Post-Employment Noncompetition Clauses in California Employment Agreements Are Invalid

By Gerald V. Niesar and June Lin

Introduction

Imagine an employment agreement with a standard post-employment noncompetition clause that is reasonable in geographic scope and duration. In many states courts would uphold such a clause. But not in California, especially after the Supreme Court's 2008 decision in the case *Edwards v. Arthur Andersen, LLP* [1].

Facts of *Edwards*

Mr. Edwards was employed by Arthur Anderson LLP ("AA") as an estate planner for high net worth individuals, and had signed AA's standard employment agreement containing a clause that prohibited certain post-employment activities, including:

- provision of services of the type he provided to AA clients, to any client for whom he had worked at AA, for eighteen months;
- solicitation of any AA clients to whom he was assigned at AA, for services of the type he performed at AA, for twelve months; and
- solicitation of AA professional personnel, for eighteen months.

When AA collapsed, following prosecution for its involvement with Enron, it sold off components of its business to other entities. The component Edwards worked for was sold to an HSBC subsidiary called Wealth and Tax Advisory Services ("WTAS"). AA employees "sold"

[1] 44 Cal. 4th 937 (2008).

to WTAS were required by WTAS to sign a Termination of Non-Competition Agreement (“TONC”), drafted by AA, pursuant to which they waived substantially all claims against AA, including indemnification claims, in consideration of which AA released them from the non-competition agreement. Edwards refused to sign the TONC and WTAS withdrew its offer of employment.

Edwards’ Claims

Edwards asserted several causes of action against AA, most of which were dismissed at various stages, leaving only the cause of action for intentional interference with prospective economic advantage. The critical element of the cause of action that remained at issue was that the defendant must have committed an intentional act designed to disrupt the plaintiff's favorable relationship with a third party. By case law, the intentional act must be "intentionally wrongful," which means wrongful by some measure beyond the mere fact of the interference itself.

Edwards asserted that the non-competition clause was a violation of California Business and Professions Code (“B&P”) Section 16600, which provides that: "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." There are several statutory exceptions, primarily having to do with sales of businesses and/or goodwill, or an interest in a business, which are inapplicable to a pure post-employment prohibition against noncompetition. Edwards' other claim of "intentionally wrongful" acts relied on California Labor Code Section 2802, which provides an employee broad statutory indemnification rights against expenses and losses incurred in direct consequence of the discharge of his or her duties, unless arising from an act the employee believed, at the time

he or she acted, was unlawful. Labor Code Section 2804 makes any agreement purporting to waive the benefits of Section 2802 "null and void."

Employee Non-Competition Agreement Issue

AA argued that the non-competition agreement it sought to enforce only impacted a small portion of the relevant market for Edwards' services, which entailed providing estate planning services for high net worth individuals. AA cited several Ninth Circuit United States Court of Appeals holdings under B&P Section 16600 that had created a doctrine referred to as the "narrow restraint" exception to the prohibition of non-compete clauses, applicable in cases where the part of the market foreclosed to the former employee by the non-compete clause was such a minimal part of the whole available market that the ability of the employee to engage in his business was minimally impacted, and therefore enforcement of the covenant was appropriate.

The trial court agreed with AA and observed that there are so many wealthy persons in Los Angeles that the restrictions did not constitute "even perhaps any minimal restriction on [Edwards'] ability to work."

The California Court of Appeal disagreed and, in effect, overruled the reasoning of the Ninth Circuit based on the legislative history of B&P Section 16600 and case law in California courts. In particular the California Court of Appeal cited *D'Sa v. Playhut, Inc.*:[2] "We foresee situations where the uninformed...employee will forego legitimate [employment] rather than assume the risk of expensive, time-consuming litigation...." The California Court of Appeal held that AA's enforcement of the non-compete agreement, via its refusal to release its provisions unless Edwards executed the TONC, was an intentionally wrongful act supporting the critical element of Edwards' intentional interference tort claim. In its opinion the court rejected the

[2] 85 Cal App 4th 927 (2nd dist. 2000).

"narrow restraint" exception to the prohibition against non-compete agreements that had been crafted by the U.S. Court of Appeals for the Ninth Circuit in its opinions construing Section 16600.

The Supreme Court agreed with the Court of Appeal that no prior California court facing similar situations had accepted the "narrow restraint" exception. The Supreme Court noted that the specific language of B&P Section 16600, invalidating "every contract by which anyone is restrained from engaging in a lawful profession...", is clear and unambiguous. Thus, the law in California is now clear that any contractual restraint on a person's right to compete in the former employer's business, no matter how narrow or minimal the restraint, is void and unenforceable.

Unlimited Waiver of Claims by Employee Issue

The California Court of Appeal also found that the TONC, by purporting to exclude future indemnity claims, violated the fundamental public policy of California. Thus, Edwards' claim that AA prohibited him from obtaining employment with WTAS by conditioning such employment on his execution of a contract containing a waiver that was clearly against public policy was an independent and intentionally wrongful act supporting the critical element of the intentional interference cause of action. AA argued that, since California Labor Code Section 2804 made the waiver clause null and void, Edwards would not have been restrained or prejudiced by agreeing to it. The Court of Appeal held that the *"in terrorem* effect of the Agreement will tend to secure employee compliance with its illegal terms in the vast majority of cases."

Surprisingly, the Supreme Court accepted AA's reasoning and overrruled the Court of Appeal’s holding on this issue (with a strong dissent written by one Justice and concurred in by another Justice).

