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California's *Edwards v. Arthur Andersen* Decision And The Future for Employee Noncompetition Agreements And Other Post-Employment Restraints

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by David J. Murphy, James Pooley

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In a closely watched decision issued on August 7, 2008, the California Supreme Court in *Edwards v. Arthur Andersen* unanimously determined that a provision in an employment agreement restricting an employee from serving customers or competing with a former employer was invalid under California Business & Professions Code section 16600, which contains California's general statutory prohibition for noncompetition agreements. As the Supreme Court held, noncompetition agreements between an employer and employee that even just "partially" or "narrowly" restrict an employee's ability to practice the employee's trade or profession are prohibited, contrary to what the Ninth Circuit and other federal courts had previously approved as reflecting California law.

The Supreme Court's Decision: Rejection Of The Narrow Restraint Doctrine

Arthur Andersen's noncompetition agreement restrained Edwards from: (1) performing work for clients he had previously serviced at Andersen for 18 months following the termination of his employment; and (2) soliciting any client of his office for 12 months after his termination. Arthur Andersen argued that "only contracts that totally prohibit an employee from engaging in his or her profession, trade or business are illegal," based on the "narrow restraint" exception found in Ninth Circuit decisions. *See Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499 (9th Cir. 1987) (preventing use of certain psychological tests); *IBM Corp. v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (restricting work for only one competitor); *General Comm. Packaging v. TPS Package* 126 F.3d 1131(9th Cir. 1997) (restricting work for only one customer and related entities introduced through that relationship). The Court rejected Arthur Andersen's argument and the Ninth Circuit's interpretation of California law, explaining under 16600's plain terms, no "restraint" on lawful competition would be tolerated; and it was no answer to say that a restriction was not a "prohibition."

The Practical Effects Of The Court's Decision

Noncompetition Agreements Are Invalid Unless Authorized By A Statutory Exception. The Court confirmed that any "restraints" on lawful competition would be unenforceable in California, unless they qualify under one of the recognized statutory exceptions to section 16600. These consist of agreements in connection with the sale or dissolution of corporations (section 16601), partnerships (section 16602) or limited liability corporations (section 16602.5).

The Future Of The "Trade Secrets Exception." Despite stating in its Case Summary that it expected to address the judicially created "trade secrets exception" to section 16600, the Court ultimately announced in a footnote to its opinion that it had declined to do so.

More recent authority views the "exception" skeptically, treating it essentially as confirmation that real trade secrets can be protected by contract just as they can be protected otherwise. *See, e.g., Thompson v. Impaxx, Inc.*, 113 Cal.App.4th 1425, 429-30 (2003) (nonsolicitation covenants are enforceable only to the extent misuse

of trade secrets are involved); *Reddylink Healthcare v. Cotton*, 126 Cal.App.4th 1006, 1022 (2005) ("Misappropriation of trade secrets information constitutes an exception to section 16600."). Thus, we believe that the California Supreme Court, if it decides to address this issue in the future, may find that this line of cases merely holds that an employer can protect by contract only that information that is protectable under the Uniform Trade Secrets Act. Therefore, when relying on the "trade secrets exception" hereafter, companies should consider restricting noncompetition provisions to behavior that involves misuse of trade secrets, and refrain from instituting litigation based on the noncompete agreement unless actual trade secrets are actually involved. Such contracts still may serve important collateral purposes, such as defining trade secret information, and providing other valuable protections, such as an arbitration or attorney's fee provision, that would not exist without a contract.

Recommended Review Of Current Employment Documents. Given the strict constructionist approach toward section 16600 adopted in the Supreme Court's decision in *Edwards v. Andersen*, it would be advisable to review all employment-related and proprietary information agreements to ensure that any noncompetition or nonsolicitation provisions are compliant with this newly announced judicial philosophy. Such a review would help avoid both claims of unenforceability under section 16600 as well as potential related unfair business practice claims under California Business & Professions Code section 17200. It also would avoid the type of tort claims for interference with contract or economic advantage such as highlighted in Edwards itself if the employee claims to have lost a job or other opportunities due to a provision unlawful under section 16600. Given the risks involved in including noncompetition agreements in any documents, companies may want to consider placing noncompetition provisions in separate documents, or at least including robust severability provisions.

Possible ERISA Implications. A path to avoiding California's restrictive view of noncompetition agreements may be available through ERISA plans, as ERISA preempts state law relating to noncompetition clauses in ERISA plans. Besides noncompetition provisions in profit-sharing and pension plans already held by the Ninth Circuit to be valid, commentators have suggested that another effective ERISA vehicle for such noncompetes may be through "top-hat plans" for pension or deferred compensation provided to key executives. *See* 29 U.S.C. § 1051(2). ERISA severance plan payouts structured over time to be coextensive with continuing noncompete obligations may also provide a similar result. These and other approaches remain largely untested, but developments in this area are likely to receive increased attention.

Trade Secret Protection Programs. Since the "partial" or "narrow restraint" approach for employee noncompetition agreements is clearly no longer permitted, an employer's trade secret compliance programs and policies should take on increased importance. Maintaining and updating these programs and policies is essential to help ensure that actual protected "trade secret" status for technological, customer, and other proprietary information remains intact. Otherwise, if this protected "trade secret" is lost, the opportunity to rely on any "trade secret exception" to enforce noncompetition or nonsolicitation provisions may also be lost.

Concerns For National Employers. The *Edwards* decision heightens the tension between California and states that generally enforce restrictive covenants. California very likely will protect the employee's right to compete and will not recognize another state court's judgment enforcing the noncompete agreement, even where the contract included a choice of law provision favoring the other forum. *See Application Group, Inc. v. Hunter Group, Inc.,* 61 Cal. App. 4th 881, 885 (1998) (applying California law to invalidate a noncompete valid under Maryland law, entered into by a Maryland resident who agreed to "telecommute" for a California company).

Companies with employees in multiple jurisdictions outside of California may wish to require employees in other jurisdictions to sign noncompetition agreements. Two important provisions for multi-state employers to consider in drafting restrictive covenant agreements are (1) choice of law (the law that will govern the interpretation and enforceability of the agreement) and (2) choice of forum (the forum in which the parties agree to bring disputes related to the agreements). As each state's law governs the enforceability of restrictive covenants differently, employers often decide to choose the state law that most strongly enforces noncompete restrictions. However, the risk in doing so is that the covenant may not be enforced in some states; and as noted California courts have also refused to apply out-of-state choice of law provisions.

This divergence in state laws and potential differing enforcement of noncompete covenants may also reinvigorate the "race to the courthouse" in the competing state jurisdictions potentially involved, putting a premium on being the first party to file suit. *See Advanced Bionics Corp. v. Medtronic, Inc.,* 29 Cal. 4th 697 (2002) (former employee moved to California to work for a California employer and filed action in California court one day before former employer filed action in Minnesota).

Conclusion

In many respects, both employers and employees in California can regard the *Edwards* decision as a victory. For employees, it provides the obvious benefit of confirming a robust right to mobility. And for California employers looking to hire employees (including those living outside the state) who are subject to restrictive covenants, it reduces exposure to liability for claims of interference or inducement of breach of contract. However, it also serves as a clarion call to all employers – particularly national corporations with operations in California – to take a close look at their policies and contracts around trade secret protection and post-employment contractual restraints.