 F. Supp. 2d 217, 221 (D. Conn. 2000) (citing Collum v. Chapin, 40 Conn. App. 449, 452 (1996)).

### **b. Tortious Interference With Business Relationship**

A claim for tortious interference with a business relationship arises from the common law duty of loyalty that an employee owes to his current employer. If a competitor recruits an employee with the knowledge that the employee is or will be soliciting customers of his current employer, then the competitor could be liable for tortious interference with business relations/expectations.

Under New York law, to state a claim for tortious interference with business relations, a plaintiff must show: "(i) business relations with a third party; (ii) the defendant's interference with those business relations; (iii) [that] defendant acted with the sole purpose of harming the plaintiff (i.e., with malice) or used dishonest, unfair, or improper means; and (iv) injury to the relationship." Solar Travel Corp. v. Nachtomi, No. Civ 3564, 2001 U.S. Dist. LEXIS 7549 (S.D.N.Y. June 8, 2001) (citing Purgess v. Sharrock, 33 F.3d 134, 141 (2d Cir. 1994)). In a recent case, Don Buchwald & Assoc., Inc. v. Rich, 281 A.D.2d 329, 723 N.Y.S.2d 8 (1st Dep't 2001), a New York appellate court stated that the improper means must exceed that of generally acceptable business persuasion, but that the means did not need to be illegal to be within the scope of the tort.

Connecticut courts analyze a claim for tortious interference with business relations in the same manner as a claim for tortious interference with contract. See Solomon v. Aberman, 196 Conn. 359, 364, 493 A.2d 193, 196 (1985). "The essential elements of a [claim for tortious interference with business relations] include ... the existence of a ... beneficial relationship and that the defendant(s), knowing of that relationship, intentionally sought to interfere with it; and, as a result, the plaintiff claimed to have suffered actual loss." Id.; see also S.A. Candelora Enterprises v. Wild, No. CV 01 0447877, 2002 WL 241481 at \*2 (Conn. Super. Feb. 4, 2002).

### **c. Civil Racketeering And/Or Business Conspiracy**

Generally, to face liability under civil racketeering laws regarding hiring employees, a defendant must be guilty of misappropriating trade secrets or knowingly aiding an employee in violating an enforceable covenant not to compete.

The federal RICO statute, 18 U.S.C. § 1962 (c) and (d), forbids persons associated in an enterprise in interstate commerce from engaging in a pattern of racketeering or conspiring to racketeer. Racketeering activity can include raiding of employees and/or misappropriation of trade secrets. In Brandenburg v. Seidel, 859 F.2d 1179, 1187 n.7 (4th Cir. 1988), the Fourth Circuit stated that for civil RICO, the plaintiff was required to show injury to the business, and that the injury derived from a racketeering activity which violated the RICO statute.

**D. HOW SHOULD MY COMPANY ADDRESS THESE ISSUES IN HIRING?**

Each time a company interviews a prospective new employee, it is vital that the company protect itself from potential legal action from the employee's former employers. This means gathering facts and background information from the candidate and other sources. The actions employers should focus on include the following:

- v Determine whether the job candidate is subject to a written agreement with current or former employer(s) which may restrict their employment with your company. This includes, for example, covenants not to compete, non-disclosure agreements and confidentiality agreements.
- v Specifically request copies of any such agreements and have them reviewed by counsel before making any decisions on employment. Often, there may not be time to review such agreements before a hiring decision needs to be made. If there is not sufficient time to have counsel review the agreement, make any hiring decisions specifically dependent upon counsel's review.
- v Have a proper party debrief the employee on his previous employment before he begins work. Consult with counsel to design the debriefing so that any information divulged does not give rise to liability.
- v If the incoming employee states he is not subject to any limitations from a prior employer, have him sign a written agreement before starting employment confirming that he is not subject to any restrictions that would prevent his employment.
- v Require incoming employees to sign an agreement promising not to disclose any trade secrets acquired from prior employers and specifying that such disclosure of other employers' trade secrets can constitute grounds for discharge.
- v As a condition of employment, have any new employee sign a covenant not to compete, a non-solicitation agreement, and/or a confidentiality agreement with the company. It is important that there be "consideration," i.e., some form of payment, for the employee signing these agreements. By making the signing of the agreements a condition of employment, an employer can usually satisfy this requirement.
- v Inform the employee that he may want to consult with his attorney to discuss his responsibilities to his prior employer before beginning work.

**E. WHAT SHOULD MY COMPANY DO WHEN AN EMPLOYEE DEPARTS TO WORK FOR A COMPETITOR?**

Each time an employee is hired away by a competitor or potential competitor, it is important to perform certain protective actions to safeguard the company. These actions should include emphasizing to the departing employee and/or the employee's new employer that the employee and the competitor are responsible for safeguarding the trade secrets under the employee's control. Employers should also inform the employee of the rights the employer has to enforce any non-competition or non-solicitation agreements, and the duty the employee has to return any company property, trade secrets or confidential documents prior to departure. The best way to perform these responsibilities is to implement a comprehensive exit interview policy. The matters to be addressed in any such exit interview include, but are not limited to, the following:

- v Emphasize to the employee that the company has a policy governing confidential and proprietary information, including, but not limited to trade secrets, customer lists, lists of fellow employees, etc.

- v Inform the employee of his responsibilities under the signed agreement to abide by the company's policy governing confidential and proprietary information, and, pursuant to that policy, not disclose any of the company's confidential and proprietary information.
- v Explain the employee's contractual duty not to attempt to take from the company customers serviced and inventions created while employed or fellow employees.
- v Make sure the employee returns all company property, including intellectual property, i.e., computer programs and electronic versions of documents, before leaving.
- v Inform the employee of his duty not to do anything that would pose a conflict of interest to him or the company. This includes a conflict of interest resulting from employment with a competitor and/or using information acquired while at the company or in any way damaging the business name of the company.

**F. WHAT SHOULD MY COMPANY DO WHEN A MANAGER JOINS A COMPETITOR AND TAKES HIS TEAM AND/OR CUSTOMERS WITH HIM?**

When a high profile or key manager leaves a company to work for a competitor, there are often significant legal issues that arise, including trade secret theft. When the manager attempts to bring customers and/or employees with him, there are additional problems. The best way to protect the company is to perform the due diligence necessary to inform managers and employees of their pre- and post-employment duties and responsibilities to the company, including verification of the existence of signed non-solicitation agreements and/or non-competition agreements with all such management-level employees. It is also incumbent on human resources personnel to conduct exit interviews of such management employees, regardless of the likelihood of the team or customers departing. Indeed, if the company maintains proper agreements regarding trade secrets, non-solicitation, confidentiality and/or non-competition, and conducts exit interviews with its personnel, the likelihood of the team or customers being taken should be significantly reduced.

