Life *and* Death on the Corporate Battlefield

Advice to management employees departing to form new companies

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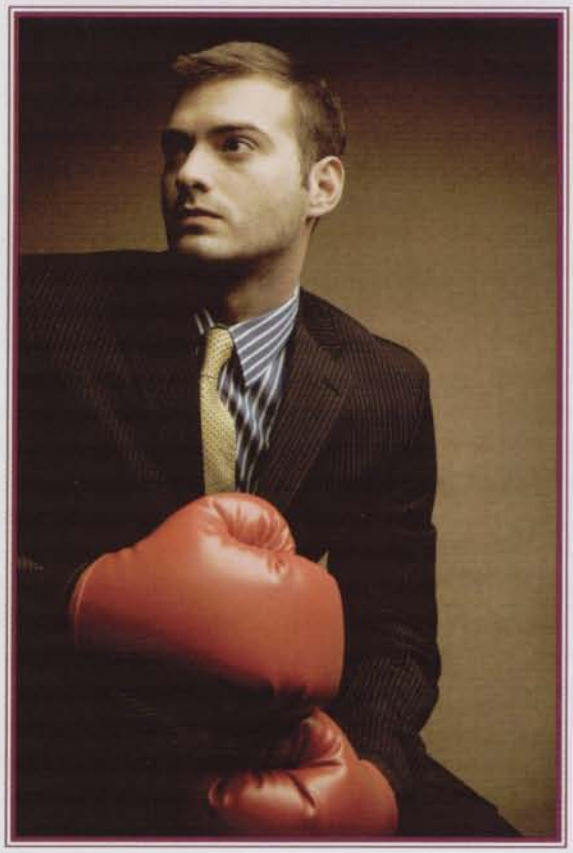
The Modern Battlefield

Often, a company's founders are individuals who together left their former employer to start a competing company. The rationale for leaving such employment is usually the employee's frustration with the employer's bureaucracy or inability to recognize new ideas and new opportunities. However, the ultimate nightmare for the founders of a new company is to be sued by their former employer. In the rush and excitement to leave their employer and form the new company to pursue an innovative idea, entrepreneurs are often unaware that they may be walking into a minefield.

Former employers sometimes use the threat of litigation and a broad and intimidating interpretation of their rights to deter former employees from competing; and sometimes they initiate litigation. Employers are concerned about protecting their technology, customers or confidential information. However, these concerns may mask the real reason for threats and litigation, namely to stop a new competitor from emerging. It is common for former employers to feel betrayed or deceived by a departing group of employees. Once this group establishes a potentially competing company, all of the former employer's suspicions appear to be confirmed. But the tools most often used to pursue this strategy are accusations that the employees (i) misappropriated trade secrets, (ii) violated their fiduciary duties or duties of loyalty by using or disclosing confidential information, (iii) failed to disclose information about plans to depart and compete, (iv) failed to return company equipment, such as laptops, or documents, and (v) breached non-disclosure agreements and other similar claims.



A start-up company can rarely afford the economic cost and distraction of this competitive warfare. Trade secret litigation is common in high technology and other industries, and the courts have become a battlefield where wars over ideas, technology and customers are often fought. Trade secret lawsuits are not only used to protect legitimate business interests in intellectual property; they are also used as competitive weapons an established company can use to crush an upstart competitor. Even the fear of a lawsuit against the start-up company can be all that is necessary to deter the former employees and their start-up company from competing.

Current Legal Requirements

The real dilemma begins when the departing employees intend to set up a company that will compete with the former employer by selling the same or similar products and services. In general, California law recognizes a former employee's right to do this as a fundamental and important right of the employee, protected by the important state policy of encouraging employee mobility and betterment. While this is generally protected, there are many mistakes that an employee might make to give the employer a basis to claim that illegal conduct occurred. The dilemma is compounded when these products and/or services are intended to be sold to the same clients or customers. Without a doubt, the former employer views such competition as a threat to its business interests and territory, and may file a lawsuit against its former employees.

If the departing employees were officers or high-level management, they not only have a duty to refrain from misappropriating trade secrets, they also have a fiduciary duty to the former employer while they were still employed. This fiduciary duty includes a duty of loyalty and a duty of care. These duties prevent the former officer from preparing to compete and from recruiting employees of the former employer prior to his or her departure. Additionally, to the extent such plans are made while still employed, the high level former employee (such as an officer) may have a duty to disclose such plans to the employer.

If the former employees were not high-level management, they still owe the employer a duty of loyalty that is easily violated by such preparations. They may have signed non-disclosure or employment agreements restricting their ability to compete. They also have a continuing duty after they leave, even if they have not signed a non-disclosure agreement, to preserve and keep confidential any trade secret information of the employer. They may not use or disclose it in their new job, even if it is preserved in memory rather than written down.