Notwithstanding the majority's clear endorsement of an "any and all claims waiver," we would discourage an employer from putting such a clause in a termination agreement unless followed by a statement to the effect that the clause is not intended to imply that the employee waives his or her rights under California Labor Code Section 2802 or any other state or federal statute providing non-waivable rights. In a court action where the AA-type waiver is in the agreement, employee testimony that he or she believed it would prohibit even an indemnification claim might be used to discredit the employer, even if that particular issue is not ultimately the issue in the lawsuit. In fact, the majority's opinion is footnoted with an observation that Edwards might proffer proof in the lower court on remand showing that AA's actual conduct (for instance, a letter or other communication from the employer indicating that Edwards had waived his indemnity rights) might prove the exception to the general rule that the Supreme Court had endorsed regarding an "any and all" waiver as not applicable to non-waivable rights.

The Trade Secret Exception

There is a possibility that a post-employment covenant not to compete could be drafted and defended on the ground that it is necessary to protect the employer's trade secrets or other proprietary information. This “trade secret” exception to B&P Section 16600 was not addressed in the *Edwards* case. Employers have a right to protect their proprietary information and trade secrets, although doing so via an agreement not to solicit customers or other employees is probably dangerous and could jeopardize the employer's legitimate right to protect proprietary information.

Two recent cases illustrate the danger, although neither arose out of an attempt to enforce a non-compete agreement. *Flir Systems, Inc. v. Parrish*[3] involved a former employer Flir suing two former employees alleging that their competing business was built upon, at least in part, misappropriated or threatened misappropriation of trade secrets. Flir’s case was based upon the "inevitable disclosure"

[3] 174 Cal. App. 4th 1270 (2d Dist. 2009).

doctrine. This doctrine would apply in a situation where the employee could be shown to have held such a sensitive position that if she were to go to work for a competitor of the former employer it is not conceivable that she would not share with the new employer proprietary information, including trade secrets, of the former employer.

Flir's problem, however, was that California courts do not recognize the "inevitable disclosure" doctrine. Thus, it is necessary that the former employer actually prove the theft and misuse of trade secrets or other proprietary information. Flir compounded its errors in the case by testimony from its officers that contradicted allegations in the complaint and established an anticompetitive motive for the lawsuit, e.g., "we can't tolerate a direct competitive threat by [the former employees]." The trial court found that Flir had filed the lawsuit in bad faith in order to eliminate competition, and that it committed a further unlawful act when it proposed a settlement agreement that would include a prohibition against the former employees soliciting other Flir employees and other anticompetitive clauses. As a result, the trial court awarded the former employees damages, as well as attorneys fees, in the total amount of $1,641,216.78. The Court of Appeal upped the recovery by awarding the former employees their costs and attorneys fees incurred in the appeal.

The other recent case is *The Retirement Group v. Galante.*[4] In this case the former employees of an investment advisory and securities brokerage firm were sued because they solicited customers of their former employer. The plaintiff former employer sought and obtained an injunction that precluded the employees from: (1) soliciting any current customer of their former employer; and (2) wrongfully using information found solely and exclusively on the former employer's databases. On appeal, the former employees challenged only the first prong of the injunction, i.e., prohibiting solicitation of customers. The Court of Appeal, citing *Edwards*, found that the challenged portion of

[4] 176 Cal. App. 4th 1226 (4th Dist. 2009).

the injunction could not be upheld as it was not limited to the legitimate objective of protecting trade secrets.

These two cases demonstrate that California courts will examine closely any attempt to prohibit a former employee from engaging in a competitive business, even where the claim is that the prohibition is to protect the former employer's trade secrets. Any agreement with a former employee that prohibits solicitation of the employer's customers or employees, even if claimed to be necessary for protection of trade secrets, may be subject to challenge as having an anticompetitive motive. It would be better to limit the agreement to the employee agreeing not to use any employer trade secrets or proprietary information in any business activity that is competitive with the employer's business. Then if the employer decides to enforce its rights to prohibit unlawful use of its trade secrets, it should proceed with great care and only after a very thorough investigation sufficient to produce evidence supporting a reasonable belief that the employee has actually misused the employer's trade secrets or other proprietary information. Failure to establish such actual abuse by the former employee may subject the employer to the kind of heavy penalties imposed upon Flir Systems, Inc.

Conclusion

As demonstrated by California's position on noncompetition agreements, California is generally viewed as having a very strong employee bias in its laws. Most other states are much more relaxed when it comes to covenants not to compete. In fact, it is entirely possible that an agreement that is illegal under California law, entered into in California with a California employee, may be enforced in another jurisdiction that does not have employee protection laws similar to the California laws discussed above. Conversely, it is probable that an out-of-state company, seeking to enforce an agreement with its former employee who lived in another state when the agreement

was signed, will find that California Courts refuse to enforce the agreement if the former employee is now a California resident. This may lead to a "race to judgment", i.e. the out-of-state company successfully sues in its home state where covenants not to compete are enforceable to enjoin an employee who has signed such an agreement from going to work for a California competitor. At the same time, that employee and the new California employer successfully sue in California to invalidate the covenant. The first final judgment on the merits will be entitled to full faith and credit in the other state even if it is contrary to local public policy in that state.[5]

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. Gerald Niesar and June Lin are attorneys at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance.

[5] See *Baker by Thomas v. General Motors Corp.* (1998) 522 US 222, 223, 118 S.Ct. 657, 664 (there is no roving "public policy exception" to the full faith and credit due judgments).