**G. WHAT HAPPENS IF DUE DILIGENCE IS NOT ENOUGH TO PREVENT LEGAL DISPUTES?**

Regardless of how diligent human resources staff are, a newly hired employee or ex-employee's conduct may force the company to prosecute or defend itself in court on trade secret or competitive disadvantage issues. To protect itself in litigation, it is vital that all policies and procedures regarding trade secrets, non-solicitation, and non-competition be well published in employee manuals, and/or distributed to employees. It is also vital that the human resources department have a due diligence policy that sets forth the company's duties and rights, and that the policy be followed in the case of every new hire or departing employee. Most importantly, the human resources file for each employee should contain all necessary documents to prove the existence of and validity of any restrictive agreement between the employee and the company. This may mean the difference between long, costly litigation and a quick settlement or dismissal.

**VI. COVENANTS NOT TO COMPETE:  
JUDICIAL DEVELOPMENTS AND DRAFTING GUIDELINES**

**A. GENERAL PRINCIPLES**

**1. Types Of Restrictive Covenants**

Restrictive covenants are generally put in employment agreements. However, they may also be contained in stock purchase agreements and post-hire agreements. Restrictive covenants in employment agreements generally fall into four categories:

- v Covenants not to compete with the business of the former employer.
- v Covenants not to solicit business from or provide services to clients of the former employer.
- v Covenants not to solicit business from or provide services to clients or customers with whom the employee had contact while employed by the former employer.
- v Covenants not to solicit or hire employees of the former employer.

Generally, New York and Connecticut courts will enforce such covenants to the extent that they are reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee. See, e.g., Reed, Roberts Assocs., Inc. v. Strauman, 40 N.Y.2d 303, 307, 386 N.Y.S.2d 677, 679 (1976); Robert S. Weiss & Assocs. v. Wiederlight, 208 Conn. 525, 529, 546 A.2d 216 (1988).

New York law regarding restrictive covenants is founded on the premise that "powerful considerations of public policy ... militate against sanctioning the loss of a man's livelihood." Purchasing Assocs. v. Weitz, 13 N.Y.2d 267, 272, 246 N.Y.S.2d 600, 603 (1963). Recognizing that our economy is based on "the competition engendered by the uninhibited flow of services, talent and ideas," New York courts generally oppose restrictions on "an employee's right to apply to his own best advantage the skills and knowledge acquired by the overall experience of his previous employment." Reed, Roberts, 40 N.Y.2d at 307, 386 N.Y.S.2d at 679. As a result, New York courts strongly disfavor restrictive covenants calculated to keep an employee from engaging in a similar vocation after termination of employment. Nigra v. Young Broadcasting Co. of Albany, Inc., 676 N.Y.S.2d 848, 177 Misc. 2d 664 (1998).

Similarly, Connecticut courts will not enforce a restrictive covenant if it would bar an individual from "pursuing his occupation and thus prevent[ing] him from supporting himself and his family." Scott v. General Iron & Welding Co., 171 Conn. 132, 137, 368 A.2d 111 (1976).

Nevertheless, New York and Connecticut courts will uphold "the legitimate interest an employer has in safeguarding that which has made his business successful and to protect himself against deliberate surreptitious commercial piracy." Reed, Roberts, 40 N.Y.2d at 308, 386 N.Y.S.2d at 680. In such instances, restrictive covenants would be considered "valuable business asset[s] which [are] entitled to protection." Torrington Creamery, Inc. v. Davenport, 126 Conn. 515, 521, 12 A.2d 780 (1940). Thus, an employer is permitted to protect against unfair competition by use of restrictive covenants.

## **2. Factors Determining Enforceability**

To enforce a restrictive covenant, an employer must show that the covenant meets the following requirements:

- (i) Is designed to safeguard a protectable interest of the employer;
- (ii) Is reasonable in its scope and duration;
- (iii) Is not harmful to the general public; and
- (iv) Is not unreasonably burdensome to the employee.

### **B. PROTECTABLE INTERESTS**

Courts have recognized the following protectable interests of an employer:

- (i) Trade secrets;

- (ii) Confidential customer information;
- (iii) Confidential customer lists;
- (iv) Goodwill of the business;
- (v) Employees' "unique or extraordinary" services, which, if lost, would expose the employer to special harm; and
- (vi) Client or customer relationships.

## **2. Trade Secrets And Confidential Information**

As discussed above, an employer has protectable interests in trade secrets and confidential information. Data Sys. Computer Centre, Inc. v. Tempesta, 566 N.Y.S.2d 955, 957, 171 A.D.2d 724, 725 (2d Dep't 1991); Conn. Gen. Stat. § 35-51(d).

### **a. Customer Lists**

Customer lists may qualify as trade secrets or confidential information where the information is not readily ascertainable but rather must be obtained with considerable effort and maintained through the expenditure of significant amounts of time and money. Ivy Mar, 907 F. Supp. at 556-57; see also Walter Karl, Inc. v. Wood, 528 N.Y.S.2d 94, 137 A.D.2d 22 (1988); Conn. Gen. Stat. § 35-51(d); Town & Country House & Homes Service, Inc. v. Evans, 150 Conn. 314, 319, 189 A.2d 390 (1963).

Customer lists will not ordinarily qualify as trade secrets or confidential information where the names of the customers can be ascertained from sources outside the employer's business. See Catalogue Serv. of Westchester, Inc. v. Henry, 484 N.Y.S.2d 615, 616 (2d Dep't 1985); Wildowsky v. Dudek, 30 Conn. Supp. 288, 289-90, 310 A.2d 766 (1972).

### **b. Customer Preferences And Ordering Patterns**

"Client information, such as data on the types of hardware and software ordered by specific clients, lists of products sold to clients but not yet developed and problems arising in the course of client relations, are also protectable trade secrets." Business Intelligence Services, Inc. v. Hudson, 580 F. Supp. 1068, 1072 (S.D.N.Y. 1984). Customer preferences and ordering patterns constitute trade secrets, unless such information "could be easily recalled [by the former employee] or obtained by contacting those customers directly." Ivy Mar, 907 F. Supp. at 557-58. See also DoubleClick, Inc. v. Henderson, No. 116914/97, 1997 WL 731413 (Sup. Ct. N.Y. Co., Nov. 7, 1997) (determining that employer's arrangement with clients regarding distribution of advertising revenues derived from the clients' web sites constituted a trade secret).