An employer will likely claim that everything the employee learned while employed with the former employer is property of the employer. Under most circumstances, all property developed or information learned during and in connection with the employment relationship belongs to the employer. Generally speaking, however, a former employee may take the general skills and knowledge acquired during his or her former employment as long as they are not a trade secret. As a precaution, an employee should take no property whatsoever from the employer. This is especially true if the employee has signed a non-disclosure and/or a non-solicitation agreement. Although California courts generally do not enforce non-competition agreements, they do enforce non-disclosure, non-solicitation and most employment agreements containing limited restrictions, to the extent they protect trade secrets of the employer.

As referenced above, the most important weapon to wield against former management employees is trade secret protection. However,

the definition of a trade secret is not always easy to understand. Most management-level employees and technical employees know what kind of technical information the company considers a trade secret. Assuming the employer takes reasonable steps to maintain secrecy, such technical information should be protected and cannot be taken. If the management employee was the inventor of the secret information, it still belongs to the employer in most instances, even in the absence of any agreement.

Non-technical information, such as customer information, is far more difficult to deem a trade secret. In California, the employer cannot make information a trade secret simply by defining it as such in non-disclosure agreements. It must actually qualify as a trade secret. Generally, information is a trade secret if: (1) it is valuable and its value derives from the fact that it is secret; and (2) reasonable steps are taken to preserve the secrecy of the information.

Employers and former employees are constantly battling over customer information. Depending on the circumstances, some customer information qualifies as a trade secret, while some does not. It really depends on the circumstances. Employers will frequently take the position that the identities of customers are a trade secret, so that the former employee's knowledge of the identity of the customer can never be used to compete with the former employer. Employers claim that a list of customers, even if not taken, could have been reduced to memory, and those customers are off-limits. However, the former employer does not own its customers. Customer identities are often well-known to outsiders, particularly sales people, who know, naturally, who the customers are in a given industry.

Customer requirements and needs are also sometimes claimed to be trade secrets. While they can be given that protection, the former employee is not prevented from having this information if he acquired it after his departure. Sometimes a successful defense of an employee alleged to have misappropriated this kind of information simply depends on showing that the information was known before he joined the employer, or was acquired directly from the customer after his departure.

Former employers usually consider prices and profit margins trade secrets. But this information, if disclosed in price proposals or bids to customers, may no longer be eligible for protection. This information can be obtained from the customer directly.

Employers will complain if their former employees are soliciting their customers. They will often point to clauses in employment agreements and non-disclosure agreements where the employee agrees not to solicit the employer's customers for some period of time after they depart. Although such clauses are usually enforceable, at least if it was necessary to protect the employer's trade secrets, the employee may be able to solicit that customer if: (i) he did not know that the customer was a customer of the former employer, (ii) the customer's identity was not a trade secret, or (iii) the customer approached the employee first, asking the employee for a proposal. Employees in California also have the right to "announce" their new employer so long as they do not solicit business from that customer as part of the announcement.

Practical Steps to Avoid Litigation

As a result of the widespread use of lawsuits in these situations, and the devastating impact a lawsuit could have on the new venture, a departing employee should be aware of, and consider, steps he or she can take to avoid a lawsuit. While no one step is guaranteed to prevent an angry or vindictive employer from filing a lawsuit, the following steps will substantially reduce the risk that such a lawsuit will be filed.

1. Steps to Be Taken Prior to the Termination of Employment

a. **Avoid Using the Equipment or Facilities of the Employer.** Individuals terminating their employment should not use any of the tools or instrumentalities of the former employer including telephones, computers, e-mail, or other items for planning or starting a new company. Use of such items may give the employer a claim to ownership of the new business and its assets, and generally appears unfair. Irrespective of the law, any appearance that a departing employee has been unfair to the former employer will hurt the employee if litigation results. In addition, the planning for the venture should take place during non-work hours. It should be noted that the use of the employer's e-mail system leaves a damaging trail of evidence. On countless occasions, employees have left business plans, spreadsheets, logo designs and product plans on the employer's computer system. Any email sent should be personal email.

b. **Be Honest.** Employees preparing to leave should be honest with their employer. It is better to say nothing than to give an erroneous answer. When employees are vague or evasive regarding their future plans, employers become suspicious. An element of mistrust is created, and the employer is unlikely to give the benefit of the doubt to the departing employee. Accordingly, a departing employee should respond accurately and truthfully to any questions posed by the employer's personnel about future plans. Also, the employer will closely scrutinize post-termination business activities.

