CEB

CALIFORNIA BUSINESS LAW REPORTER

Volume 21 / Number 5 / March 2000

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Inevitable Disclosure Arrives in California

Under the inevitable disclosure doctrine, a former employer can obtain an injunction against a former employee's misuse of trade secrets without evidentiary proof of actual or threatened misappropriation. *Electro Optical Industries, Inc. v White* heralds the arrival of the inevitable disclosure doctrine in California. Brian Irion discusses strategies for dealing with the doctrine and raises the question of whether *Electro Optical* is all that it seems.

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Inevitable Disclosure Arrives in California

BRIAN IRION

A frequently encountered scenario in trade secrets litigation occurs when an employee leaves a job to work for a competitor or starts his or her own company, which then competes with the former employer. Laden with the double burden of not only losing a valued employee, but losing that employee to a direct competitor, the former employer then files suit to enjoin the perceived unfair competition and misappropriation of its trade secrets. Many reported cases repeat this story. See Irion, *Hiring Employees From Competitors*, 13 CEB Cal Bus L Prac 65 (Summer 1998).

"Inevitable Disclosure" of Trade Secrets

In general, a trade secret is (1) information, that (2) has economic value from not being generally known to those in the trade or others, and that (3) is the subject of reasonable efforts under the circumstances to maintain its secrecy. CC §3426.1(d). Actual or threatened misappropriation may be enjoined. CC §3426.2(a).

The so-called "inevitable disclosure" doctrine allows a plaintiff to substitute a reasonable inference of misuse, in lieu of evidentiary proof of actual or threatened misappropriation, in its quest to enjoin a former employee from disclosing trade secrets to a competitor.

Although the inevitable disclosure doctrine is not new, it has recently enjoyed a renaissance. Since the Seventh Circuit Court of Appeals published its opinion in *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262, intellectual property lawyers have hotly debated the issue of whether an employer should be able to enjoin a former employee from working for a competitor on the ground that the employee could not possibly work for the competitor without "inevitably" disclosing the former employer's trade secrets. On one hand, a business has a legitimate interest in ensuring that its former employees do not disclose its trade secrets to competitors who would benefit from their use. On the other hand, eliminating an at-will employee's ability to better his or her terms of employment by selling his or her services to a competitor smacks of involuntary servitude, leading Judge Learned Hand to emphatically pronounce the concept "so extraordinary a doctrine, that we do not feel called upon to consider it at large." *Triangle Film Corp. v Artcraft Pictures Corp.* (2d Cir 1918) 250 F 981, 983. See also *Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 110, 148 P2d 9 ("[e]very individual possesses as a form of property, the right to pursue any calling, business or profession he may choose"); *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 262, aff'd (9th Cir 1960) 283 F2d 695, disapproved on other grounds in 541 F2d at 793 n3 ("[o]f necessity . . . it is inevitable that some of the knowledge acquired while in the employ of the other should be made available to the new employer.")

Electro Optical Industries v White

The inevitable disclosure doctrine was rejected in the Ninth Circuit at the district court level in *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1119, and two earlier district court cases cited in *Bayer*, and until recently no California court had applied the doctrine.

On November 30, 1999, the Second District Court of Appeal expressly adopted the inevitable disclosure doctrine as part of the law of trade secrets in California. *Electro Optical Indus., Inc. v White* (1999) 76 CA4th 653, 660, 90 CR2d 680. Defendant was a sales manager of Electro Optical Industries, Incorporated (Electro Optical), a company engaged in selling infrared devices to the military and defense contractors. Electro Optical was one of a small number of firms that sold this kind of equipment to about 100 customers worldwide. Because defendant was the key sales contact between Electro Optical and its customers, defendant knew about Electro Optical's sources of supply, production costs, customer lists and requirements, sales prices and volume, marketing

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plans, and finances. Although he was not an engineer, he was aware of technical information about the design and manufacture of Electro Optical's existing and future products.

Defendant accepted a job at Santa Barbara Infrared, Incorporated (SBIR), an Electro Optical competitor. His new duties were to include developing a marketing plan, developing a profile of competitors, and trying to increase SBIR's customer base. In what must have been a very full day, defendant gave immediate notice to Electro Optical that he was leaving at the end of the day, signed a termination document, and was served with a complaint seeking to enjoin him from working for SBIR.

