

California Supreme Court Confirms That Agreements Restricting Employees' Subsequent Employment Are Generally Unenforceable - Rejects "Narrow Restraint" Doctrine

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In a long-awaited decision, the California Supreme Court has confirmed that restrictive agreements that limit an employee's ability to engage in a lawful profession are unenforceable in California unless given in connection with a sale or dissolution of a corporation, a partnership or a limited liability corporation. In *Edwards v. Arthur Andersen LLP*, Cal. No. S147190 (August 7, 2008), the court held that the provisions of a restrictive agreement given in connection with employment are unenforceable and expressly rejected the "narrow restraint" doctrine that has been recognized by the Ninth Circuit, the federal court jurisdiction that includes the state of California.

Raymond Edwards was hired as a tax manager for Arthur Andersen LLP ("Andersen"). As a condition of hire, he was required to sign a noncompetition agreement, agreeing that for a period of time after separation from Andersen, he would not provide the same type of professional services to clients that he had provided while employed by Andersen and would not solicit such clients to offer such services. The agreement did not prohibit Edwards from accepting employment with a client, so long as he did not provide the same services to the client as a direct employee that he had previously provided while affiliated with Andersen. The agreement also did not prohibit Edwards from working in his trade for non-clients, although he was prohibited from soliciting any former clients of the Andersen office in which he had worked for one year after leaving Andersen.

At the core of Edwards' case against Andersen was whether the noncompetition agreement was enforceable. California Business and Professions Code section 16600 states: "Except as provided in this chapter, every contract by which any one is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." The exceptions in the chapter are those noted above.

Andersen argued that the word "restrained" meant wholly prevented or precluded. It argued that because Edwards was not entirely prevented from performing his trade, but was prevented only from performing it on behalf of certain former clients for a limited period of time and from soliciting clients, he was not "restrained" from practicing his trade as a tax manager. The Supreme Court noted, however, that all of the cases cited by Andersen were cases that *did* involve the statutory exceptions. The court rejected Andersen's argument, finding any limitation on an employee's ability to practice his or her vocation, unless given in connection with one of the exceptions, would be void. Thus, the court held the provisions that restricted Edwards from performing his trade for a specified universe of clients, and from soliciting them to work with him after his departure from Andersen, were impermissible "restraints." The court specifically rejected the Ninth Circuit's ruling upholding the enforceability of noncompetition agreements when they minimally restrained the employee from performing his business, trade or profession. The court concluded: "Noncompetition agreements are invalid under section 16600 even if narrowly drawn, unless they fall within the applicable statutory exceptions. . . ."

What This Means for Employers

There is no longer any doubt that noncompetition agreements are unenforceable in California unless given under one of the statutory exceptions. Even agreements that purport only to limit the employees' working for clients or customers, or from soliciting such clients or customers, will be found unenforceable. Employers who require employees to sign such agreements do so at their peril - they may be found to have engaged in unlawful acts and unfair competitive business practices by requiring their employees to execute unenforceable agreements.

Of course, employers have a legitimate need to prevent former employees from unfairly competing against them. This may be accomplished through the use of carefully-crafted trade secret and proprietary information agreements, and careful programs aimed at establishing the confidential nature of the company's trade secrets. A common mistake on the part of many companies is the failure to properly define trade secrets or to take precautions to protect such information as proprietary and confidential. Notably, the court specifically declined to address the "applicability of the so-called trade secret exception to section 16600, as Edwards [did] 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." Presumably, the court was referring to various cases that have held that customer lists rise to the level of a protectable trade secret, and that a provision preventing solicitation of said customers is therefore enforceable. *Moss, Adams & Co. v. Shilling* (1986) 179 Cal. App. 3d 124; *Gordon v. Landau* (1958) 49 Cal.2d 690. While the court's decision does not appear to impact this concept, employers should be careful before relying on this "exception."

