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Recent Developments

A YEAR-END WARNING – REQUIRING EMPLOYEES TO SIGN A CONFIDENTIALITY AGREEMENT CONTAINING UNENFORCEABLE NON-COMPETE PROVISIONS CAN LEAD TO LIABILITY FOR WRONGFUL DISCHARGE

(December 27, 2000)

Summary: At this time of the year, we scarcely need to be reminded of the dangers of "overindulgence." But right before Christmas, the California Court of Appeal issued a decision that amounts to a warning to California employers who are overzealous in their attempts to prevent their employees from misappropriating trade secrets through the use of non-compete provisions: If an employee is fired for refusing to sign an agreement that violates California's broad protection of the employee's right to compete, the employee can recover tort damages for a wrongful discharge in violation of public policy. *D'Sa v. Playhut, Inc.* (December 21, 2000).

The Case: Richard D'Sa was an employee of Playhut, Inc., a toy manufacturer. Playhut presented its entire workforce with a Confidentiality Agreement which it required all employees sign.

The Agreement generally addressed the employee's responsibilities and the company's rights regarding non-disclosure of trade secrets and assignment of rights to inventions and patents. However, the Agreement also contained a broad provision restricting competition:

> Employee will not render services, directly or indirectly, for a period of one year after separation of employment with Playhut to any person or entity in connection with any Competing Product. A "Competing Product" shall mean any products, processes or services of any person or entity other than Playhut in existence or under development, which are substantially the same, may be substituted for, or applied to substantially the same end use as the products, processes or services with which I work during the time of my employment with Playhut or about which I work during the time of my employment with Playhut or about which I acquire Confidential Information through my work with Playhut.

Playhut fired D'Sa after he refused to sign the Agreement. He sued, and the trial court granted summary judgment for the company. On appeal, the California Court of Appeal reinstated D'Sa's claim, holding that he could proceed with a claim for wrongful discharge in violation of public policy, entitling him to the full range of tort damages (economic losses, emotional distress, and potentially, punitive damages).

Analysis: Unlike most other states (e.g., New York, Washington), California has a strong public policy protecting the right of individuals to engage in competition with their former employers. This public policy is grounded in section 16600 of the California Business and Professions Code, which provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." Although it is established that employers have the right to protect against disclosure of trade secrets and other confidential information, it is equally clear that

agreements which go beyond this limitation and encroach on the employee's right to compete, are void and unenforceable as against public policy.

In this case, the court first determined that the non-compete provision of the Confidentiality Agreement "comes, at least in part and perhaps entirely, within the prohibitory provisions of section 16600." The court rejected the employer's argument that the provision was simply an attempt to prohibit the disclosure of its trade secrets. In reaching this conclusion, the court observed that non-disclosure of trade secrets was separately addressed in the Agreement and the provisions were not subject to a one-year limitation.

The court also rejected the employer's argument that forcing its employees to sign the Agreements did not violate public policy because the Agreement contained a "severability" clause, which stated that if any provision of the Agreement was unenforceable, the remaining provisions would still remain in full force and effect. The court reasoned that notwithstanding the severability clause, an average employee would interpret the non-compete provision as prohibiting competition, and would likely forego legitimate employment rather than assume the risk of expensive, time-consuming litigation by the former employer. Therefore, the court concluded that Playhut violated the public policy of section 16600 when it fired D'Sa for refusing to sign the Confidentiality Agreement.

What This Means: In an economy characterized by technology and mobile employees, employers must aggressively protect their confidential information and trade secrets. Today, most employers use some form of a non-disclosure/confidentiality agreement prohibiting employees from disclosing trade secrets and confidential information, and assigning inventions and patents developed during the employee's employment. These agreements often include provisions prohibiting the solicitation of other employees. However, many employers go beyond what is permitted under California law by including provisions that are either designed to, or have the effect of, limiting competition. Until now, many employers believed that there was little downside to including non-compete provisions within their confidentiality agreements, even if those provisions might not ultimately be enforceable.

The *D'Sa* case raises the stakes for employers who, intentionally or not, are using agreements that go beyond what is permitted under California law. After this decision, all employers should re-evaluate their standard non-disclosure agreements to ensure that they do not contain any provisions that would violate Business and Professions Code section 16600.

If you have any questions about this or any other topic, please contact Fred Plevin (fplevin@paulplevin.com) or at (619) 744-3650 at Paul Plevin & Sullivan.

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