Noncompetition Clauses in California Employment Agreements Are (Probably) Invalid

By Gerald V. Niesar*

I. Introduction

As illustrated in *Edwards v. Arthur Andersen LLP*,[1] noncompetition clauses in California employment contracts probably are invalid; an attempt to enforce such an agreement may constitute a wrongful act supporting a claim by the former employee for intentional interference with prospective economic advantage.

II. 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,[2] 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" 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 (HSBC) withdrew its offer of employment.

III. 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 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. Section 2804 makes any agreement purporting to waive the benefits of section 2802 "null and void."

IV. Enforcement of a Covenant Not to Compete as an Intentionally Wrongful Act

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 "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. Under that doctrine, the Ninth Circuit had, in a series of cases discussed in the California Court

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1. 142 Cal. App. 4th 603 (Cal. Ct. App. 2006); petition for review granted, 147 P.3d 1013 (Cal. 2006).

2. *See, e.g.*, Symposium, *Corporate Governance in the Twenty-First Century*, 60 Consumer Fin. L.Q. Rep. 18 (2006).

of Appeal opinion in *Edwards*, carved out from the arena of unenforceability those situations where the restriction on the plaintiff is limited and leaves a large or substantial portion of the market available to the employee. The lower court in the *Edwards* case had observed that: "there were more than enough of these wealthy folks...in L.A. for all CPA's to do the kind of work [Edwards] was doing....There wasn't even perhaps any minimal restriction on his 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 section 16600 and case law in California courts. In particular the California Court of Appeal cited *D'Sa v. Playhut, Inc.*:[3] "we foresee situations where the uninformed...employee will forego legitimate [employment] rather than assume the risk of expensive, time-consuming litigation...."

This issue has been accepted by the California Supreme Court for review. The questions presented include: Does section 16600 prohibit all employee non-competition agreements (other than the limited sale of a business or business interest exceptions), or only those that actually prevent the pursuit of a lawful trade, profession or business?

V. Edwards' Claim Based Upon Labor Code Section 2802

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 section 2804 made the waiver clause null and void, Edwards would not have been restrained or prejudiced by agreeing to it. The court 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."

This issue has also been accepted for review by the California Supreme Court.

VI. A Likely Extension of the Scope of Employer Exposure

In *Edwards*, the California Court of Appeal several times cited *Baker Pacific Corp v. Suttles*.[4] In *Baker Pacific*, workers engaged in asbestos removal work were required, as a condition of continued employment, to sign a release in favor of their employer that would exempt the employer from responsibility for fraud and intentional acts, in contravention of California Civil Code section 1668 (a contract provision purporting to exempt one from responsibility for his own fraud, willful injury to property or person of another, or willful or negligent violation of law is void as against public policy).

A logical extension of *Baker Pacific* and *Edwards* (and other cases discussed in the *Edwards* opinion) is that a refusal to hire a person who declines to sign an employment contract with one or more of the covenants discussed above that are against public policy would give rise to a cause of action for "wrongful non-hiring." While your author is not aware of any case in California that has found such an action viable, there does not appear to be any reason why such a cause of action would not be found to be implied under the cases discussed above. It should be noted, however, that Edwards apparently did not sue WTAS, although WTAS is the entity that refused to hire him when he did not sign the offending agreement.

VII. Stay Tuned for Further Developments

As noted above, the issue of whether section 16600 establishes a total ban on all employee covenants not to compete has been accepted by the California Supreme Court for review. On January 17, 2007 the Supreme Court instructed the parties to limit briefing to the following two 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?[5]

Your author promises to update this article if and when the Supreme Court issues its opinion.

Appendix

California Business and Professional Code

[Section] 16600. Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.

[Section]16601. Any person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold, or that of

3. 85 Cal App 4th 927 (2nd dist. 2000).

4. 220 Cal. App. 3d 1148 (1st Dist. 1990).

5. 07 CDOS 662.

the business entity, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein.

For the purposes of this section, "business entity" means any partnership (including a limited partnership or a limited liability partnership), limited liability company, or corporation.

For the purposes of this section, "owner of a business entity" means any partner, in the case of a business entity that is a partnership (including a limited partnership or a limited liability partnership), or any member, in the case of a business entity that is a limited liability company, or any owner of capital stock, in the case of a business entity that is a corporation.

For the purposes of this section, "ownership interest" means a partnership interest, in the case of a business entity that is a partnership (including a limited partnership a limited liability partnership), a membership interest, in the case of a business entity that is a limited liability company, or a capital stockholder, in the case of a business entity that is a corporation.

For the purposes of this section, "subsidiary" means any business entity over which the selling business entity has voting control or from which the selling business entity has a right to receive a majority share of distributions upon dissolution or other liquidation of the business entity (or has both voting control and a right to receive these distributions.)

[Section]16602. (a) Any partner may, upon or in anticipation of any of the circumstances described in subdivision (b), agree that he or she will not carry on a similar business within a specified geographic area where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any such other member of the partnership, carries on a like business therein.

(b) Subdivision (a) applies to either of the following circumstances:

(1) A dissolution of the partnership.

(2) Dissociation of the partner from the partnership.

[Section]16602.5. Any member may, upon or in anticipation of a dissolution of a limited liability company, agree that he or she or it will not carry on a similar business within a specified geographic area where the limited liability company business has been transacted, so long as any other member of the limited liability company, or any person deriving title to the business or its goodwill from any such other member of the limited liability company, carries on a like business therein.