Employers should conduct reasonable due diligence in hiring employees and should determine whether any of those employees have executed noncompetition agreements in other states where such restrictions are enforceable. Though the agreements will not be enforced in California (even where the parties agree that the contact will be governed by the law of another state that enforces these restrictions), the employer who unknowingly hires employees who are bound by a former employer's noncompetition agreement may suddenly find itself entrenched in litigation with the former employer. Employers should know before hiring whether an employee comes with this potential "baggage," and should have a plan to address the possibility that a former employer will seek to enforce the noncompete, usually by suing the worker and the new employer in another state.

The ruling in the *Edwards case* is far reaching. Employers should not rely upon old forms of offer letters or other documents containing post-employment restrictions, but should have them reviewed and possibly revised in light of the new ruling.

Practical Implications for Employers in California

The *Edwards* decision underscores California's strong prohibition on noncompetition and customer nonsolicitation agreements, except in a few specific circumstances. The ruling also solidifies how different California's laws are from other states in the areas of employee mobility and competition. The decision should prompt employers to do the following:

1) Assess noncompetition and nonsolicitation agreements for their enforceability.

After *Edwards*, even if narrowly drawn, a noncompetition and customer nonsolicitation agreement generally will be held invalid unless it falls under one of the statutory exceptions to section 16600 and, for the time being, the "so-called trade secrets exception." Outside of these exceptions, a noncompete and customer nonsolicit agreement likely will be held invalid by a California court.

Agreements between employees and employers should be reviewed to determine whether they impermissibly restrict employees' rights to engage in competitive and employment activities. In-house counsel and human resource personnel should consult with their attorney regarding the review of such agreements and before sending demand letters or commencing litigation concerning such agreements. Employers with restrictive covenants unnecessary to protect genuine trade secrets run the risk not only of courts invalidating the agreements, but also of being sued for interfering with an employee's ability to obtain a new job.

(2) Assess whether noncompetition/nonsolicitation agreements based on the "so-called trade secrets exception" are defensible.

The Court's decision places an increased focus on trade secrets. The Court's decision may be seen by some employees as allowing greater mobility, even where proprietary information is taken. Auditing your organization's trade secret protections is a valuable first step toward protecting against this risk and ensuring that your organization's intellectual capital is adequately protected. While *Edwards* has left the viability of the "so-called trade secrets exception" untouched for now, it serves as a reminder to employers to confirm that their trade secrets, i.e., customer lists, are actually trade secrets that can be protected by what would otherwise be an invalid noncompetition/nonsolicitation agreement. This exception will likely be tested based on the sweeping language used in the Court's disposition of the noncompete issue. Employers should take special care before including non-solicitation of customer and employee provisions in any employment agreements.

(3) Eliminate the use of a noncompetition agreement in exchange for severance payments.

The *Edwards* decision affirms that any noncompetition agreement that does not clearly fall within one of the statutory exceptions is likely to be held invalid. Thus, any arrangements that provide for severance payments in exchange for an agreement not to compete are likely invalid under California law. Prior to *Edwards*, the Ninth Circuit's "narrow restraint" doctrine and its holding in *IBM Corp. v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) offered hope to employers that such an arrangement would not run afoul of section 16600. The *Edwards* decision now raises serious questions about the enforceability of these arrangements.

(4) Include a severability clause in agreements that contain restrictive covenants, including employee nonsolicitation provisions.

The inclusion of a severability clause in any agreement that contains a covenant not to solicit a former employer's employees or a customer nonsolicitation or noncompete provision based on the protection of trade secrets is warranted after *Edwards*. If a court determines that any of those provisions do not actually meet the exception or are otherwise unenforceable, the court may invoke the clause to sever the offending provision. Employers should be aware, however, that courts may decide not to sever and instead find the entire agreement unenforceable.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call or email Diana M. Saca (415) 505-5003 (Diana@Sacalaw.com), or Jennifer J. Hagan at The Hagan Law Firm (650) 322-8498 (Jhagan@Haganlaw.com).