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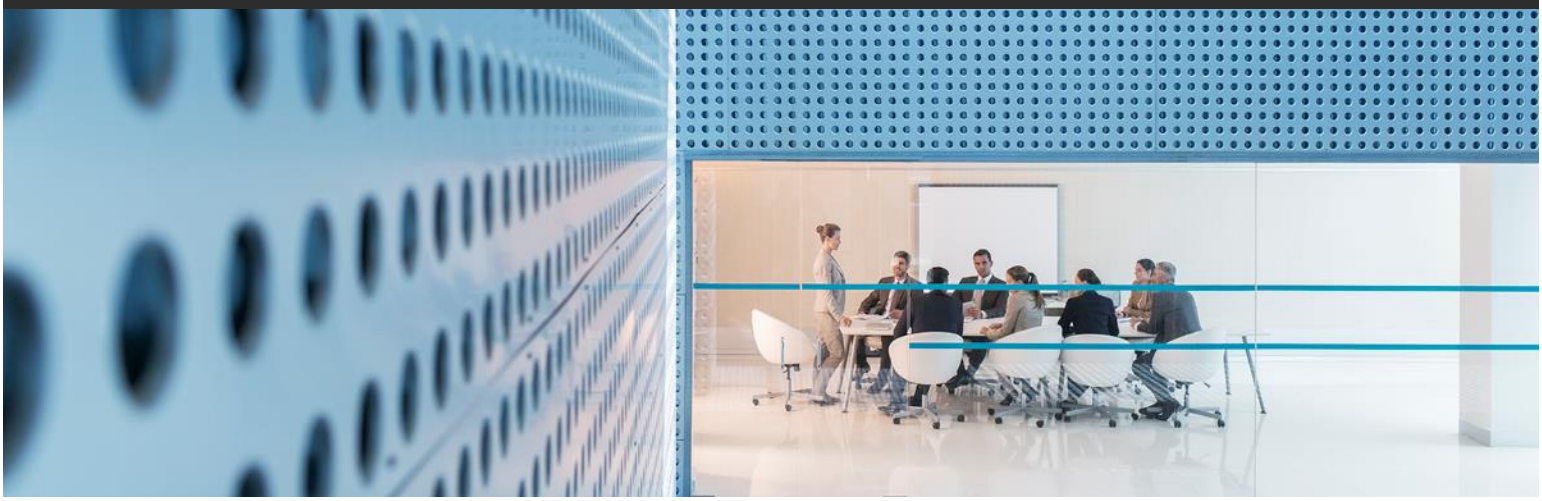

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California Appellate Court Decision Challenges Enforceability of Employment Agreement Overbroad Confidentiality Provisions

Although California generally prohibits non-competition agreements, employers have commonly understood that they could prevent an employee and his or her new employer from using former employers' confidential information. A recent California appellate case, however, has called into question the enforceability of overbroad confidentiality provisions commonly found in employment contracts. *Brown v TGS Management Company, LLC,* 57 Cal. App. 5th 303 (4th Distr. 2020). Such provisions must now be carefully scrutinized. If the provisions are not narrowly tailored to comply with Business and Professions Code Section 16600, the employer risks them being later found void as a "de facto" noncompete, potentially violating the Unfair Competition Law, Business and Professions Code, Section 17200.

Factual Background

The facts in *Brown* are not complex. TGS Management Company (TGS) engages in a computerized form of equities trading called "statistical arbitrage." As in any number of industries where employers attempt to protect confidential information, TGS required its employee, Richard Brown (Brown), to sign an employment agreement with a confidentiality clause. The employment agreement also had an arbitration provision.

Brown worked for TGS for 10 years and was highly compensated. In 2016, TGS terminated Brown's employment, and characterized the termination as "without cause," to permit Brown to receive a bonus of approximately one million dollars. Brown sued seeking a declaratory judgment that he could compete with TGS, and included a copy of his draft separation agreement, which identified TGS's clients and bonus formula. In response, TGS asserted counterclaims against Brown for breach of contract and declaratory relief. In that regard, TGS alleged that, by filing the draft separation agreement, Brown divulged TGS's confidential information, and demanded that Brown return his bonus. TGS also alleged that Brown stole its information about its historical earnings by copying electronically stored information onto his cell phone, but inexplicably did not sue for trade secret misappropriation. The court referred the matter to arbitration, in accordance with the parties' employment agreement.

At arbitration, Brown requested declaratory relief that the confidentiality provision was illegal and unenforceable under Business and Professions Code 16600. He contended that the provision was overbroad, vague and ambiguous, and that, as written, he would be unable to practice his profession of statistical arbitrage without being subjected to unfounded claims that he had used TGS's trade secrets and confidential information.

More specifically, the definition of "Confidential Information" included all information "used or usable" in "analyzing, executing, trading and/or hedging in securities and financial instruments," unless the information is "generally known." The agreement further provided that Brown could use "Confidential Information" only if he had written records evidencing that he possessed such information on a non-confidential basis prior to his TGS employment.

The arbitrator denied Brown's declaratory relief request, as Brown never sought alternative employment, and the request was therefore not ripe. The arbitrator denied the remainder of Brown's claims. The arbitrator found, however, that Brown violated his contractual obligations by stealing TGS's confidential information. Accordingly, the arbitrator ordered Brown to return a portion of his bonus, and also awarded TGS over $2.5 million in attorneys' fees and costs, finding that Brown acted in bad faith in pursuing meritless claims.