The trial court denied Electro Optical's request for a preliminary injunction, finding that there was no evidence that defendant used or disclosed Electro Optical trade secrets, or that defendant threatened to use such information to compete unfairly. The court also found that defendant would not inevitably disclose such information.

The Second District Court of Appeal affirmed. Citing *PepsiCo* and two other out-of-state cases, the court of appeal stated that "[a]lthough no California court has yet adopted it, the inevitable disclosure rule is rooted in common sense and calls for a fact specific inquiry. We adopt the rule here." 76 CA4th at 660. The court then held that the trial court did not abuse its discretion in holding that defendant lacked the technical training to misuse plaintiff's technical trade secrets, and that plaintiff's alleged nontechnical trade secrets did not qualify for protection. SBIR had presented evidence that it did not want or need the disputed information, and Electro Optical presented no contrary evidence.

The court specifically held that Electro Optical's customer list did not warrant trade secret protection. The market for Electro Optical and SBIR's products was small and it would not be difficult to learn the identity of actual customers. Sales price information was readily available by telephoning suppliers and competitors. Although information about Electro Optical's production costs appeared to be confidential, the companies did not compete on price and the information was not valuable to SBIR.

With regard to nontechnical proprietary information such as marketing plans and sales strategies, the court found that these strategies were a matter of common knowledge and were not the confidential proprietary ideas of Electro Optical. Because the strategies did not qualify as trade secrets, the fact that SBIR might emulate them did not justify injunctive relief.

Dealing With *Electro Optical*

As long as *Electro Optical* remains good law, employment and business law practitioners—litigation and transactional—will have to grapple with its implication that a form of "no fault" trade secrets liability may attach in a particular situation even though neither the former employee nor the new employer have acted inappropriately. Following are some strategies on how to address the inevitable disclosure doctrine.

Three Strategies for Litigation Defendants

Defenses to a claim of trade secrets misappropriation generally include that the information is known in the industry or is readily ascertainable and not subject to protection. See CC §3426.1(d)(1). Another oft-encountered defense is that the owner of the purported secret already disclosed it in press releases, publications, trade journals, or otherwise. See *Stutz Motor Car, Inc. v Reebok Int'l, Ltd.* (CD Cal 1995) 909 F Supp 1353, 1359. As applied to the inevitable disclosure doctrine in California, however, three particular and often overlooked strategies should be considered.

Take Reasonable Measures To Protect Secrecy: Long-Term Employment Contracts for "Need to Know" Employees

California's unique employment laws suggest that employers should consider long-term employment contracts for key employees as a "reasonable measure" to protect their trade secrets.

Unlike other areas of intellectual property, trade secrets law generally is not controlled by a federal statutory scheme. Rather, it is developed either by case law, or by formal adoption by state legislatures of the Uniform Trade Secrets Act (UTSA) or some variant of UTSA. See, *e.g., Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 40 L Ed 2d 315, 95 S Ct 1879 (comparing trade secrets with patent and copyright law). Lacking a federal scheme, but involving several other substantive areas of law, including employment, contract, and unfair competition (as well as conflicts of laws), trade secrets law can impact and be impacted by these other substantive areas of law that vary from state to state. See, *e.g., Scott v Snelling & Snelling, Inc.* (ND Cal 1990) 732 F Supp 1034, 1039 (contrasting Pennsylvania and California law regarding noncompetition covenants and invalidating Pennsylvania choice-of-law provision in employment contract on public policy grounds).

Perhaps uniquely in contrast to other states, California employment law favors employee freedom of mobility. See *e.g., Scott v Snelling & Snelling, Inc., supra* (holding that California refuses to follow "rule of reason" in invalidating noncompete clauses in employment contracts). Compare Bus & P C §16600 with *Camco, Inc. v Baker* (Nev 1997) 936 P2d 829, and cases cited therein (enforceability of noncompete provisions under Nevada, Arizona, and Texas law). Thus, although noncompetition clauses may provide protection to employers in other

states, such an option is not available in California. Instead, California courts have held that when employers do not wish their employees to be solicited by competitors, they should enter into exclusive long-term employment contracts with them. *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 862, 27 CR2d 573.

