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EMPLOYMENT LAW

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# *California Curbs Enforceability of Non-Competition Pacts*

The California Supreme Court recently issued a decision rejecting the so-called "narrow-restraint" exception used by courts to find certain noncompetition covenants valid and enforceable in the state of California.

Before *Edwards v. Arthur Andersen LLP,* 44 Cal. 4th 937 (Cal. 2008), employers had achieved some success in arguing that where a noncompetition agreement did not completely prohibit post-termination competition by an employee, California courts were permitted to enforce the agreement under such an exception.

For example, employers had effectively argued that narrowly tailored nonsolicitation covenants—agreements which prohibit former employees from soliciting or working for certain clients or customers of their former employer—came within the narrow-restraint exception and, therefore, were enforceable.[1] The *Edwards* court rejected such an exception to the general prohibition, contained in California's Business and Professions Code §16600.

The *Edwards* decision highlights California's continuing hostility to noncompetition and nonsolicitation agreements, even beyond what employers had previously understood to be the bounds of judicial antipathy in California. California's interpretation of restrictive covenants stands in stark contrast to governing law in virtually every other state in the United States.

Multistate employers with operations in California should familiarize themselves with the *Edwards* case, and its impact on existing noncompetition agreements. In this article, we discuss approaches other than the use of noncompetition agreements that employers may wish to consider for protection of their confidential information in light of *Edwards*.

## Background

Plaintiff Raymond Edwards II worked as a certified public accountant and a tax manager for Arthur Andersen LLP. At the commencement of Mr. Edwards' employment in 1997, Arthur Andersen required Mr. Edwards to sign a restrictive covenant, one which the *Edwards* court referred to as a noncompetition agreement. This agreement prohibited Mr. Edwards, among other things, from working for or soliciting certain Arthur Andersen clients for limited periods following his termination of employment. The agreement provided that although Mr. Edwards was "not to perform professional services of the type [he] provided for any client on which [he] worked prior to [his] release or resignation" and "not to solicit…any client," it explicitly did "not prohibit [Mr. Edwards] from accepting employment with a client."[2]

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In 2002, in response to the U.S. government's indictment of Arthur Andersen in connection with the investigation of Enron, Arthur Andersen ceased its accounting practices in the United States, and HSBC USA Inc. purchased a portion of Arthur Andersen's tax practice, including Mr. Edwards' group. HSBC offered Mr. Edwards a job contingent upon Arthur Andersen releasing him from his noncompetition agreement; Arthur Andersen agreed to do so only if Mr. Edwards agreed to release "any and all" claims he might have against the company. He refused to agree to such a release, and so in response, Arthur Andersen refused to release Mr. Edwards from his noncompetition agreement. As a result, HSBC withdrew its offer of employment, and Mr. Edwards subsequently brought clams against Arthur Andersen alleging, among other things, interference with prospective economic advantage.

To prove a claim for interference with prospective economic advantage, Mr. Edwards needed to prove the following: (1) an economic relationship between Mr. Edwards and HSBC, with the probability of future economic benefit to Mr. Edwards; (2) Arthur Andersen's knowledge of the relationship; (3) an intentional act by Arthur Andersen designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) economic harm to Mr. Edwards proximately caused by Arthur Andersen's wrongful act.[3] Mr. Edwards further needed to prove that the interference essential to the third element was "independently wrongful" or "unlawful."[4]

Mr. Edwards argued that he satisfied the "independently wrongful act" requirement, noting that the restrictive covenant Arthur Andersen required him to sign violated California law and was, therefore, unenforceable.[5] The trial court determined that the agreement Mr. Edwards entered into "did not violate section 16600, because it was narrowly tailored and did not deprive [Mr.] Edwards of the right to pursue his profession,"[6] but the California Court of Appeal reversed the trial court's judgment as to this finding. Review was granted by the California Supreme Court, which affirmed in relevant part the judgment of the Court of Appeal.