TGS petitioned the trial court to confirm the arbitration award (having prevailed on its claims against Brown), and Brown filed a petition to vacate the award, arguing that the arbitrator exceeded his powers in issuing an award violating fundamental public policy and California statutes. The trial court denied Brown's petition, and Brown appealed. On appeal, the Court of Appeal reversed and remanded.

The Appeal

In general, courts are extremely hesitant to overturn an arbitration award, with very limited exceptions. One exception exists when an award conflicts with "unwaivable" statutory rights. The Court of Appeal ruled that the arbitrator's decision was inconsistent with protecting Brown's fundamental right to work in his chosen profession.

The court observed that Business and Professions Code 16600 declared that "every contract" that restrains "anyone from engaging in a lawful profession, trade or business of any kind is to that extent void." It then cited cases where such a determination was made on the face of the contract, where no evidence was taken.

Having held that the determination could be made based on the face of the agreement, the court ruled that the arbitrator should have declared the anticompetitive provisions of the employment agreement void under Section 16600.

The Court Holds that Confidentiality Provisions Effectively Bar Brown From Making a Livelihood, in Violation of Section 16600

As noted above, the employment agreement defined "Confidential Information" as "information, in whatever form, used or usable in, or originated, developed or acquired for use in, or about or relating to, the Business[.]" The word "Business" is further defined to include "without limitation analyzing, executing, trading and/or hedging in securities and financial instruments and derivatives thereon, securities-related research, and trade processing and related administration…."

According to Brown's unrebutted testimony, these provisions were so expansive that Brown was not only excluded from statistical arbitrage, he could not even trade in securities at all – even for his own benefit – for life.

The Court of Appeal not only agreed that the definition of "Confidential Information" was "strikingly" broad but also held that the two "exceptions" to "Confidential Information" further underscored TGS's overreaching.

One exception, commonly found in such agreements, was that "Confidential Information" did not encompass "information which is or becomes generally known in the securities industry through legal means without fault by" Brown. Brown contended, and the court agreed, that this exception was worthless to someone wishing to work in statistical arbitrage because statistical arbitrage was profitable only if the variables and methods behind it were not generally known. Put another way, Brown claimed he would be unable to work profitably in statistical arbitrage if he was restricted to using only securities-related information that is "generally known."

The other exception supporting the court's conclusion that the provision was overreaching was another common provision in such agreements: an exclusion for information that the employee knew on a non-confidential basis prior to his initial engagement or employment by the employer, as evidenced by the employee's written records. In approving Brown's description of the exception as an "absurdity," the court criticized the notion that securities-related information that was not confidential before Brown's employment with TGS could somehow become TGS's "Confidential Information" unless Brown had written records proving his prior knowledge of the information.

Based on these provisions, the court concluded Brown mounted a facial challenge to the provisions and that the factual details of Brown's future employment were irrelevant. Put simply, the restrictions were invalid *ab initio*, and the arbitrator erred by conditioning their enforceability on Brown's job search efforts.

In reviewing the provisions *de novo*, the Court of Appeal concluded that, as a practical matter, they "patently" violated section 16600. According to the court, the provisions operated as a *de facto* noncompete provision. As the court construed them, they "plainly bar Brown in perpetuity" from doing any work in the securities field, much less in his chosen profession of statistical arbitrage.

The Court Rejects TGS's Argument that the Agreement Protects Its Trade Secrets

TGS argued that, without such provisions, it would not have the ability to protect its confidential information, including trade secrets. The Court of Appeal disagreed.

First, the court noted that a properly drawn agreement could avoid this result. Notably, the court did not say what that might entail. Presumably it had a narrower definition of "Confidential Information" in

mind, something that does not limit an employee's ability to use it outside the specific industry in which they were operating. But even limiting "Confidential Information" to TGS's manner of statistical arbitrage may still not have been enough. Further, it is difficult to discern how limiting "Business" to the practice of statistical arbitrage would have led to a different result.

Second, the court noted that TGS could easily avail itself of remedies for trade secret misappropriation, under the CUTSA (California Uniform Trade Secrets Act). As noted, TGS did not raise such a claim, suggesting that it did not have evidence that secret information was being used to do such things as identify existing customers, facilitate such customers, or otherwise unfairly compete.

Takeaway Lessons

Brown v. TGS is the most recent reminder of California's hostility toward non-competes, going so far as to invalidate an arbitrator's decision, which is otherwise entitled to substantial deference. This extraordinary remedy was based on loose wording in a confidentiality provision. Nor did the court modify ("blue-pencil") the confidentiality provision to salvage it. The court further determined that the employee's uncontested theft of confidential information was irrelevant. Put simply, because TGS's definition of "confidentiality" was overreaching, the entire confidentiality portion of the employment agreement was void, and TGS lost the right to protect otherwise confidential information.

Following *TGS*, employers should review such provisions to make clear they protect information that is truly confidential. Employers should also review the agreements to ensure that they are not overreaching to the extent that, as a practical matter, they may prohibit employees from engaging in fair competition.

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