### **c. Computer Software And Other Information Developed By The Company**

Computer software may also constitute trade secrets. See Conn. Gen. Stat. § 35-51(d). For instance, in Business Intelligence Services, 580 F. Supp. at 1072, the former employee had "extensive knowledge" of her former employer's international currency management computer program and attendant source codes. The former employer took significant measures to ensure the secrecy of its software. The district court enjoined the former employee from working for a "vigorous competitor[] in the rapidly developing market for computer software where design and program are paramount." Id. at 1071. See also Matter of Belth v. Insurance Dep't., 406 N.Y.S.2d 649, 95 Misc. 2d 18 (Sup. Ct. N.Y. Co. 1977) (description of computer program and details of mathematical models, procedures and statistical assumptions developed by an insurance company constitute trade secrets); Trio Laboratories Inc. v.

Computer Energy Corp., 320 N.Y.S.2d 445, 36 A.D.2d 750 (2d Dep't 1971) (computer programs and information relating thereto deemed trade secrets).

#### **d. Pricing Information**

In some contexts, "courts have found that particularized marketing plans, costing and price information may constitute trade secrets." EarthWeb, 71 F. Supp. 2d at 314; see also Lumex, 919 F. Supp. at 629-30 (stating that information pertaining to "prototypes of new and future [products], including manufacturing costs and pricing structure, sales training, projected release dates and projected life span, ... [are], of course, confidential...."). See also Elm City Cheese Co., Inc. v. Federico, 251 Conn. 59, 74, 752 A.2d 1037 (1999) (holding that employer's "list of suppliers and the costs it paid for its supplies could be found to be trade secrets.").

Pricing information is not granted trade secret status if it is "disseminated openly to the public through widely distributed catalogs." Ivy Mar, 907 F. Supp. at 558. Furthermore, even unpublished pricing information is not likely to constitute a trade secret where it would be outdated and thus of little value. Id.

### **3. Business Goodwill**

An employer has a protectable interest in the goodwill of its business. Ivy Mar, 907 F. Supp. at 555; see also Carvel Corp. v. Leopold DePaola, No. CV 00 0505443, 2001 WL 528203 at \*11-\*12 (Conn. Super. Apr. 24, 2001) (granting motion for temporary injunction where defendants' competition in violation of restrictive covenants was diminishing plaintiff's goodwill). The goodwill of a business is an intangible asset, and includes customer loyalties that the business has established and nurtured over time. See Mohawk Maintenance Co., Inc. v. Kessler, 52 N.Y.2d 276, 285-86, 437 N.Y.S.2d 646 (1981); Kraft Agency, Inc. v. Delmonico, 494 N.Y.S.2d 77, 80, 110 A.D.2d 177, 181 (4th Dep't 1985). The goodwill of a business is related to its protectable interests in trade secrets and confidential information, particularly with respect to customer lists. Thus, a court will not allow solicitation of customers "who are not openly engaged in business in advertised locations" or whose "availability as patrons cannot readily be ascertained but 'whose trade and patronage have been secured by years of business effort and advertising, and the expenditure of time and money, constituting a part of the good will of a business which enterprise and foresight have built up.'" Ivy Mar, 907 F. Supp. at 557.

The New York Court of Appeals has also held that an employer's protectable interests include an interest in "preventing former employees from exploiting or appropriating the goodwill of a client or customer, which [has] been created and maintained at the employer's expense, to the employer's competitive detriment." BDO Seidman v. Hirshberg, 93 N.Y.2d 382, 383, 690 N.Y.S.2d 854, 859 (1999).

### **4. Unique Or Extraordinary Employee Services**

An employer may also have a protectable interest where an employee's services are unique or extraordinary. See BDO Seidman, 93 N.Y.2d at 389, 690 N.Y.S.2d at 857; Reed, Roberts, 40 N.Y.2d at 308, 386 N.Y.S.2d at 680. Generally, services are deemed unique when what the employee actually does is unique, such as the way he or she sings or otherwise performs. See King Records, Inc. v. Brown, 252 N.Y.S.2d 988, 21 A.D.2d 593 (1964) (regarding James Brown's talents as a "vocalist, musician and orchestra leader" to be unique and extraordinary). "It must also appear that his services are of such character as to make his replacement impossible, or that the loss of such services would cause the employer irreparable injury." Purchasing Assocs., 13 N.Y.2d at 274, 246 N.Y.S.2d at 605.

Merely being talented or excelling in one's vocation is insufficient to render one's services unique. See Purchasing Assocs., 13 N.Y.2d at 274, 246 N.Y.S.2d at 606; Diaz v. Indian Head, Inc., 402 F. Supp. 111, 115 (N.D. Ill.), aff'd, 525 F.2d 694 (7th Cir. 1975). Holding a key position or being of high value to the employer is likewise insufficient. See Ivy Mar, 907 F. Supp. at 555 n.7; Reed, Roberts, 40 N.Y.2d at 309, 386 N.Y.S.2d at 681.

The New York courts generally do not uphold a restrictive covenant purely on the theory that the employee's services are unique or extraordinary. See, e.g., Reed, Roberts, 40 N.Y.2d at 307, 386 N.Y.S.2d at 679 (finding employee who became vice president of internal affairs after designing and setting up the company's computer system and forms is not unique); Newco Waste Systems, Inc. v. Swartzenberg, 510 N.Y.S.2d 399, 125 A.D.2d 1004 (4th Dep't 1986) (holding that chief operating officer and vice president were not unique). Rather, in recent case law, the courts have used this theory to protect special client relationships that the employee has developed while working with the employer. See, e.g., Contempo Communications, Inc. v. MJM Creative Services, Inc., 582 N.Y.S.2d 667, 182 A.D.2d 351 (1st Dep't 1992); Ticor Title Ins. Co. v. Cohen, 173 F.3d 63 (2d Cir. 1999).

In Ticor, 173 F.3d 63, the Second Circuit upheld a clause that prohibited Cohen from working in the title insurance business for six months if he breached his employment agreement by resigning early. Ticor agreed to pay Cohen, who earned \$1 million a year, his salary for the six-month period. Thus, without a showing of special talents or abilities, the Second Circuit held that an employee may be deemed unique "when the employee's relationship with the customers is such that there is a substantial risk that the employee may be able to divert all or part of the business." Id. at 72.

