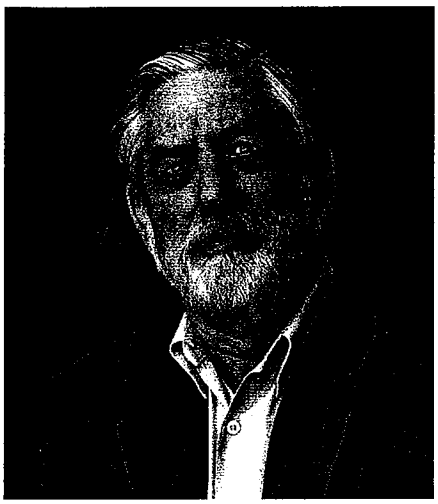
Noncompetition Clauses in California Employment Agreements Are Definitely Invalid

By Gerald V. Niesar



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A regular speaker at ABA programs, Mr. Niesar recently chaired a program at an annual meeting addressing "speed bumps in California law that trip up out of state lawyers." His activities at the ABA have included past chair positions on the Partnership Committee as well as the Task Force on Private Placement Broker Dealers, which grew out of his original proposal to the ABA Small Business Committee.

Mr. Niesar graduated from the University of Pennsylvania Law School, *cum laude*, in 1969 where he was also admitted to Order of the Coif. His undergraduate studies were at the Wharton School at the University of Pennsylvania.

I. Introduction

A previous issue of this journal contained an article[1] describing the then-questionable validity of post-employment covenants not to compete that were often included in employment agreements with California based employees. This article assumes that readers will review that article for a statement of the facts and discussion of the relevant law in the case, *Edwards v. Arthur Andersen, LLP*.[2] As noted in that article, the decision of the California Court of Appeal had been accepted for review by the California Supreme Court. Your author promised to update the article when the California Supreme Court decision was final. In August, 2008 the Supreme Court issued its opinion,[3] affirming one holding of the Court of Appeal but overruling the other holding. This article reviews the California Supreme Court decision, and briefly describes two recent Court of Appeal cases that address attempts to quell competition by former employees based upon a claim that the competition would involve misuse of trade secrets or other proprietary information.

II. The Issues in *Edwards* on Review by the Supreme Court

The California Supreme Court directed the parties to limit their briefing to two specific issues:

- to what extent does Business and Professions Code section 16600 prohibit employee non-competition agreements; and
- does a contract provision releasing "any and all" claims encompass nonwaivable statutory protections, such as the employee indemnity protection of Labor Code section 2802.

III. The Supreme Court on the Employee Non-Competition Agreement Issue

Arthur Anderson (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. The non-competition clause in Edwards' agreement[4] prohibited him from soliciting: (1) any person to whom he had provided such services while employed with AA (eighteen months); (2) any client to whom he was assigned while so employed (twelve months); and (3) any AA professional personnel (eighteen months). The trial court had held that in Los Angeles there are so many wealthy persons that the restrictions did not constitute "even perhaps any minimal restriction on his ability to work." AA cited several Ninth Circuit United States Court of Appeals holdings under the relevant statute[5] that had created a doctrine referred to as the "narrow

1. *See* Gerald V. Niesar, *Noncompetition Clauses in California Employment Agreements are (Probably) Invalid*, 61 Consumer Fin. L.Q. Rep. 396 (2007).
2. 142 Cal. App. 4th 603 (Cal. Ct. App. 2006), *petition for review granted*, 147 P.3d 1013 (Cal. 2006).
3. 44 Cal. 4th 937 (2008).
4. As noted in the previous article, Edwards refused to sign the agreement, which led to his losing another employment opportunity. For convenience, we refer to the proffered agreement as the Edwards agreement.
5. Cal. Bus. & Prof. Code § 16600.

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 so minimally impacted that enforcement of the covenant was appropriate.

The Court of Appeal had overruled the trial court, and the Supreme Court agreed with the Court of Appeal that the language of section 16600 of the California Business and Professions Code is unambiguous and that no prior California court facing similar situations had accepted the "narrow restraint" exception. The Supreme Court noted that the specific language, 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.

IV. The Supreme Court on an Unlimited Waiver of Claims by an Employee

This issue concerned the argument that, because the Edwards agreement contained a provision purporting to waive any and all claims he might have against AA, any attempt to enforce such a provision would be illegal in view of sections 2802 and 2804 of the California Labor Code. Section 2802 provides an employee an indemnification claim against his or her employer with respect to any claim asserted against the employee that arises out of the employee's services, so long as the employee's actions were not known to him or her to be unlawful. Section 2804 provides that the employee's rights under section 2802 are not waivable. Therefore, Edwards argued, AA's attempt to have him sign a complete, unlimited waiver of any and all claims he might have against AA was an unlawful act.

AA's position was that, because section 2804 made unwaivable the protections of section 2802, the contract provision was not an unlawful attempt to force Edwards to waive the protections in section 2802. Your author had predicted (privately) that the Supreme Court would not buy into AA's argument but, in fact, the Supreme Court accepted AA's reasoning and ruled in AA's favor on that issue. However, it is comforting to your author that while AA convinced a majority of four Justices on this issue, a strong dissent was written by Justice Kennard and concurred in by Justice Werdegar.

In the dissent it was pointed out that the existence of the "any and all claims waiver" in an agreement signed by a person not intimately familiar with the Labor Code would present an *"in terrorem* effect [that] will tend to secure employee compliance with its illegal terms in the vast majority of cases." It is worth noting that in the Court of Appeal opinion that was under review, that court had cited this "*in terrorem*" effect as one of the reasons why a narrow restraint exception to the general prohibition of non-compete agreements should not be endorsed by the courts.

Notwithstanding the majority's clear endorsement of an "any and all claims waiver," your author 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 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.

V. The "Trade Secret" Angle

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. 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*[6] involved a former employer 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" 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

6. 174 Cal. App. 4th 1270 (2d Dist. 2009).

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, worthy of a brief mention here, is *The Retirement Group v. Galante*.[7] 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 the 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 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. It is submitted that 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, will 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 very thoroughly prepare its case on hard and objective evidence that demonstrates the misuse of its trade secrets. 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.

VI. Conclusions

It should be emphasized that this article addresses only California law. Most other states are much more relaxed when it comes to non-competition agreements. In addition, California is generally viewed as having a very strong employee bias in its laws. Thus, the issues discussed above may not relevant in other states. 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 present former employees with forum-shopping opportunities. As the *Flir Systems, Inc.* case demonstrates, before suing a California former employee to prevent his or her involvement with a competitor, the former employer 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.

7. 176 Cal. App. 4th 1226 (4th Dist. 2009).

Update on Avoidance of Subordinate...

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view directed at perceptions of "predatory" lending now threatens to broadly invalidate second mortgage liens, including many prime credit transactions. If this happens, the consequences are likely to include another decline in the availability of mortgage credit, shutting off a valuable source of liquidity for consumers. It is time for the courts to reconsider these issues, this time with a more careful reference to the law.

Articles Solicited

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