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Edwards v. Arthur Andersen LLP: One Year Later

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INTRODUCTION

On August 7, 2008, the California Supreme Court issued its highly anticipated decision in *Edwards v. Arthur Andersen LLP*, unanimously holding that Business & Professions Code section 16600 invalidated a provision in Edwards's employment agreement that restricted him from serving customers and competing with Arthur Andersen following the termination of his employment.[1] The Supreme Court rejected the "narrow restraint" exception[2] that the Ninth Circuit and federal courts had previously embraced, and instead held that a provision prohibiting solicitation of customers that even "partially" or "narrowly" restricts an employee's ability to practice the employee's trade or profession is prohibited.

The *Edwards* decision certainly provided clarity regarding the invalidity of restrictive covenants prohibiting post-employment customer solicitation. However, in a footnote, the court expressly stated that it was not opining on the "so-called trade secret exception to section 16600," and also noted that Edwards was also not contending that the provision prohibiting him from recruiting Andersen's employees violated section 16600.[3] Despite this arguable window for limiting the scope of the *Edwards* court's condemnation of restrictive covenants, an evaluation of published and unpublished decisions issued since *Edwards* reveals that the courts are largely interpreting *Edwards* broadly, sometimes even in cases where confidential or trade secret information is implicated.

THE RETIREMENT GROUP V. GALANTE ADDRESSES THE QUESTION OF THE "SO-CALLED TRADE SECRET EXCEPTION TO SECTION 16600" LEFT UNANSWERED IN *EDWARDS*.

To date, the California Court of Appeal has cited *Edwards* in only one published opinion that addresses the issue of noncompetition agreements – *The Retirement Group v. Galante*. In *Galante*, Division One of the Fourth Appellate District held that section 16600 invalidated a provision in a preliminary injunction that prohibited former independent contractors from

soliciting customers to transfer their business away from The Retirement Group (TRG).[4]

Galante involved a situation where former investment advisors of TRG left the company to establish a competing business and, in the process, contacted many of their customers to solicit their business. TRG sought and obtained a preliminary injunction on several grounds from the trial court. The Court of Appeal reversed the portion of the injunction prohibiting solicitation of TRG's customers, whose contact information was obtained without the use of trade secrets. In invalidating the challenged provision of the preliminary injunction, the *Galante* court broadly and deferentially interpreted *Edwards*.

Significantly, *Galante* also addressed one question left unanswered by *Edwards* – whether there is a "trade secret exception" to section 16600. The *Galante* court determined that misappropriation of trade secrets is "enjoinable *not* because it falls within a judicially created 'exception' to section 16600's ban on contractual nonsolicitation clauses, but is instead enjoinable because it is wrongful independent of any contractual undertaking." Although TRG argued that the challenged portion of the preliminary injunction was necessary to protect its trade secret information, the Court of Appeal disagreed, finding that the provision was not "designed to have the limited effect of protecting against TRG's trade secrets," and instead had the "*additional* operative effect" of "bar[ring] solicitations *not* involving the use of trade secret information."

GUIDANCE FROM UNPUBLISHED CASES.

Although unpublished decisions are not citable as precedent, an examination of these decisions provides helpful insight into how the lower courts are applying *Edwards*.

For example, Division Five of the Second Appellate District voided a covenant not to compete because it did not fall within one of the express, enumerated exemptions in sections 16601, 16602, and 16602.5 – it was not connected to the sale of a business, the dissolution of a partnership or of a partner from the partnership, or the dissolution of, or termination of a member's interest in, a limited liability company. In this case, the plaintiffs sought declaratory relief invalidating a covenant restricting them from competing, for a period of 20 years within a radius of 10 miles, with a business with which they had a significant investment interest and an ongoing business relationship. The court followed *Edwards* in holding that noncompetition covenants, even those narrowly drawn, *and even those that prohibit competition during an ongoing business relationship*, are unenforceable unless they fall into a statutorily recognized exception.

In another unpublished case decided before the *Galante* decision was ordered published, Division Seven of the Second Appellate District affirmed a dismissal for failing to state a claim because the plaintiff failed to allege that the information used to solicit was not protectable proprietary information or a trade secret. The plaintiff argued that the nonsolicitation clause in an employment agreement he refused to sign – which prohibited solicitation of customers and employees for a period of one year following termination of employment – violated section 16600. The challenged provision expressly stated that the identities and other information about the employer's customers "is secret and confidential." The court disagreed that the challenged nonsolicitation provision violated section 16600 on its face, holding that it was valid "as long as it protects information which is confidential, proprietary or a trade secret." Because the plaintiff failed to allege that the information was not protectable in his second

amended complaint, the court held that he had failed to state a cause of action. The court – noting that "there was no claim in *Edwards* 'that the provision of the noncompetition agreement prohibiting [plaintiff] from recruiting [defendants'] employees violated section 16600'" – also concluded that section 16600 is not violated by a provision that prevents employees from raiding their former employer's staff.

On the other hand, one federal district court in Los Angeles recently opined in an unpublished decision that the prohibition against non-competition and non-solicitation covenants extends to covenants not to solicit employees. While we do not read the holding of *Edwards* so broadly, it is notable that at least one court does.

CONCLUSION

The cases decided in the aftermath of *Edwards* reveal a general proclivity of California courts – and courts applying California law – to invalidate restrictive covenants unless they clearly fall into one of the statutory exceptions set forth in section 16601, 16602, and 16602.5. While courts will readily prohibit misappropriation of an employer's trade secret or confidential information, and may also be willing to uphold contractual provisions that are narrowly designed to only protect such information, the post-*Edwards* decisions to date indicate that even provisions restricting an employee's use of an employer's confidential or trade secret information for competitive purposes will be scrutinized – and potentially invalidated – under section 16600 if they are overly broad. Accordingly, California employers should carefully review any policies and contractual provisions that could be viewed as restricting competition, including those relating to protection of trade secrets and confidential information.[5] ■

1 *Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937 (2008). *See also* David J. Murphy & James Pooley, *California's* Edwards v. Arthur Andersen *Decision and the Future for Employee Noncompetition Agreements and Other Post-Employment Restraints*, Morrison & Foerster Trade Secrets Report, August 2008.

2 Under the "narrow restraint" exception, limited restrictions on competition that did not amount to total preclusion from engaging in a lawful profession, trade, or business could be upheld under a section 16600 challenge.

3 44 Cal.4th 937, 946, n.4 (2008).

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

5 Labor Code section 432.5 makes it illegal to require an employee to sign a document containing a provision that the employer knows to be prohibited by law. While beyond the scope of this article, employers should keep this in mind when drafting these types of agreements.

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