## **5. Non-Solicitation Of Employees**

Although there exists a considerable body of law defining the scope and validity of noncompetition provisions, the opportunity for New York and Connecticut courts to address the enforceability of contractual clauses restricting an employee's ability to solicit or hire other employees of the former employer has been more limited. Nevertheless, the existing case law indicates that such a provision will be upheld where it is reasonable and necessary to protect an employer's legitimate business interests. See Natsource LLC v. Paribello, 151 F. Supp. 2d 465 (S.D.N.Y. 2001) (granting preliminary injunction enforcing, *inter alia*, an employment agreement provision prohibiting former employee for one year after leaving the former employer's employ from "encouraging or agreeing with any [other] employee [of the former employer] to leave [the former employer] and accept employment with a ... competitor.").

### **C. REASONABLENESS**

To be enforceable, a restrictive covenant must be reasonable as to scope, geography and time. Yet "only after determining that a restrictive covenant would serve to protect against ... 'unfair and illegal' conduct and not merely to insulate the employer from competition, does the reasonableness of the covenant in terms of its 'time, space or scope,' or the oppressiveness of its operation become an issue." Ivy Mar, 907 F. Supp. at 555-56. Nevertheless, no hard and fast rules exist for determining reasonableness and "the courts have been continuously engaged in the ongoing task of determining what restrictions are reasonable given the peculiar circumstances and context of each individual case." Ivy Mar, 907 F. Supp. at 555.

"[T]ime and geographical restrictions are to be viewed as intertwined considerations when a determination is made on the reasonableness of the limitations of an employee's post-termination activities." Van Dyck Printing Co. v. DiNicola, 43 Conn. Supp. 191, 197, 648 A.2d 898 (1993) *aff'd*, 231 Conn. 272, 648 A.2d 877 (1994). Therefore, a "restriction covering a large area might be reasonable if in effect for a brief time, while a restriction covering a small area might be reasonable for a longer time." Id.

A restrictive covenant must be reasonably limited temporally and geographically. See Columbia Ribbon & Carbon Mfg. Co., Inc. v. A-1-A Corp., 42 N.Y.2d 496, 499, 398 N.Y.S.2d 1004 (1977); see also Robert S. Weiss & Associates, Inc. v. Wiederlight, 208 Conn. 525, 530, 546 A.2d 216 (1988); Ranciato v. Nolan, No. CV 97 0401729, 2002 WL 313892 at \*4 (Conn. Super. Feb. 7, 2002). "The application of this rule 'depends entirely on the totality of the circumstances.'" Ivy Mar, 907 F. Supp. at 558-59. As a result, "courts have upheld restrictive covenants of extensive or unlimited duration where warranted by the specific circumstances of the case" as well as "restrictive covenants of broad or unlimited geographic

scope ... where such restrictions were reasonable in view of the specific facts of the case.” Ivy Mar, 907 F. Supp. at 559.

### **1. Reasonable Restrictions**

- v Covenant restricting a physician from practicing within a 30-mile radius for five years, where medical group had developed its practice for over 20 years. Gelder Medical Group v. Webber, 41 N.Y.2d 680, 394 N.Y.S.2d 867 (1977).
- v One-year covenant prohibiting competition in Connecticut, New York, and Massachusetts. Gartner Group Inc. v. Mewes, No. CV 91 0118332, 1992 WL 4766 (Conn. Super. Jan. 3, 1992) (court severed broader geographic restriction, which the court found to be unreasonable).
- v Covenant unlimited temporally but geographically restricted to five small rural counties coextensive with plaintiff’s business. Karpinski v. Ingrasci, 28 N.Y.2d 45, 320 N.Y.S.2d 1 (1971).
- v Covenant prohibiting former employee for two years from performing competitive services for customers with whom he dealt or whose identity he had known while employed with former employer. New Haven Tobacco Co. v. Perrelli, 18 Conn. App. 531, 534-35, 559 A.2d 715 (Conn. App. Ct. 1989).
- v Covenant restricting use of privileged information and prohibiting competition with plaintiff anywhere in the continental United States for one year after termination of employment. Plaintiff’s business – developing and designing airline business centers – was national in scope. Innovative Networks Inc. v. Satellite Airlines Ticketing Centers, 871 F. Supp. 709 (S.D.N.Y. 1995).
- v One-year, geographically unlimited covenant where plaintiff’s computer development and licensing business was international in nature. Business Intelligence Services, 580 F. Supp. 1068.
- v Covenant covering the United States, Canada, Western Europe, and Japan where employer’s product was being developed in each of those areas. Continental Group, Inc. v. Kinsley, 422 F. Supp. 838, 843 (D. Conn. 1976).
- v Covenant not to perform work for 18 months on any public relations account former employee had been involved with during employment. Mallory Factor Inc. v. Schwartz, 536 N.Y.S.2d 752, 146 A.D.2d 465 (1st Dep’t 1989).

### **2. Unreasonable Restrictions**

- v Covenant not to compete for two years after termination within any territory to which former employee had been assigned within last two years where covenant was “unrestrained by any limitations keyed to uniqueness, trade secrets, confidentiality or even competitive unfairness.” Columbia Ribbon, 42 N.Y.2d 496, 396 N.Y.S. 1004.
- v A two-year non-compete provision, without geographic limitation, prohibiting former employee from working for any competitor of the former employer in the building inspection business. Building Inspections, Inc. v. Paris, No. CV 97-0072871, 1997 WL 97334 (Conn. Super. Ct. Feb. 20, 1997).

- v Covenant not to compete for two years within a 300-mile radius of New York City where covenant lacked consideration and defendant's services were not "unique." Purchasing Assocs., 13 N.Y.2d 267, 246 N.Y.S.2d 600.