## Narrow-Restraint Exception to §16600

The *Edwards* court addressed the validity of the restrictive covenant at issue under California's Business and Professions Code §16600, which provides that most "contract[s] by which anyone is restrained from engaging in a lawful profession, trade, or business" are void in California.[7] Arthur Andersen argued that the term "restrain" should be interpreted by the court "to mean simply to 'prohibit,' so that only contracts that *totally prohibit* an employee from engaging in his or her profession, trade, or business [would be] illegal."[8] Arthur Andersen also argued that the U.S. Court of Appeals for the Ninth Circuit had applied this limited or "narrow-restraint" exception to §16600, citing *Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499 (9th Cir. 1987). The California Supreme Court noted that *Campbell* relied upon two cases that did "not provide persuasive support for adopting the narrow-restraint exception…. The restriction [at issue in the first case cited by *Campbell*]…was not upon the plaintiff's practice of a profession or trade, but…[instead] involved the use of…land, [and] section 16600 was not implicated."[9] In the second case cited in *Campbell*, "the court applied a trade secret exception to the statutory rule against noncompetition clauses."[10]

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Arthur Andersen's arguments did not persuade the *Edwards* court, and neither did the handful of federal cases which purport to apply the judicially created narrow-restraint exception.[11] Despite the fact that the narrowly tailored nonsolicitation agreement entered into by Mr. Edwards only "restricted [Mr.] Edwards from performing work for Arthur Andersen's Los Angeles clients," it "restricted his ability to practice his accounting profession" and, therefore, was invalid.[12] The California Supreme Court held that there is no narrow-restraint exception under California law and provided, that "Section 16600 is unambiguous, and if the Legislature intended for the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect…. [W]e leave it to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to the prohibition-against-restraint rule under section 16600."[13]

The *Edwards* court did not evaluate whether noncompetition agreements would be permitted to the extent necessary to protect an employer's trade secrets. In a footnote, the court states, "[w]e do not here address the applicability of the so-called trade secret exception to section 16600, as [Mr.] Edwards does not dispute that portion of his agreement or contend that the provision of the noncompetition agreement prohibiting him from recruiting Andersen's employees violated section 16600."[14] The court further cites with approval *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal.2d 239 (Cal. 1965), a case which held that contracts prohibiting an employee from working for a competitor violated §16600 "unless they are necessary to protect the employer's trade secrets."[15]

## Impact of 'Edwards'

Multistate employers with operations in California should review their employment agreements in light of *Edwards*. Consistent with *Edwards* and given the unavailability of the "narrow restraint" exception, employers who intend to enforce noncompetition agreements in California should seek to meet the requirements of the various exceptions to §16600. Section 16600 provides for exceptions to the prohibition of noncompetition agreements where the agreement was entered in connection with the sale or dissolution of a business, partnership, or limited liability corporation or the sale of a shareholder's stock[16] or where the agreement is necessary for the protection of trade secrets.[17]

Based on the trade-secret exception, employers may seek to enforce confidentiality, noncompetition, and/or nonsolicitation agreements against former employees to the extent such agreements are necessary to protect the employers' trade secrets.[18] Employers who wish to enforce noncompetition agreements based on the trade-secret exception should define their trade secrets with precision and ensure their definitions are supportable both legally and factually. For example, to the extent factually supportable in specific cases, employers may seek to include within the scope of trade-secret information their customer lists, vendor lists, product information, financial information and strategic business information. Employers should be aware that California law defines trade secrets as information that "derives independent economic value…from not being generally known to the public…" and information that "is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[19]

Employers also may wish to consider negotiating agreements other than traditional restrictive covenants as a way to protect their confidential information. For example, employers may wish to include in their employment agreements a clause requiring the return of all documents containing confidential, proprietary and/or trade secret information, as well as all other company property, before an individual leaves the employ of the company.

Employers should be aware that even in California they may include noncompetition covenants or so-called "forfeiture for competition agreements" within certain ERISA plans, including severance pay, top hat and pension plans.[20] Because ERISA preempts state law, an employer may argue that state law prohibitions on noncompetition agreements, such as §16600, do not apply where the restrictive covenant or "forfeiture for competition agreement" is part of an ERISA plan. To the extent that such covenants require the forfeiture of ERISA-protected benefits following competition, ERISA permits such forfeitures only in excess of minimum vesting requirements in 29 U.S.C. §1053.[21]

Employers outside of California also should consider the ramifications of *Edwards* and §16600. For example, employees who sign noncompetition agreements governed by non-California law, and who worked outside of California have sought to relocate to California following termination of employment and to apply to California courts to nullify their noncompetition agreements under §16600. To combat such maneuvers, employers outside of California should ensure that they include clauses in their noncompetition agreements which state that the agreement shall be governed by the law of a state outside California without regard to that state's choice of law rules. In such cases, even California courts have allowed enforcement of non-California law, particularly where the employer also was vigilant in protecting its rights in courts outside California.[22]

1. See, e.g., *Corporate Express Document & Print Mgmt. v. Coons*, 2000 U.S. Dist. LEXIS 22243 (C.D. Cal. April 21, 2000). In *Coons*, the court determined that a restrictive covenant that prohibited the employee only from soliciting or doing business with his former customers would likely be enforced. "[A] contract is valid, despite a restriction on competition, if the promisor is 'barred from pursuing only a small or limited part of the business, trade or profession….'" *Coons*, 2000 U.S. Dist. LEXIS 22243 at *14-15 (internal citations omitted).

