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California Court Strikes Down More Non-Compete Provisions

by Jennifer Brown Shaw

Employers in many states use “restrictive covenants,” such as non-compete or non-solicitation agreements, to deter employees from changing jobs. Purchasers of businesses also rely on these agreements. These agreements usually are made to protect trade secrets, such as customer lists, or other proprietary information. Most states’ laws limit these agreements to one extent or another. With just a few narrow exceptions, however, non-compete agreements are per se illegal in California. Two recent decisions by the California Court of Appeal exemplify California law in this area.

Non-Compete Agreements Cannot Preclude a Business Seller From Soliciting the Buyer’s Customers and Employees

With Halloween approaching, consider the buyer of a scary doll business from someone who is famous for manufacturing and selling these ghoulish toys. Let’s also say the seller lives in the buyer’s town and does not know how to do anything else. The sales price includes an allowance for the uniqueness of the dolls, and the list of devoted distributors (known as “good will”). The buyer naturally would not buy the business knowing that the seller planned to open up a competing firm in the same town. In situations like this, the buyer and seller could include a provision precluding the seller from soliciting the buyer’s customers or employees. Even in connection with the sale of a business, however, these agreements are not always enforceable.

In *Strategix, LTD. v. Infocrossing West, Inc.*, the Fourth Appellate District Court of Appeal discussed a similar issue, albeit without the

ghouls. *Strategix* and *ePassage* sold all of *Strategix*’s goodwill and most of its assets to *SMS*, *Infocrossing*’s predecessor. In connection with the purchase contract, the parties also entered a consulting agreement which contained a restrictive covenant. Under this provision, *ePassage* was prohibited from soliciting *SMS*’s customers and employees for a period of one year after termination of the consulting relationship.

The court first reviewed the basic rule in California that contracts restraining trade and the ability to engage in a lawful profession are void. It then discussed the exception under California law for non-compete agreements made in connection with the sale of a business, as had occurred in *Strategix*.

The court rapidly concluded that the “sale of business” exception did not save the non-solicitation covenants at issue in *Strategix* because those provisions were broader than the statutory exception allows (Business & Professions Code section 16601). The court then explained that non-solicitation covenants barring a seller from soliciting all customers and employees of a buyer (even those who were not former employees or customers of the sold business) are not enforceable. However, non-solicitation covenants barring a seller from soliciting customers and employees *that were affiliated with the business at the time it was sold* will be upheld.

Even “Narrow Restraints” on an Employee’s Right to Engage in a Competitive Profession are Unenforceable

In *Edwards v. Arthur Andersen LLP*, the Second Appellate District outright rejected long-

standing Ninth Circuit decisions addressing California’s non-compete laws. *Edwards* worked as a CPA for *Arthur Andersen*. When hired, *Edwards* signed a non-compete agreement which prohibited him from soliciting or providing professional services to certain *Arthur Andersen* clients for a period of 18 months after the termination of his employment. The agreement also provided that *Edwards* could not solicit *Arthur Andersen* employees for a period of 12 months after the termination of his employment.

Arthur Andersen sold its tax practice (*Edwards*’ group) to *HSBC*. But the sale agreement provided that *HSBC* only could hire *Arthur Andersen* employees who agreed to sign an agreement terminating the limited non-competition agreement *Edwards* and the other employees signed. The Termination of Non-Compete Agreement (“TONC”) essentially provided that the company would release the employee from the non-compete agreement and consent to his or her employment with *HSBC* in exchange for: (1) a release of all claims against *Arthur Andersen* arising from his or her employment; (2) an agreement to preserve the company’s confidentiality and trade secrets indefinitely; (3) an agreement not to disparage *Arthur Andersen*; and (4) an agreement not to cooperate with litigation and investigations against *Arthur Andersen* (except as required by law).

Edwards refused to sign the TONC. *HSBC* subsequently withdrew its offer of employment and *Edwards* sued, primarily alleging *Arthur Andersen* interfered with his prospective economic advantage. This claim was dependent on the legal question of

whether the initial non-compete contract and the TONC were unenforceable, and therefore illegitimate “interferences” with Edwards’ attempt to join HBSC.

With respect to the non-compete agreement, the court held that the terms prohibiting Edwards from soliciting and providing professional services to Arthur Andersen clients was not enforceable and void against public policy. The court came to the same conclusion regarding the term prohibiting Edwards from soliciting Arthur Andersen employees. In reaching this conclusion, the court strictly interpreted the plain language of the relevant non-compete statutes (Business & Professions Code sections 16600, 16601).

The *Arthur Andersen* court analyzed the three limited exceptions to the general rule against non-competition agreements: (1) the sale of business exception; (2) an exception allowing members of partnerships to enter non-competes where a dissolution of the partnership is anticipated; and (3) an exception allowing for the protection of trade secrets. The court determined that these exceptions are very explicit and narrow, and that the Legislature did not intend any further exclusions. Because the contract provisions at issue in *Arthur Andersen* did not fall into any of these three categories, the court held they were void.

In striking down the TONC, the Court rejected long-standing Ninth Circuit precedent holding that, under California law, a non-competition agreement is valid if the restrictions imposed are limited and leave a substantial portion of the job market available to the employee. The trial court relied on this very rule prior to being reversed, and ruled that Edwards’ non-compete agreement was covered by the Ninth Circuit’s “narrow restraint” exception. In making this ruling, the trial court announced “there were more than enough . . . wealthy folks in L.A. for all CPAs to do the kind of work [Edwards] was doing. So there wasn’t even [a] minimal restriction on his ability to work.”

The Court of Appeal disagreed, holding that even a “narrow” restraint was an unlawful restraint under California law. As such, the Court found that the agreement provided the “independently wrongful act” element of Edwards’ interference claim.

Lessons Learned About Non-Competes

A valid non-compete agreement can be invaluable to a business seeking to protect good will gained in a sale, or valuable trade secrets. However, an illegal non-compete may create more problems than the freedom to solicit and compete. Employees terminated for refusing to sign non-competes may bring lawsuits for wrongful termination in violation of public policy.

Businesses should enlist the aid of counsel experienced in drafting restrictive covenant provisions. California courts often refuse to reform or strike overbroad restrictive covenants. For example, the *Strategix* court refused to “blue pencil” the illegal terms in the non-compete agreement at issue, despite that doing so would have salvaged the remainder of the contract. The court instead took the position that the parties should have negotiated a different deal if that is what they intended.

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