In determining the reasonableness of temporal and geographic restrictions, courts examine the duration and scope of the restrictions themselves as well as the circumstances surrounding the particular case. In so doing, they have taken into account whether:

- v The covenant enables the former employee to obtain full compensation during the restricted time period; Lumex, 919 F. Supp. at 632;
- v Trade secrets could possibly be disclosed; id. at 632;
- v The former employee's inability to perform could alienate prospective employers or render the former employee unemployable within the industry; id. at 632-33;
- v Disclosure of trade secrets is inevitable; id. at 633;
- v The former employee's services were unique or the former employee had a unique or special relationship with customers; id. at 633;
- v The former employee and his new employer used good faith in their dealings; id. at 633;
- v Even if there were good faith, it would be virtually impossible not to use or divulge trade secrets and confidential information; id. at 634;
- v The covenant places restrictions over unspecified prospective products and/or customers (such covenants have been held to be "unreasonable as a matter of law.") Ivy Mar, 907 F. Supp. at 559-60; and
- v An imbalance in bargaining power exists between the parties; Prudential Securities, Inc. v. Plunkett, 8 F. Supp. 2d 514, 519 (E.D. Va. 1998) (applying New York law).

#### **D. HARM TO THE GENERAL PUBLIC**

Courts will refuse to enforce any restrictive covenant that, if upheld, would cause harm to the general public. See BDO Seidman, 93 N.Y.2d at 389, 690 N.Y.S.2d at 857; Mallory Factor, 536 N.Y.S.2d at 753, 146 A.D.2d at 467; Spitz, Sullivan, Wachtel & Falcetta v. Murphy, No. CV 86 0322422, 1991 WL 112718 at \*6 (Conn. Super. June 13, 1991). In determining whether a restrictive covenant unreasonably interferes with the public, Connecticut courts will consider "(1) the extent of the effect on the public; (2) the likelihood that the covenant will create or maintain a monopoly; and (3) the extent of the interest protected by the covenant." Spitz, 1991 WL 112718 at \*6.

In BDO Seidman, for instance, the New York Court of Appeals weighed the potential harm an 18-month restrictive covenant contained in an accountant's employment agreement would cause to the general public. 93 N.Y.2d 382. The court concluded that the restriction did not "seriously impinge on the availability of accounting services [to the public], or cause any significant dislocation in the market or create a monopoly in accounting services in [the affected] locale." Id. at 393.

#### **E. UNREASONABLY BURDENSOME TO THE EMPLOYEE**

Restrictive covenants also cannot be unreasonably burdensome to the employee. See BDO Seidman, 93 N.Y.2d at 389, 690 N.Y.S.2d at 857; Mallory Factor, 536 N.Y.S.2d at 753, 146 A.D.2d at 467; Scott, 171 Conn. at 137, 368 A.2d at 114-15. The courts, on occasion, will address this matter when balancing the equities in furtherance of deciding whether a preliminary injunction should issue. See, e.g.,

Nigra v. Young Broadcasting of Albany, Inc., 676 N.Y.S.2d 848, 177 Misc. 2d 664 (Sup. Ct. Albany Co. 1998) (enjoining former employer from enforcing a restrictive covenant that would have rendered departing employee, a television reporter, “unemployable in her area of experience and expertise in ... her home region.”).

## **F. COVENANTS RESTRICTING COMPETITION BETWEEN PROFESSIONALS**

Generally, restrictive covenants applicable to members of the “learned professions” have been held to a less stringent standard and greater weight has been given to the employer’s interest in restricting competition within a particular area. See BDO Seidman, 93 N.Y.2d at 389, 690 N.Y.S.2d at 857. Restrictive covenants are regularly held enforceable under New York and Connecticut law against physicians and accountants. See, e.g., Gelder Medical Group, 41 N.Y.2d 680, 394 N.Y.S.2d 21; BDO Seidman, 93 N.Y.2d 382, 690 N.Y.S.2d 854; Spitz, 1991 WL 112718. According to the New York Court of Appeals, the “rationale for the differential application of the common-law rule of reasonableness expressed in our decisions was that professionals are deemed to provide ‘unique or extraordinary’ services.” BDO Seidman, 93 N.Y.2d at 389, 690 N.Y.S.2d at 857 (citing Reed, Roberts, 40 N.Y.2d at 308, 386 N.Y.S.2d at 677). Several other factors account for the courts’ tendency to be more willing to enforce restrictive covenants with respect to professionals:

- v more balance of bargaining power;
- v higher salaries;
- v access to confidential information;
- v closer and/or stronger relationship with customers;
- v greater likelihood of fiduciary relationship with covenantee; and
- v importance of professional to a partnership or other organization.

The rule regarding the enforceability of restrictive covenants against lawyers is different. New York courts have developed a virtual per se rule declaring attorneys’ restrictive covenants invalid based upon public policy concerns. In Denburg v. Parker Chapin Flattau & Klimpl, 82 N.Y.2d 375, 604 N.Y.S.2d 900 (1993), an attorney withdrawing from his former firm brought a declaratory action seeking to invalidate a restrictive covenant contained in the partnership agreement. The restrictive covenant purported to require an exiting partner who practiced in the private sector to pay to the former firm a penalty, which was based upon the greater of either the withdrawing partner’s allocable share of firm profits over the past two years, or a percentage of the profits the partner derives from servicing the former firm’s clients. The Court of Appeals affirmed a lower court decision invalidating the offending provision, concluding “‘financial disincentives’ against competition as well as outright prohibitions, are objectionable primarily because they interfere with the client’s choice of counsel.” Denburg, 82 N.Y.2d at 380, 604 N.Y.S.2d at 903.

Generally, Connecticut law also prohibits the application of a noncompete agreement to restrict an attorney’s ability to practice law when departing from a law firm. See Schoonmaker v. Cummings and Lockwood of Connecticut, P.C., 252 Conn. 416, 747 A.2d 1017 (2000).

## **G. CONSIDERATION**

Because “restrictive covenants are, first and foremost, contracts,” they must be supported by adequate consideration. Zellner v. Stephen D. Conrad, M.D., P.C., 589 N.Y.S.2d 903, 906, 183 A.D.2d 250, 254 (2d Dep’t 1992); see also Van Dyck Printing Co. v. DiNicola, 43 Conn. Supp. 191, 648 A.2d 898 (Conn. Super. Ct. 1993). A “promise to refrain from competition is unreasonable and unenforceable

where the promise is not ancillary either to a contract for the sale of a business or to existing employment or a contract of employment.” Zellner, 589 N.Y.S.2d at 906, 183 A.D.2d at 254.

An offer of at-will employment constitutes sufficient consideration to support a restrictive covenant. Zellner, 589 N.Y.S.2d at 906, 183 A.D.2d at 254; Van Dyck, 43 Conn. Supp. at 195-96, 648 A.2d at 901.