Traditionally discussed measures to protect the secrecy of information include advising employees of the existence of a trade secret, limiting access to it to a "need to know basis" and keeping the purported secrets under lock and key. *Religious Technol. Ctr. v Netcom On-Line Communication Servs., Inc.* (ND Cal 1995) 923 F Supp 1231, 1253.

Defense counsel in inevitable disclosure cases may also argue that "reasonable measures" to protect a trade secret in California should include long-term contracts for those employees who have a "need to know" the alleged trade secret, especially when the employees in question helped to develop the alleged secret. Otherwise, it may be difficult to differentiate between the employee's generalized knowledge and a secret owned by the employer. See *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 262. An employer cannot claim it used "reasonable measures" to protect secrets when it insists on keeping its pool of talent on an "at will" employment leash. See *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1179 ("[t]hey cannot expect more from their employees than they were willing to give"). In sum, defense counsel may posit that when a former employer must (or does) rely on the inevitable disclosure doctrine to prevent its employees from working for competitors, the former employer's efforts at taking "reasonable measures" to protect those putative secrets should have included entering into long-term employment contracts with the affected employees.

Argue That Electro Optical *Is Not Necessarily Binding Authority*

At first blush, the Second District Court of Appeal's unequivocal and express adoption of the inevitable disclosure doctrine would appear to end any dispute regarding whether the doctrine is now part of the California legal landscape. This is not necessarily the case.

First, federal courts are required to note the decision and accord it "great weight." They are not, however, bound by a court of appeal's holding, because it is not the highest court of California. *Green v Green* (9th Cir 1938) 100 F2d 241, 244. (It can also be argued that the court's ruling on the inevitable disclosure doctrine was mere dictum, unnecessary to its holding affirming the denial of an injunction.)

An artful litigator might argue that even California trial courts are faced with conflicting inferences. On one hand, the appellate court in *Electro Optical* expressly adopted the inevitable disclosure doctrine. On the other hand, the California Supreme Court has indicated that an individual has a "right" to work for a competitor or even to compete against his former employer directly unless he actually competes unfairly. *Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 110, 148 P2d 9. The California Supreme Court's general pronouncement endorsing an employee's right to compete against his former employer except when such competition is conducted unfairly expresses its implicit disapproval of a doctrine that necessarily substitutes the speculation of unfair competition in place of actual or threatened misappropriation. See *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1119. When there are conflicting appellate decisions, a trial court may choose the decision it finds most persuasive. *Sears v Morrison* (1999) 76 CA4th 577, 587, 90 CR2d 528.

A defendant may also argue that the doctrine of "inevitable disclosure" is a misnomer. *Electro Optical* expressly relied on *PepsiCo*. And although the *PepsiCo* court may have popularized the notion that the inevitable disclosure doctrine does away with a plaintiff's need to prove actual or threatened misappropriation, close inspection reveals that the court in that case doubted defendant's credibility in presenting evidence that he would not misuse trade secrets. Rather, the trial court characterized his testimony as "out and out lies." *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262, 1270. Although the inevitable disclosure doctrine may *diminish* the need to prove a threat of misappropriation when circumstances indicate the likelihood exists, the doctrine does not *eliminate* a plaintiff's need to prove that element. See *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 1111, 1118.

Argue That Plaintiff Should Pay Defendants' Damages

Because the inevitable disclosure doctrine creates "no fault" trade secrets liability, a defendant should argue that a plaintiff should have to pay defendant's damages associated with the relief plaintiff requests, including the former employee's lost wages and the competitor's costs.

