

Management Alert

California Court Rejects Contrary Federal Case Law and Reiterates That Employer Non-Compete Agreements are Generally Unlawful in California

In *Edwards v. Arthur Andersen LLP*, 2006 WL 2498013 (August 30, 2006), the California Court of Appeal for the Second Appellate District expressly rejected somewhat settled Ninth Circuit case law that provides an exception to the general rule in California that covenants not to compete are unlawful. In evaluating a noncompetition agreement that prohibited an employee from performing services for certain former clients of the employer, the state court held that the agreement was invalid. Alone, this holding is unremarkable. However, in reaching this conclusion, the court applied California Business and Professions Code section 16600 literally, and expressly rejected the so-called "narrow restraint" doctrine the Ninth Circuit has developed as an exception to the general rule in California that covenants not to compete are unlawful. The narrow restraint exception essentially provides that a noncompetition agreement is not unlawful where it leaves a substantial portion of the market open to the employee. The California court directly stated that it views the Ninth

Circuit's narrow restraint doctrine as "a misapplication of California law when applied to an employee's noncompetition agreement."

The Court's Decision

Raymond Edwards, a CPA employed by the Arthur Andersen accounting firm, alleged that the noncompetition agreement that he was required to sign as a condition of his employment at Andersen was invalid. Edwards challenged the noncompetition agreement when, as part of the dissolution of the Andersen firm, Andersen sought to sell the portion of its Los Angeles, California tax practice where Edwards was employed. As part of this sale, Andersen required its employees to release any claims that they might have against Andersen related to the noncompetition agreement. When Edwards refused to sign the release, Andersen terminated his employment and withheld severance benefits. The

company purchasing Andersen's Los Angeles tax practice then withdrew its offer of employment to Edwards. Edwards sued, alleging among other things, interference with prospective economic advantage and that the noncompetition agreement was invalid. The trial court held that the noncompetition agreement was valid because it fell within the narrow restraint exception.

The appellate court held that the noncompetition agreement was invalid because it violated California Business and Professions Code section 16600, which, according to the court, prohibits noncompetition agreements between employers and employees even where the restriction on future employment is narrowly drawn and leaves a substantial portion of the market available to the employee. In reaching this conclusion, the court first held that section 16600 was unambiguous in its prohibition of noncompete agreements like that at issue in *Edwards* because it states "Except as provided by 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."

The court then analyzed why the narrow restraint doctrine did not apply. First, the court distinguished the cases relied upon by the Ninth Circuit in developing the narrow restraint doctrine. Second, the court reasoned that, because section 16600 has express exceptions to the prohibition against noncompetition agreements – where one sells the good will of a business or where a partner agrees not to compete in anticipation of dissolution of a partnership – the presence of such exceptions ordinarily implies that additional exceptions are not contemplated.¹ Finally, the court held that policy considerations favor prohibiting noncompetition agreements as does the

legislative history of section 16600.

The court stated that the Ninth Circuit's development of the narrow restraint doctrine relied primarily on two cases, both of which it distinguished. The first case, *King v. Gerold*, 109 Cal.App.2d 316 (1952), involved a contract that prohibited a trailer manufacturer from manufacturing a particular type of trailer if the trailer designer did not renew its contract with the manufacturer. The court noted that *King* did not support the Ninth Circuit's relatively broad interpretation of the narrow restraint doctrine because the restriction at issue in *King* really amounted to a prohibition on using trade secret information, and thus fell within the trade secret exception to section 16600.

Next, the court distinguished *Boughton v. Socony Mobil Oil Co.*, 231 Cal.App.2d 188 (1964). The court distinguished *Boughton* because it addressed whether the restriction on the use of land violated section 16600. *Boughton* did not address a restraint on the plaintiff's ability to engage in or carry on a profession, trade or business, but instead involved a restraint on plaintiff's ability to do business on a particular piece of property. Thus, the court found this analysis had no application when evaluating the validity of a noncompetition agreement between an employer and its employee.

Because section 16600 has express exceptions, the court found that other exceptions are not to be implied or presumed unless a contrary legislative intent is evident. The court did not find any such intent. Instead, the court noted that, although the trade secret exception to section 16600 is not statutory, the trade secret exception is based on principles of fairness (equity), and that equity should not apply to allow an employer – who generally is in a

¹The court also recognized the trade secrets exception to section 16600, established by long-standing case law holding that section 16600 does not invalidate noncompetition agreements that are necessary to protect the employer's trade secrets.

far superior bargaining position than the prospective or terminated employee – to impose restrictions on the employee’s future livelihood.

The court also found that policy considerations and the legislative history of section 16600 weighed strongly against adopting the narrow restraint exception for noncompetition agreements between employees and employers. According to the court, employers have incentives to draft increasingly broad agreements while arguing they are still but narrow restraints. Moreover, said the court, whether such agreements are narrow restraints would be highly fact specific and may cause prospective future employers to be reluctant to hire an employee who has signed a questionable noncompetition agreement. Finally, in analyzing the precursor code sections to section 16600, the court found that those codes supported the court’s view that the narrow restraint doctrine should not apply to noncompetition agreements between employers and employees.

Concluding its narrow restraint analysis, the court held:

In sum, we conclude that the ‘narrow restraint’ doctrine is a misapplication of California law. Noncompetition agreements are invalid under section 16600 even if narrowly drawn, unless they fall within the statutory or trade secret exceptions.²

What Edwards Means For You:

The *Edward’s* decision neither changes federal law nor is binding on federal courts. However, because the narrow restraint doctrine is based on California law, and California courts are not required to follow Ninth Circuit decisions,

California employers should be aware that:

1. In California state courts, noncompetition agreements between employers and employees will be held invalid unless falling within one of the recognized statutory or common law exceptions to section 16600, and *Edwards* calls into question references to Ninth Circuit authority in support of a narrow restraint;
2. Although federal courts may be more inclined to follow the narrow restraint doctrine, because the doctrine is based on state law, *Edwards* may make it more likely that federal courts will reject the application of the narrow restraint doctrine and automatically invalidate noncompetition agreements between employers and employees; and
3. To the extent possible, agreements between employees and employers should (a) be reviewed to determine whether they impermissibly restrict employees’ rights to engage in competitive business or employment activities, and (b) where applicable, expressly tie the competitive limitations placed on employees to a prohibition against disclosure of the employer’s trade secrets. Because judicial challenges are always possible, such provisions must be drafted and reviewed with care.

Seyfarth Shaw LLP is a nationally recognized leader in employment law and intellectual capital litigation with a specialized group of attorneys comprising its Corporate Espionage, Trade Secrets and Unfair Competition Practice Group which stands ready to answer any questions you may have about Edwards or other non-competition matters. If you have questions please contact the Seyfarth Shaw attorney with whom you normally work or any attorney on our website at www.seyfarth.com.

²The court remanded the case to the trial court, noting that Andersen would there have the opportunity to prove whether the trade secret exception applies.

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