In New York, for both at-will employees as well as independent contractors, continued employment (which in essence constitutes the legal detriment of forbearance to discharge) serves as adequate consideration to support a restrictive covenant entered into after the employment relationship has begun. Zellner, 589 N.Y.S.2d at 907, 183 A.D.2d at 256. However, under Connecticut law, continued employment, without more, will not constitute adequate consideration. Dick v. Dick, 167 Conn. 210, 355 A.2d 110 (1974).

A change in the terms and conditions of employment is likely to provide sufficient consideration to sustain a restrictive covenant entered into after the employment relationship has begun. See Walter Karl, 528 N.Y.S.2d 94, 137 A.D.2d 22 (2d Dept. 1988); see also Torrington Creamery, Inc. v. Davenport, 126 Conn. 515, 12 A.2d 780 (1940).

## **H. BLUE PENCILLING**

To varying degrees, New York and Connecticut courts are empowered to cure an unreasonable aspect of a restrictive covenant by partial enforcement or severance. In a recent pronouncement on this issue, the New York Court of Appeals stated:

The prevailing, modern view rejects a per se rule that invalidates entirely any overbroad employee agreement not to compete. Instead, when, ... the unenforceable portion is not an essential part of the agreed exchange, a court should conduct a case specific analysis, focusing on the conduct of the employer in imposing the terms of the agreement.... Under this approach, if the employer demonstrates an absence of overreaching, coercive use of dominant bargaining power, or other anti-competitive misconduct, but has in good faith sought to protect a legitimate business interest, consistent with reasonable standards of fair dealing, partial enforcement may be justified.

BDO Seidman, 93 N.Y.2d at 394, 690 N.Y.S.2d at 860-61 (internal citations omitted).

If the restrictions in a covenant are overly broad and thus unreasonable, New York courts may modify the covenant to make the restrictions more narrow, thereby rendering the covenant reasonable and enforceable. See, e.g., BDO Seidman, 93 N.Y.2d 382, 690 N.Y.S.2d 854 (carving exception in restrictive covenant permitting employee to continue servicing those clients he brought when starting employment with former employer); Muller v. New York Heart Ctr. Cardiovascular Specialists P.C., 656 N.Y.S.2d 464, 466, 238 A.2d 776 (App. Div. 3d Dep’t 1997) (revising restrictive covenant to allow cardiologist to attend to patients that were referred to area city hospitals). For instance, if a covenant lacks a geographic restriction, the court may supply the appropriate terms and read one into the covenant, or if the geographic restriction is ambiguous, the court may interpret it in such a way that it would be reasonable. See Deborah Hope Doelker, Inc. v. Kestly, 449 N.Y.S.2d 52, 87 A.D.2d 763 (1st Dep’t 1982).

Connecticut courts employ a more limited form of blue pencilling. Connecticut courts are empowered to sever portions of a restrictive covenant if what would remain is reasonable. A court has described this form of blue pencilling as follows:

Whether severance is appropriate depends primarily upon the intent of the parties as determined by a fair construction of the language they use. "A restrictive covenant which contains or may be read as containing distinct undertakings bounded by different limits of space or time, different in subject-matter, may be good as to part and bad as to part. But this does not mean that a single covenant may be artificially split-up in order to pick out some part of it that can be upheld. Severance is permissible only in the case of a covenant which is in effect a combination of several distinct covenants. Where the covenant is intended by the parties to be an entirety, it cannot properly be so divided by a court that it will be held good for a certain area but invalid for another." As the court said in Beit v. Beit, at 15 Conn. Supp. 191, 196, "this is the so called blue pencil rule and applies only to cases where the contract in terms specifies several distinct areas, so by erasing the description of one or more of these areas there is left the description of an area for which the restriction is reasonable," all without rewriting the contract.

Gartner Group Inc. v. Mewes, 1992 WL 4766 at \*4.

## VII. CALIFORNIA LAW – RESTRICTIVE COVENANTS

Although restrictive covenants are enforceable in states such as New York and Connecticut if they are reasonable, California law has rejected this so-called rule of reasonableness. See Bosley Medical Group v. Abramson, 161 Cal. App. 3d 284, 288 (2d Dist. 1984). Accordingly, California courts will generally not enforce a restrictive covenant.

### A. **COVENANTS NOT TO COMPETE – LEGAL BACKGROUND**

California law strongly disfavors covenants not to compete. Section 16600 of the California Business & Professions Code (the "B&P Code") provides: "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." This provision is "an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice." Metro Traffic Control, Inc. v. Shadow Traffic Network, 22 Cal. App. 4th 853, 859 (2d Dist. 1994).

Because Section 16600 represents a strong and well-settled public policy favoring open competition, the exceptions to that public policy are very narrow. In this regard, Section 16601 of the B&P Code provides in pertinent part:

Any person who sells the goodwill of a business, or any shareholder of a corporation selling or otherwise disposing of all his shares in said corporation, or any shareholder of a corporation which sells (a) all or substantially all of its operating assets together with the goodwill of the corporation, (b) all or substantially all of the operating assets of a division or a subsidiary of the corporation together with the goodwill of such division or subsidiary, or (c) all of the shares of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of said corporation, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein.

Section 16602 of the B&P Code contains similar language relative to the sale of a partnership interest, and Section 16602.5 of the B&P Code contains similar language relative to the sale of an interest in a limited liability corporation.

Read literally, Section 16601 appears to allow an individual disposing of all his shares in a corporation to enter into a noncompete agreement with the purchaser. However, that is not how Section 16601 has been interpreted. In Bosley Medical, 161 Cal. App. 3d 284, the Court of Appeal reviewed a situation where a doctor was required, pursuant to a stock purchase agreement, to purchase shares equaling a nine percent interest in the medical group. He received dividends on the shares but his interest payments roughly equaled them. In addition, the doctor was required to purchase the shares, and his income remained dramatically less than the major shareholder. Under these circumstances, the court held that the stock purchase agreement was a sham devised to circumvent the prohibition against restrictive covenants. Id. at 288. The court, after reviewing the legislative history of the statute, explained:

We are satisfied that the Legislature, in amending section 16601, intended to permit noncompetition agreements only in situations in which the transfer of "all" of the owner's shares involves a substantial interest in the corporation so that the owner, in transferring "all" of his shares, can be said to transfer the goodwill of the corporation. Id. at 290.

