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Noncompete News: Is The Duty Of Loyalty Dead In California?

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Much to the chagrin of many business owners, California courts have consistently favored open competition and employee mobility, and will not enforce noncompete and nonsolicitation agreements that govern an employee's post-employment activities.[1] Despite this, employers have taken comfort in the fact that California law recognizes that an employee owes a "duty of loyalty" to his or her employer during the term of employment.[2] Although only a handful of cases have discussed the subject, courts have found a breach of the duty of loyalty to support an affirmative defense to a wrongful termination claim[3] and have suggested that an employee may be liable for any resulting damages under a tort theory of liability.

Unfortunately, an employee's "duty of loyalty" has been turned on its head by the recent decision of a federal trial court in California. In *Mattel, Inc. v. MGA Entertainment, Inc.*, the court held that "[i]n California, there is no tort for 'breach of duty of loyalty' that is distinct from the recognized tort of 'breach of fiduciary duty'. The fiduciary relationship is a prerequisite to the existence of a duty of loyalty." The court noted that imposing a duty of loyalty upon all employees would ignore the "consistent safeguards upon employee mobility and the freedom to work in the State of California."

The court dismissed Mattel's claim for breach of the duty of loyalty against its former employee, Carter Bryant, who it claimed secretly created the Bratz doll line for its rival, MGA, while employed by Mattel. Mattel is the manufacturer of the Barbie doll, which enjoyed a considerable market share until the Bratz dolls became an overnight success.

While employed by Mattel, Bryant was a designer who worked in the "Barbie Collectibles" department where he designed fashion and hair styles for Barbie dolls. In 1999, he entered into an employment agreement with Mattel that contained an invention assignment clause. Despite this, according to Mattel's allegations, Bryant created the idea for the Bratz dolls, directed the production of the dolls and began secretly working for MGA for months while he was still employed by Mattel. Mattel also claimed that Bryant directed other Mattel employees unknowingly to work on Bratz dolls using Mattel's resources.

When Mattel found out that Bryant created the Bratz dolls while he was a Mattel employee, a flurry of lawsuits was filed by Mattel, its former employees and MGA. At the conclusion of the first trial, a jury awarded Mattel $10 million and the trial court imposed a constructive trust that essentially transferred the Bratz trademark portfolio to Mattel. The Ninth Circuit vacated the award and ordered a second trial, which is currently underway.

The Court Dismissed Mattel's Duty of Loyalty Claim Against its Former Employees Because the Former Employees were not Fiduciaries of the Company

During the second trial, MGA sought dismissal of Mattel's claim for a breach of the duty of loyalty against its former employees, arguing that the duty only applies to employees who are fiduciaries, i.e., "officers of a company who participate in management of the company and have discretionary authority in that managerial capacity."[4] In opposition, Mattel argued that California courts recognize that all employees owe their employers an undivided duty of loyalty regardless of whether they are fiduciaries.[5] In support of this argument, Mattel relied, in part, on the language of the court in *Fowler v. Varian Assoc., Inc.,* "[w]hile California law does permit an employee to seek other employment and even to make some 'preparations to compete' before resigning, California law does not authorize an employee to transfer his loyalty to a competitor."[6]

The court agreed with MGA and ruled that non-fiduciary employees owe no duty of loyalty to their employers. The court recognized that, in the context of fiduciary obligations, "equity and conscience demand that individuals not 'use their position of trust and confidence to further their private interests.'" However, the court went on to say that "no good reason exists to extend these principles to all aspects of the employment relationship," which is separate and apart from any fiduciary or contractual duties. "The law of contracts more than adequately governs the restrictions, if any, upon an employee's use of its own labor and skill; other laws, including the laws of fiduciary obligations and trade secrets law, adequately remedy the misuse of an employer's property and authority."

Despite The *Mattel* Ruling, California Employers Still Have Adequate Recourses against Employees Who Unfairly Compete

While an employee's duty of loyalty is not dead in California, the *Mattel* ruling makes clear that it is certainly more limited. If a duty of loyalty is breached by a fiduciary, the employer may sue that employee pursuant to a tort theory of recovery for compensatory and punitive damages. However, if the offending employee is not a fiduciary, and is unfairly working for a competitor during his or her employment, the employer must pursue other remedies.

First, the employer may immediately terminate the offending employee's employment. A breach of the duty of loyalty is still applicable as an affirmative defense to a wrongful termination claim. The California Court of Appeal opinion in *Stokes v. Dole Nut*[7] makes clear that an employer has good cause to terminate an employee who is actively involved in an attempt to establish a competing business. "[A]n employer is not required to retain an employee while awaiting the commission of a tort."[8]

Second, the employer may pursue any applicable remedies contained within an employment contract. Although the court in *Mattel, Inc.* dismissed Mattel's tort claim, the court made clear that the law of contracts provides adequate protections for employers. Thus, an employment contract may be beneficial to employers who want to prevent valuable employees with special skills or knowledge from being lured away by competitors. A contract can also provide a concise summary of the terms and conditions of employment, which may include an invention assignment clause.

Third, California's Uniform Trade Secret Act affords protections to any information that derives independent economic value and is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[9] Thus, an employer may bring a claim for trade secret misappropriation if an employee has misappropriated any of the

employer's valuable information that qualifies as a trade secret.

Finally, the employer may bring a claim for unfair competition for any unlawful, unfair or fraudulent business act or practice by the employee.[10]

California Employers' Bottom Line:

The ruling in *Mattel* stresses the importance for California employers to protect themselves from employees who have access to valuable information and may use that information to unfairly compete. Employers should take the necessary precautions to protect themselves, which may include entering into an employment contract with any employee who plays a critical role in the business and implementing a trade secrets protection program.

If you have any questions regarding the issues addressed in this *Noncompete News*, please contact the author, Michelle Brauer Abidoye, an associate in our Los Angeles office, at mabidoye@fordharrison.com, or Jeff Mokotoff, jmokotoff@fordharrison.com, the editor of the *Noncompete News,* or the Ford & Harrison attorney with whom you usually work.

[1] *See* Cal. Bus. & Prof. Code § 16600; *see also Edwards v. Arthur Anderson, LLP* (2008) 44 Cal.4th 937.

[2] *See* California Labor Code § 2863, "[a]n employee who has any business to transact on his own account, similar to that intrusted [sic] to him by his employer, shall always give the preference to the business of the employer."

[3] *See Fowler v. Varian Assoc*. (1987) 196 Cal.App.3d 34, 41; *see also Stokes v. Dole Nut Co.* (1995) 41 Cal.App.4th 285.

[4] *See GAB Bus. Servs., Inc. v. Lindsey & Newson Claim Servs.* (2000) 83 Cal.App.409, 420-421; *see also Enreach Tech., Inc. v. Embedded Internet Solutions, Inc.* (2005) 403 F.Supp.2d 968, 976.

[5] *See Stokes v. Dole Nut Co.* (1995) 41 Cal. App. 4th 285, 295; *see also Fowler v. Varian Assoc., Inc.* (1987) 196 Cal.App.3d 34, 41.

[6] *Fowler v. Varian Assoc*. (1987) 196 Cal.App.3d 34, 41.

[7] *Stokes v. Dole Nut Co.* (1995) 41 Cal.App.4th 285, 295.

[8] (*Id.*)

[9] *See* Cal. Civ. Code § 3426.1.

[10] *See* Cal. Bus. & Prof. Code § 17200-17301.