2. *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937, 942 (Cal. 2008).

3. Id. at 944 (citing *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal.4th 1134, 1153-1154 (2003)).

4. Id. (citing *Della Penna v. Toyota Motor Sales, U.S.A. Inc.*, 11 Cal.4th 376, 392-393 (1995); *Korea Supply*, 29 Cal.4th at 1159).

5. Mr. Edwards also maintained that he satisfied the "independently wrongful act" requirement with respect to the release Arthur Andersen attempted to have him sign, which was drafted to release Arthur Andersen from "any and all" claims. Id. at 944-45. Mr. Edwards argued that this language encompassed his statutorily nonwaivable rights and, therefore, was unlawful. The *Edwards* court disagreed, concluding that the language in the agreement did not purport to release Mr. Edwards' nonwaivable rights. Id. at 950-55.

6. *Edwards*, 44 Cal. 4th at 944.

7. CAL. BUS. & PROF. §16600 (2008).

8. *Edwards*, 44 Cal. 4th at 947 (emphasis added).

9. Id. at 949.

10. Id.

11. See, e.g., *IBM v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (contract is valid under §16600 if employee is barred from pursuing only a small or limited part of the business, trade or profession); *General Commer. Packaging v. TPS Package Eng'g*, 126 F.3d 1131 (9th Cir. 1997) (contract is valid under §16600 unless it completely restrains employee from plying its trade or business).

12. *Edwards*, 44 Cal. 4th at 948.

13. Id. at 950.

14. Id. at FN 4.

15. *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal.2d 239, 242 (Cal. 1965).

16. CAL. BUS. & PROF. §§16601, 16602, 16602.5 (2008).

17. See e.g., *D'Sa v. Playhut*, 85 Cal. App. 4th 927 (2000); *Muggill*, 62 Cal.2d 239; see also CAL. CIV. CODE §3426, et seq. (California's Uniform Trade Secrets Act, governing trade secret protection).

18. See, e.g., *Lillge v. Verity*, 2008 U.S. Dist. LEXIS 26164, 17-20 (N.D. Cal. March 31, 2008). In *Lillge*, the court held that where a noncompete clause was narrowly tailored in both time and scope and designed to protect the employer's trade secrets, the employer was "well within its right to demand its employees sign a noncompete agreement in order to protect [these] trade secrets."

19. CAL. CIV. CODE §3426.1(d).

20. See Jeffrey S. Klein and Nicholas J. Pappas, "Enforceability of 'Forfeiture-for-Competition' Agreements," New York Law Journal at p. 3 (Feb. 3, 2003).

21. See, e.g., *Clark v. Lauren Young Tire Center Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987) (upholding a noncompete forfeiture provision and noting that where a plan is "'more liberal' than ERISA demands, the employer may condition his liberality with a noncompetition requirement"); *Lojek v. Thomas*, 716 F.2d 675, 679 (9th Cir. 1983) ("ERISA does not prohibit forfeiture of [nonvested] benefits in excess of ERISA's minimum vesting requirements…in §1053.").

22. See *Advanced Bionics Corp. v. Medtronic Inc.*, 29 Cal. 4th 697 (2002). Even where the employee first brings suit in California, the employer may wish to also quickly bring suit in its home jurisdiction. See *Medtronic*, 29 Cal. 4th 697. In *Medtronic*, a Medtronic employee, living in Minnesota, entered into a noncompetition agreement with his employer, which was governed by Minnesota law. He then accepted a position with a competitor in California, and on the day he resigned from Medtronic, the former employee, along with his new employer, brought suit in California to have the agreement declared void, even though the former employee had not yet moved to California. The following day, Medtronic commenced an action in Minnesota and obtained a temporary restraining order preventing the former employee from violating his noncompetition agreement; the court subsequently granted Medtronic a temporary injunction for the entire two-year term of the agreement. The California court then enjoined Medtronic from proceeding in Minnesota. Ultimately, relying on principles of judicial restraint and comity, the California Supreme Court quashed the California injunction enjoining Medtronic from taking action in Minnesota. While the court noted that California has a strong interest in protecting its employees from enforcement of noncompetition agreements, it said that public policy interest was not enough to suspend actions brought in other states.