In Bosley Medical, the court noted that if Section 16601 were literally applied, it would permit major corporations to require stock purchase and buyback agreements that would then validate a noncompete agreement – "an absurd result." Id. at 291. The court emphasized that the employee was required to purchase the shares and that the stated purpose of the agreement, to provide the employee with an incentive for a professional relationship, made little sense.

The same result was reached by the Court of Appeal in the more recent decision, Hill Medical Corp. v. Wycoff, 86 Cal. App. 4th 895 (2d Dist. 2001). There, a medical group attempted to enforce a three-year restrictive covenant against a departing doctor. The doctor was required under a stock redemption agreement to purchase 100 shares of the medical group at the commencement of his employment and sell those shares back to the medical group at the time his employment terminated. In reviewing the "economic realities" and the "practical effect of the [stock sale] transaction," the court rejected the medical group's argument that the sale of the doctor's shares (representing seven percent (7%) of the outstanding shares) brought the restrictive covenant within the exception of Section 16601 of the B&P Code. Id. at 903, 906-07. This conclusion primarily was based on the finding that the sale of the corporate fractional interest did not involve a transfer of the medical group's goodwill – an element that the court deemed crucial to an application of the narrow exception under Section 16601. Id. at 904-07 (relying substantially on Bosley Medical).

In contrast with the Bosley Medical and Hill Medical decisions, Vacco Industries, Inc. v. Van Den Berg, 5 Cal. App. 4th 34 (2d Dist. 1992), provides an example of the circumstances in which the application of Section 16601 of the B&P is appropriate. Vacco involved the sale of all the shares of a corporation by all its shareholders to a purchaser. Van Den Berg was an employee who had accumulated three percent of the shares of the corporation, sold them to the purchaser for \$500,000.00 (out of a total sales price of \$23 million), and signed a noncompete agreement. Van Den Berg argued that he should not be bound by the noncompete agreement because he was not a substantial shareholder, relying on Bosley Medical. The court rejected that argument, noting that the stock purchase and sale was not a sham to impose an otherwise illegal restraint on competition, and that Van Den Berg was a substantial (ninth largest) shareholder in the context of the transaction which required the acquisition of all shares of the corporation.

The public policy against restrictive covenants embodied in Section 16600 of the B&P Code is so far-reaching that some courts have found it unlawful for employers even to include restrictive covenants in their employment agreements. For instance, in Latona v. Aetna U.S. Healthcare Inc., 82 F. Supp. 2d

1089 (C.D. Cal. 1999), the court found that an employer violated California public policy by terminating an employee for refusing to sign a noncompete agreement. A significant factor leading to such a result was the in terrorem effect the noncompete agreement would have on employees:

As between [the employer] and an individual employee, the company is in an infinitely better position to acquaint itself with the applicable laws, and to know whether the non-compete clause violates section 16600. Employees, having no reason to familiarize themselves with the specifics of California's employment law, will tend to assume that the contractual terms proposed by their employer ... are legal, if draconian. Furthermore, even if they strongly suspect that a non-compete clause is unenforceable, such employees will be reluctant to challenge the legality of the contractual terms and risk the deployment of [the employer's] considerable legal resources against them. Thus, the in terrorem effect of the Agreement will tend to secure employee compliance with its illegal terms in the vast majority of cases.... This outcome is clearly in derogation of the fundamental public policy interests that section 16600 was intended to advance.

Latona, 82 F. Supp. 2d at 1096-97.

Many federal courts in California appear to be somewhat less willing to void a covenant not to compete, though they certainly do not favor them. For example, in General Commercial Packaging, Inc. v. TPS Package Engineering, Inc., 126 F.3d 1131, 1133 (9th Cir. 1997), the U.S. Court of Appeals for the Ninth Circuit enforced a noncompete agreement against a commercial entity because "section 16600 does not impair General Commercial's contract with TPS unless it entirely precludes TPS from pursuing its trade or business." There, the contract simply precluded TPS from doing business from dealing with companies introduced to it by General Commercial for one year after termination of their contract. More recently, in International Business Machines, Inc. v. Bajorek, 191 F.3d 1033 (9th Cir. 1999), the Ninth Circuit reversed a judgment in favor of a departing employee, and deemed preliminarily valid a provision in stock option agreement requiring the forfeiture of gains if the employee worked for a competitor within six months of leaving IBM. The court reaffirmed the notion that "a contract is valid, despite a restriction on competition, if the promisor is barred from pursuing only a small or limited part of the business, trade or profession...." Id. at 1040. The Ninth Circuit's perspective is perhaps best revealed in its comment in Bajorek: "It is one thing to tell a man that if he wants his pension, he cannot ever work in his trade again, as in Muggill v. Rubin H. Donnelly Corp., 62 Cal. 2d 239 (1965)], and quite another to tell him that if he wants a million dollars from his stock options, he has to refrain from going to work for a competitor for six months." Id. at 1041.

## **B. PROTECTABLE INTERESTS**

As discussed above (in Section II), California employers have a protectable interest in trade secrets, Cal. Civ. Code § 3426.1(4), which can include, but are not limited to, the following:

### **1. Customer Lists**

Customer lists may qualify as trade secrets under California law. See, e.g., Morlife, Inc. v. Perry, 56 Cal. App. 4th 1514 (1st Dist. 1997); Hollingworth Solderless Terminal Co. v. Turley, 622 F.2d 1324 (9th Cir. 1980).

In Morlife, two employees quit and competed with their former employer by using that former employer's customer list to actively solicit customers contained on the list. The court determined that the list was a trade secret within the meaning of California law because it had independent value and was not generally known within the roofing industry, the customers identities were not readily ascertainable, and the employer took reasonable steps to protect the list from disclosure. Accordingly, the Court of Appeal

affirmed the trial court's issuance of an injunction prohibiting the former employees from doing business with the employer's customers. In reaching this conclusion, the court noted:

Our Supreme Court recognized the delicate balance between promoting unfettered competition and protecting business from unfair conduct in Continental Car-Na-Var Corp. v. Moseley, [24 Cal. 2d 104, 110 (1944)]: "Equity will to the fullest extent protect the property rights of employers in their trade secrets and otherwise, but public policy and natural justice require that equity should also be solicitous for the right inherent in all people, not fettered by negative covenants upon their part to the contrary, to follow any of the common occupations of life.... A former employee has the right to engage in a competitive business for himself and to enter into competition with his former employer, even for the business of those who had formerly been the customers of his former employer, provided such competition is fairly and legally conducted...."

Morlife, Inc., 56 Cal. App. 4th at 1520.