c. **Create an Inventory of the Office Contents.** A departing employee should immediately create an inventory of his or her office and give a copy to the human resources manager or other appropriate person when they announce their departure. The inventory should be detailed and include such items as client files, employee files, marketing or sales plans, engineering notes, drawings, specifications, new service offerings and similar items. Unless the employee is prohibited from returning to his or her office on the date of departure, the employee should have a representative of the employer present when cleaning out the office or cubicle. The departing employee should go over the inventory with this person to confirm that it is still accurate on their last date of employment, and that the employee has not taken any of the company's property. The employee should obtain this person's signature on the inventory and give him or her a copy. If an inventory is prepared and signed by an employer representative, the employer will have difficulty making a claim that the employee misappropriated trade secrets or confidential information.

d. **Do Not Take Anything from the Employer.** Often, former employees take with them such things as their Rolodex, customer lists, sales prospect lists, miscellaneous business cards, employee salary

data, e-mails, computer documents and other items. These items are often taken innocently under the belief that they were created by the employee and thus belong to the employee. This can be a fatal mistake for a departing employee. Even if they were never used by the employee after they leave, the later discovery that they were not returned can cause the appearance that they were taken intentionally and misused. *No matter how innocent or useless the items appear to be, a departing employee should not take any property of the former employer!*

With many employees working from home, the temptation to keep files generated on the employee's home computer, laptop and other devices is great. Nevertheless, all such items should be returned to the former employer. Accordingly, if the employee has a laptop or PDA bought by the employer, it should be returned. Similarly, if the departing employee keeps any company files at home or on their home computer or laptop, those files should be returned as well. The departing employee should obtain a receipt for all items returned.

e. **Do Not Recruit Other Employees or Solicit Other Employees to Depart While Still Employed by the Former Employer**. Prior to leaving, the departing employee should not approach fellow employees about their potential desire to join the new company. Former employee-officers or high-level managers have a fiduciary duty to the employer to not take any action while employed that would or could hurt the employer. Other employees should heed this advice as well. Recruiting employees while still employed is a common mistake.

2. Steps to Be Taken Post-termination

a. **Take a Vacation**. If possible, the former employee should take a long vacation prior to establishing the new business. The longer the time between the departure date and the establishment of the new business, the less likely it is that a claim for misappropriation of trade secrets will prevail.

b. **Accept a Consulting Project.** In addition, if possible, the former employee should work as a consultant or accept employment with another company for an interim period. Assuming that the consulting projects or new employment do not directly compete with the former employer, this supervening event may eliminate a claim that the employee misused trade secrets obtained from the former employer.

c. **Avoid Directly Competing, if Possible**. In addition, the former employee should attempt, if possible, to avoid directly competing with the former employer, even if they have the right to do so. This direct competition, if effective, dramatically increases the risk of a lawsuit. Even if the employee has done nothing wrong, the financial impact of a lawsuit, or of a customer being dragged into the middle of it, can be devastating to the new company. To the extent that the former employee is in a similar business, it is prudent to avoid competing for the same clients, especially clients who are active with pending orders. The risk of being sued falls dramatically with this approach.

d. **Take Great Care in How Clients and Employees Are Notified.** In connection with any notice of departure sent to clients, customers and employees of the former employer, a former employee is permitted to notify them or announce his or her departure. However, the former employee should avoid soliciting such persons. "Soliciting" means, "to appeal to, to ask, to apply to for purpose of obtaining something, to ask earnestly." By contrast, merely informing the former employer's clients or customers of a change in employment without more is not solicitation. The following is an example of a notice that went too far and was deemed solicitation:

"I have left ACI and am very pleased to announce the formation of an independent insurance agency.... If you would like to learn more about our policy, I would be happy to discuss it in detail with you when you are ready to review your on-going credit insurance needs at renewal time."

This type of announcement is inviting the recipient to contact the sender and is an attempt to obtain the recipient's business. Similarly, the following is another example of a solicitation:

"I have just joined forces with other roofing and construction professionals to bring you the next generation of roofing companies. As always, you have my commitment to provide you with timely, dependable, professional solutions to alleviate your roofing problems. With rainy day weather on our doorstep, let's talk soon about how we can prevent or minimize your headaches and costs."

Under California law, a former employee is permitted to announce his or her new company or affiliation and provide contact information.

Similarly, with respect to employees, a former employee is permitted once he or she has departed to notify them of his or her new company or affiliation and have conversations with them in response to their inquiries.

This article has attempted to identify some of the major "red flags" that cause litigation brought by former employers. The best remedy to avoid such risks is not to compete, even though California law allows it. If the employee wishes to compete, it is advisable to consider having a lawyer's assistance. For example, the determination of whether certain types of information are trade secrets, or whether clauses in an employment contract or non-disclosure agreement are enforceable and which state's law would govern these questions, are not only legal questions, they are fairly complex ones, depending in large part on the particular facts and circumstances.

Although it is not always possible to avoid a lawsuit from a former employer, the steps described above can be extremely useful in deterring a lawsuit or substantially protecting a departing employee in the event a lawsuit is filed. BAL

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