Arguments against issuance of a preliminary injunction are well documented, and generally include claims that preliminary injunctive relief is an extraordinary remedy, to be used with great caution and only when other remedies do not provide adequate relief. Any doubts generally should be resolved against issuance. See generally, 6 Witkin, California Procedure, *Provisional Remedies*, §§291–298 (4th ed 1997). Further, whether, and on what conditions, preliminary injunctive relief should issue is a matter within the discretion of the trial court, based on all the facts and circumstances of the situation. *Electro Optical Indus., Inc. v White* (1999) 76 CA4th 653, 659,

90 CR2d 680; *Pahl v Ribero* (1961) 193 CA2d 154, 161, 14 CR 174.

Trade secrets lawsuits are sometimes initiated for anticompetitive reasons rather than to address actual wrongs. See *Computer Economics, Inc. v Gartner* (SD Cal 1999) 50 F Supp 2d 980, 985 n6. Although defendants are entitled to a jury trial in trade secrets cases (see *Vacco Indus., Inc. v Van Den Berg* (1992) 5 CA4th 34, 6 CR2d 602), as a practical matter, most trade secrets cases are determined at the preliminary injunction stage, because the relief requested must be obtained, if at all, long before a case typically goes to trial (compare *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262 (preliminary injunction prohibiting defendant's employment for six months) with Govt C §§68600–68620 (Trial Court Delay Reduction Act)). Defendants often are start-up companies lacking resources to pay for a complex jury trial on an expedited basis. See *Computer Economics, Inc. v Gartner Group, Inc.* (SD Cal 1999) 50 F Supp 2d 980, 985 n6 (defendants ill-equipped to spend considerable amounts in defense costs).

When it appears that a court is seriously entertaining use of the inevitable disclosure doctrine to restrain an employee from working for plaintiff's competitor without proof of inequitable conduct by either, the above considerations support a suggestion from defense counsel that the court order plaintiff to compensate the employee and new employer for damages during the period of injunctive relief as a condition precedent to granting the relief. Although the employee's salary at the competitor may not be a deterrent to plaintiff, a reasonable estimation of the competitor's lost profits, based on declarations or other evidence, may deter any anticompetitive motives a plaintiff may harbor.

Tips for Corporate Counsel

Long-Term Contracts

Protection of a company's trade secrets often involves policies such as entrance and exit interviews, requiring employees to execute nondisclosure agreements at the inception of employment, updating lists of trade secrets on a regular basis, and keeping numbered copies of any secrets that are reduced to paper under lock and key. All of these suggestions remain unaffected by the holding in *Electro Optical*.

Corporate counsel often are warned about the costs of wrongful termination actions, and companies usually maintain that all employees are employed on an "at-will" basis. Yet, California courts have suggested that one way to ensure that key employees will not depart in favor of the competition is to enter into long-term employment contracts with them. Carefully crafted language regarding what constitutes "for cause" termination may diminish the company's fear of long-term contracts and limit employees' perception of any "right" to a job.

Alternative Measures To Protect Secrets

Although the court in *Electro Optical* adopted the inevitable disclosure doctrine, it rejected plaintiff's motion for preliminary injunctive relief, and plaintiff was unable to protect information that it considered trade secrets. As *Electro Optical* illustrates, the inevitable disclosure doctrine is no panacea, and counsel should work closely with their clients to consider alternative methods to protect the company's trade secrets.

When trade secrets can be protected through measures other than secrecy, consider those methods. For example, recent developments in patent law have highlighted novel uses, such as patenting business methods. See, *e.g., State Street Bank & Trust Co. v Signature Fin. Group Inc.* (Fed Cir 1998) 149 F3d 1368, 1375.

Regularly Update Trade Secrets Lists and Nondisclosure Agreements

Some courts have considered whether companies have clearly, concisely, and fairly articulated their lists of putative trade secrets to their employees during the employment relationship or early on in litigation as a bellwether of whether trade secrets actually exist, or whether the employees can fairly be held to have knowledge of what they are supposed to keep confidential. See, *e.g., Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 253, 67 CR 19; *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1185; *AMP, Inc. v Fleischhacker* (7th Cir 1987) 823 F2d 1199, 1203 ("AMP has consistently failed throughout this litigation to identify any particularized trade secrets actually at risk"). In particular, the decision in *AMP* is instructive, as it was discussed in *PepsiCo*, which in turn was relied on by the court of appeal in *Electro Optical*. The message is clear—at the preliminary injunction stage, courts will doubt assertions that trade secrets exist when the company did not articulate the secrets before the employment relationship at issue disintegrated. Accordingly, companies should draft clear nondisclosure agreements, update lists of trade secrets regularly, and ensure that employees understand what is secret and what is not.