Whether an employee has misappropriated the former employer's customer list will depend on the nature of the actual communication between the employee and the former employer's customers. In Hilb, Rogal & Hamilton Ins. Services v. Robb, 33 Cal. App. 4th 1812 (2d Dist. 1995), an insurance company sued a former employee for breach of a noncompete agreement and misappropriation of trade secrets. In his defense, the employee claimed that he did not "solicit" customers using trade secrets, but merely informed customers that he was changing employment. The court ruled in favor of the employee, explaining that:

[o]ur Supreme Court has previously distinguished solicitation – which is actionable – from announcing a job change – which is not: "Merely informing customers of one's former employer of a change of employment, without more, is not solicitation. Neither does the willingness to discuss business upon invitation of another party constitute solicitation on the part of the invitee. Equity will not enjoin a former employee from receiving business from the customers of his former employer, even though the circumstances be such that he should be prohibited from soliciting such business."

Hilb, 33 Cal. App. 4th at 1821 (quoting Aetna Bldg. Maintenance Co. v. West, 39 Cal. 2d 198 (1952)).

The Hilb court stated that the Aetna decision remained good law, and that it is permissible for an employee to contact customers of the former employer to announce a new affiliation. Quoting from American Credit Indemnity Co. v. Sacks, 213 Cal. App. 3d 622, 636 (1989), the Court of Appeal explained that an individual has the right "to announce a new affiliation, even to trade secret clients of a former employer...."

## 2. Business Information

California courts have extended trade secret protection to certain business information developed by companies. For example, in In re Worlds of Wonder Secs. Lit., 147 F.R.D. 214, 216 (N.D. Cal. 1992), the court found that an accounting firm's internal audit manuals constitute trade secrets. Similarly, in Vacco Industries, Inc. v. Van Den Berg, 5 Cal. App. 4th 34, 42 (2d Dist. 1992), the court recognized the trade secret status of the employer's "manufacturing and engineering technology, engineering notes, initial preliminary and final drawings, quality controls and testing procedures." An employer's marketing plan also can constitute a trade secret. See Fleming v. Ray-Suzuki, Inc., 225 Cal. App. 3d 574, 576 (4th Dist. 1990).

### 3. Computer Software

Computer software may also constitute trade secrets. See MAI Sys. Corp. v. Peak Computer, Inc., 991 F.2d 511, 522 (9th Cir. 1993). In Cadence Design Sys., Inc. v. Avant! Corp., 125 F.3d 824, 826 (9th Cir. 1997), the court found that a computer source code (i.e., the language in which a computer program is written and that is readable to humans) constituted a trade secret. Also, in Vermont Microsystems, Inc. v. Autodesk, Inc., 88 F.3d 142, 147 (2d Cir. 1996), in which California law applied, the court found that the employer's "computer display list driver" was a trade secret.

#### C. CHOICE OF LAW PROVISIONS

In order to avoid an application of California law, employers may attempt to include a choice of law provision in a contract requiring the application of more favorable foreign law. However, California courts generally will invalidate such a provision and apply California law. The Court of Appeal in Frame v. Merrill Lynch, Pierce, Fenner & Smith, 20 Cal. App. 3d 668, 673 (1st Dist. 1971), found that if the terms of an agreement containing a restrictive covenant are to be carried out substantially in California, Section 16600 of the B&P Code will apply regardless of a choice of law provision selecting the law of another state. Indeed, in Application Group, Inc. v. Hunter Group, Inc., 61 Cal. App. 4th 901 (1st Dist. 1998), the California court would not enforce a noncompete agreement against a former employee who signed the agreement in Maryland, with a Maryland corporation, while she lived in Maryland and that applied Maryland law. The court held that Section 16600 of the B&P Code precluded it from enforcing the noncompete provision relative to a California-based corporation employing the former employee.

#### D. NON-SOLICITATION OF EMPLOYEES

In Loral Corp. v. Moyes, 174 Cal. App. 3d 268 (6th Dist. 1985), the court determined that an agreement prohibiting an employee from raiding his former employer for one year after termination was not void on its face under Section 16600 of the B&P Code. However, the court noted the provision must be reasonable in duration and cannot prohibit the former employee from hiring former coworkers who, unsolicited, seek employment.

#### E. NON-SOLICITATION OF CUSTOMERS

In light of Section 16600 of the B&P Code discussed above, a contractual agreement prohibiting the solicitation of customers by a former employee is disfavored, and may be enforceable under only very limited circumstances. In nearly all instances, such a covenant is valid in California only to the extent necessary to protect trade secrets. See, e.g., Gordon v. Landau, 49 Cal. 2d 690, 694 (1958) (clause prohibiting solicitation of customers valid under Section 16600 where necessary to prohibit use of confidential customer lists); Moss, Adams & Co. v. Shilling, 179 Cal. App. 3d 124, 130 (1st Dist. 1986) ("Anti-solicitation covenants are void as unlawful business restraints except where their enforcement is necessary to protect trade secrets"). Gordon Termite Controls v. Terrones, 84 Cal. App. 3d 176, 179 (2d Dist. 1978) (non-solicitation of business clause unenforceable where no trade secrets were used).

#### F. PREPARATION TO COMPETE

Even before an employee resigns, he may notify customers that he is severing his business relationship with the company and going into business for himself. However, an employee cannot solicit customers before severing the employment relationship. An employee owes his employer a duty of loyalty. See Cal. Labor Code § 2322.

At the same time, an employee may prepare to compete with his employer before actually severing the employment relationship. Indeed, in the seminal case of Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327 (1966), the California Supreme Court held that a high-ranking executive could make preparations for competing against his employer before resigning. Unfortunately, there is no clear line as to what types of conduct fall within the ambit of preparation. What is clear is that basic preparations can

be made (even in the form of purchasing a competing business), but an employee cannot solicit customers (even in the absence of a non-solicitation clause) from his employer or engage in similar acts of direct competition until after the employee has severed the employment relationship.

### **VIII. CONCLUSION**

Due diligence will not prevent all potential problems, but it is much less likely that a company will face liability or suffer financial harm if it is diligent in its employment decisions and practices. Following proper personnel policies and procedures, as outlined in this article, can provide significant protection from the legal pitfalls inherent in today's highly competitive employment market.

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Information contained in this Thelen Reid & Priest LLP outline should not be construed as legal advice or legal opinion, which can only be rendered when related to specific fact situations.

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