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California's new Labor Code Section 925: What happens in California stays in California

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Employers' confidential business information — proprietary ideas, intellectual property, business plans, customer lists and the like — are the lifeblood of their business.

Restrictive covenants — agreements not to compete, not to solicit customers of a former employer, and not to take or disclose confidential information — are for many employers the cornerstone of a protective strategy to reduce the risk of having that information walk out the door with a departing employee.

But California public policy, to put it mildly, hates restrictive covenants. Noncompete agreements that purport to restrict former employees generally are not enforceable at all.

Customer nonsolicitation agreements are enforceable only if the customer list is a true trade secret, meaning it is information that is kept under lock and key and its value comes from its very secrecy.

Many employers give up on attempting to secure these protections when it comes to their California employees, but savvy employers have turned to a clever strategy: Get disputes arising under these agreements outside California, and then you do not have a California problem at all.

Employers can do this — or at least, used to be able to do this — with a good forum-selection clause. Contrary to the well-worn assumption that noncompetes are not enforceable in California, many employers crafted restrictive covenants choosing a jurisdiction that would enforce a noncompete agreement.

The beauty of this approach was that, by contractually choosing some forum other than California, an employer could avoid the state's public policy hostility toward restrictive covenants by moving the dispute to a jurisdiction that would enforce the agreement. Notably, this could be done even if the former employee lived and worked in California.

All was well until the enactment earlier this year of a new California statute: California Labor Code Section 925.

Section 925 limits companies' ability to fight to protect business information on favorable turf (that is, in states that make it easier than California does to protect that information), instead keeping most disputes in California.

So, is that it? Are employers that attempt to use restrictive covenants stuck on California's hostile turf if an employee lives in California? Is their otherwise protectable information doomed to disclosure?

The fact is that thoughtful employers can still protect their information in California by keeping a few key principles in mind.

BREAKING UP IS HARD TO DO

Last year, Kelley Drye & Warren won injunctions for a specialty chemical product manufacturer. You have probably never heard of it, but because it makes things you use regularly but never stop to think about — like a chemical application that makes paint stick to the inside of your washing machine at home — its market cap is in the billions.

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Its salespeople sign customer non-solicitation agreements and IP nondisclosure agreements at the commencement of employment to protect against theft or misappropriation of the company's customer relationships, trade secrets and other intellectual property.

The salespeople know why the company's products work well at certain temperatures but not others. They know about supply chain problems that might make it hard for the company to deliver on time. They know which products get complaints, which ones get raves, and which ones are priced more competitively (or less competitively).

None of that information is public — though all of it is perfect fodder for a competitor's sales pitch: Don't buy the company's washing machine paint application because the company has historically delivered late to customers, or because the washing machine stuff is overpriced.

A group of salespeople left the company to work for a competitor and immediately began disclosing this kind of confidential information. One of them lived in California. When it became clear to him that his former employer had learned about his violation of his confidentiality and customer nonsolicitation agreements, the former employee got smart, hired California lawyers and commenced litigation in California to declare the restrictive covenants he signed unenforceable under California law. Had the dispute been litigated there, the former employer might have lost.

What the salesperson did not anticipate, however, was that his former employer was one step ahead of him.

Specifically, it had included choice-of-law and forum-selection provisions in his restrictive covenants that required the parties to the agreement (meaning the salesperson and the former employer) to agree that if there were any dispute under the agreement, like whether the salesperson breached it, the dispute would have to be litigated in a state or federal court in New Jersey, and once there, that court would apply New Jersey law.

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The former employer commenced another action in New Jersey, where the court found that the salesperson had engaged in impermissible forum shopping by starting an action in California and enjoined the employee from violating the terms of his restrictive covenants.

What would never have worked in California worked perfectly in another jurisdiction — one that was not hostile to restrictive covenants.

HOTEL CALIFORNIA

Wising up to the forum-selection workaround that litigators had developed, California enacted Section 925 earlier this year.

Section 925's concept is simple: It prohibits employers from requiring these employees, as a condition of employment, to agree to a contractual provision that either "require[s] the employee to adjudicate outside of California a claim arising in California" or "deprive[s] the employee the substantive protection of California law with respect to a controversy arising in California."

California has thus become like a bad remix of the classic Eagles song lyric: You can check in any time you like, but you can never leave.

But Section 925 does allow for one important exception: If an employee is represented by legal counsel in the negotiation of a restrictive covenant containing a forum-selection clause, that contractual language will stick and does not violate Section 925.

Employers that had been successful in enforcing non-California forum-selection clauses had done so by shifting the focus of the employer-employee relationship. Instead of focusing on where the employee was or is working (in California), the employer shifted the focus to the employer's established protectable interests in another state.

Section 925 shifts the focus away from the employer's otherwise protectable interests and back on to the employee.

So, what's a savvy employer to do?

LESS MAY BE MORE

The noncompete — an agreement that somebody will not work in an industry for a certain period of time at all — has the virtue of certainty. The problem with this approach, however, is that most employers that use noncompetes tend to overuse them.

One simple way to preserve your protectable interests is to do what astute employers always do: Tailor restrictive covenants to protect what you really care about, and leave the rest alone. For example, you do not need a full-blown noncompete if a promise not to disclose confidential information is enough.

A second suggestion relates to the same idea of using agreements in a narrow, focused and more effective way.

Lower-level employees are usually not in a position to harm a company by taking and disclosing competitive information, unless they are truly engaged in industrial espionage.

Higher-level employees — those who have unquestionable access to competitive information that would cause real harm if it walked out the door or fell into the hands of competitors — are very often represented by counsel in the negotiation of their employment agreements.

When they are, including when a company is willing to pay for that representation, incorporating restrictive covenants and a choice of forum that will actually enforce those covenants triggers the exception to Section 925.

THE TAKEAWAYS

The takeaways for employers are straightforward:

- Noncompetes preventing former employees from going to work for competitors never work in California. Even where you use a lesser restriction (like a customer nonsolicitation agreement), make sure that the agreement protects true trade secrets.

- Do not select a forum other than California in employment agreements of employees who primarily work or reside in California, unless that other forum is in an agreement that was negotiated by the employee's lawyer.
- No matter what forum you choose, use the least restrictive possible means of protecting confidential and proprietary business information.

In the end, protecting an employer's confidential business information in California is not so different at a practical level from protecting it anywhere else.

An overbroad restriction to prevent disclosure creates enforcement problems no matter what jurisdiction you are in. Whether in California or elsewhere, one of the greatest risks to confidential information is that employers often do not take adequate steps to protect the actual confidentiality of the information.

Start with solid confidentiality policies and procedures; bolster those protections by creating narrow restrictions that are enforceable under California law, such as a careful nondisclosure agreement or a customer nonsolicitation agreement where customer identities and information are truly secret; and expect to defend in California rather than flee to another jurisdiction.

ABOUT THE AUTHOR

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