Defensive Measures

A factor that courts have considered critical in determining whether to apply the inevitable disclosure doctrine is whether the new employer appeared to exert efforts to protect its competitor's trade secrets, or whether it appeared to have any improper purpose in hiring the employee. See *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1118 (factors courts consider in applying inevitable disclosure doctrine include

efforts to safeguard others' secrets.) An employer should specifically advise a new employee not to take any materials from the former place of employment. The employee should be further advised to purge all information from devices such as personal calendars and home computers. This should be confirmed in a writing signed by the employee.

Tips for Employee Counsel

Attorneys who regularly represent key employees are often asked to review or negotiate executive compensation packages. In reviewing any long-term employment contracts for a client, counsel should ensure that the employee's rights of termination are equal to the company's. For example, although an employee may be terminated "for cause" (*e.g.*, improper, illegal, or immoral conduct), the employee should be able to terminate the contract if the company is sold, or if the manager to whom she or he reports leaves the company's employ.

Further, just as prospective employees are asked to list prior inventions for purposes of idea ownership issues under Lab C §2870, they should ask that their employers list with specificity any trade secrets the employee is obliged to keep confidential. Although the company is not likely to accede to this request, the company's refusal to identify its trade secrets to the employee at the inception of the relationship can be used against it in later litigation.

Conclusion

At least for now, the inevitable disclosure doctrine applies in California. Counsel should be aware of the decision and take proactive steps to anticipate its application.

CORPORATIONS

Shareholders

Corporation that granted shell corporation exclusive right to use patent breached fiduciary duty to minority shareholders because it failed to inform them of the transaction.

Walczak v EPL Prolong, Inc. (9th Cir 1999) 198 F3d 725

Plaintiffs were minority shareholders of defendant corporation. Defendant, which owns the patent for a high performance lubricant additive for motor oil, entered into a license agreement with a shell corporation (shell 1), granting shell 1 the exclusive right to use its patent in exchange for a fee and a cash royalty based on a percentage of gross sales. Defendant did not inform plaintiffs of this transaction. Thereafter, defendant entered into a second transaction with another shell corporation (shell 2), which was a publicly traded corporation. If the second transaction were to be approved by the shareholders, shell 2 would acquire all the shares of shell 1 and would grant defendant's shareholders stock in shell 2. Defendant corporation would then become a wholly owned subsidiary of shell 2. Before the shareholders could vote on the second transaction, plaintiffs brought a class action shareholder derivative suit and sought a preliminary injunction to prevent the second transaction from taking place. Among the various claims against defendant, plaintiff claimed that the initial transaction constituted a breach of fiduciary duty and a fraudulent transfer. The district court granted the preliminary injunction.

The Ninth Circuit Court of Appeals affirmed. Defendant claimed that the U.S. Supreme Court's determination in *Grupo Mexicano de Desarrollo, S.A. v Alliance Bond Fund, Inc* (1999) 527 US 308, 144 L Ed 2d 319, 119 S Ct 1961, warranted a dismissal of the preliminary injunction. In *Grupo Mexicano*, the Supreme Court held that an unsecured creditor seeking legal remedies cannot obtain a preliminary injunction that freezes a debtor's assets. The Ninth Circuit distinguished *Grupo Mexicano* by holding that the preliminary injunction at issue in this case did not freeze any of defendant's assets. Instead, the district court's action was appropriate because it preserved the status quo and prevented plaintiffs' irreparable loss of rights before judgment.

The court held that plaintiffs demonstrated a strong likelihood of success on the merits on their claims for breach of fiduciary duty and fraudulent transfer. The initial agreement was inherently unfair because defendant did not notify the minority shareholders or seek their approval or ratification. The initial agreement allowed shell 1 to pay a small fee ($100,000) to defendant in exchange for control of 96.5 percent of the total sales generated by the patent, which exceeded $30 million in 1997. The transaction appeared to be designed to benefit defendant's officers and directors and to defraud the minority shareholders. The transaction was an "interested director" transaction under Corp C §310(a)(3), and defendant failed to satisfy its burden under that section to prove that the transaction was just and reasonable as to the corporation. Further, the record showed a chain of events that resulted in corporate asset transfers and alleged fraudulent stock swaps.