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Many out-of-state employers are vaguely aware that California prohibits noncompetes; many are also shocked at the breadth of that prohibition. Since recent decisions by the California Supreme Court, the law in California has only become more antagonistic to any type of restrictive covenant. This article summarizes the recent developments and provides practical examples of how California has become a virtual "killing fields" for restrictive covenants, and suggest ways to avoid this legal landscape.

You Can't Do "What" in California? A Summary of California's (Virtually Nonexistent) Restrictive Covenant Laws for Out-of-State Employers

By Stephen Tedesco

As a Littler lawyer based in California, I am often called upon to advise national clients and their in-house counsel on California noncompete laws. Many employers based in other states are vaguely aware that California prohibits noncompetes; many are also shocked at the breadth of that prohibition. Many agreements from out-of-state employers will contain at least one provision that is void under California law. Since the decision by the California Supreme Court in *Edwards v. Arthur Anderson*, 44 Cal 4th 937 (2008), California law has only become more antagonistic to any type of restrictive covenant. This article will attempt to summarize the recent developments and provide practical examples of how California has become a virtual "killing fields" for restrictive covenants, and suggest ways to navigate through this legal landscape.

Background

In California, since the nineteenth century, with certain limited exceptions, any contract under which a person is prevented from engaging in his or her profession, trade or business is considered void as against public policy. California Business and Professions Code section 16600 states as follows: "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 protection under section 16600 against any restraint on employment presents a strong public policy in California. "The interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of employers."[1] For years, section 16600 has been held to invalidate agreements that contain provisions that restrain employees from engaging in competitive employment after leaving a former employer.[2] Until the decision in *Edwards*, it was at least debatable whether lesser restrictions were valid. Much of that debate has now been settled. Employers need to be even more careful as the risk of having a restrictive covenant declared void has risen. That risk can be surprising to out-of-state employers with operations in California.

Consequences of a Void Covenant in California

To add insult to injury, the risks to an employer of a restrictive covenant are greater than

simply having an unenforceable clause in its agreements. A clause that is void under section 16600 may also violate California's Unfair Practices Act set forth in sections 17200 *et seq*. of the California Business and Professions Code.[3] Thus, an employer who includes restrictive covenants in California agreements not only risks having the clause declared unenforceable, but also risks being found to have committed an unlawful business practice.

The risk posed by restrictive covenants extends beyond the employer's California employees. In *Application Group*, the court found that section 16600, and by extension section 17200, broadly applied to any "employment in California." The court interpreted "employment in California" to mean: (1) employees living in state; (2) employees living out of state, but hired by California employers; and (3) employees living out of state but performing services in state.[4] Thus, the court in *Application Group* struck down the noncompete of a Maryland employer with a former employee living in Maryland who was hired by a California employer.

The ruling in *Application Group* has spawned an entirely new set of lawsuits against employers who use restrictive covenants. One of the favored tactics of former employees with unenforceable restrictive covenants, and the California employers who hire them, is to sue the former employer for declaratory relief to declare the clause void and for unfair business practices. In many instances, this can be an effective preemptive attack on restrictive covenants.

In addition to prohibiting the enforcement of restrictive covenants, section 16600 may also permit an employee to sue when he or she is terminated or denied employment for refusing to enter into an unlawful agreement. In *Latona v. Aetna U.S. Healthcare, Inc*.,[5] a federal trial court found that an employee had been fired for refusing to sign a noncompete agreement containing language violating section 16600. Rejecting the employer's argument that section 16600 would not apply unless it attempted to enforce the agreement, the court found that the employee's termination violated the public policy contained in section 16600 and therefore supported an action for wrongful discharge in violation of public policy. Likewise, a California appellate court held that "an employer cannot lawfully make the signing of an employment agreement which contains an unenforceable covenant not to compete, a condition of employment, even if such agreement contains choice of law or severability provisions which would enable the employer to enforce the other provisions of the employment agreement." The court further held that "an employer's termination of an employee who refuses to sign such an agreement constitutes a wrongful discharge in violation of public policy."[6] In one California case, a jury awarded a seven figure verdict against an employer for firing an employee who refused to sign an agreement containing restrictive covenants.

The *Edwards* Decision

In a long-awaited decision, the California Supreme Court in *Edwards v. Arthur Andersen L.L.P*.,[7] ruled that all restrictive covenants, except those covered by express statutory exceptions, are invalid and void as against public policy.[8] The covenants at issue in *Edwards* were as follows:

> If you leave the Firm, for eighteen months after release or resignation, you agree not to perform professional services of the type you provided for any client on which you worked during the eighteen months prior to release or resignation. This does not prohibit you from accepting employment with a client.
>
> For twelve months after you leave the Firm, you agree not to solicit (to perform professional services of the type you provided) any client of the office(s) to which you were assigned during the eighteen months preceding release or resignation.[9]

Arthur Andersen argued that the language of section 16600, which used the term "restrain," should be deemed synonymous with "prohibit," and that contractual limitations on an employee's post-employment conduct were allowed so long as that restraint did not "prohibit" an employee from engaging in his or her chosen business, trade or profession. The court rejected this argument. In doing so, the court also rejected the line of Ninth Circuit Court of Appeals decisions that recognized a "narrow restraint" exception to noncompetes. The California Supreme Court found that section 16600 "unambiguously" dictates that even partial restraints on the ability of employees to practice their profession are prohibited. Thus, the *Edwards* court not only declared the noncompete provision void, but the California Supreme Court also held for the first time held that customer nonsolicitation clauses were also void.

The Aftermath of *Edwards*: What Is Allowed in California

The California Supreme Court decision in Edwards was not a surprise to California practitioners. Many appellate court cases had declared noncompetes void, and, in the years prior to *Edwards*, several decisions found that nonsolicitation of customer clauses were also void and unenforceable under section 16600.[10] What was slightly surprising was the absolutism of the decision in Edwards. Section 16600 states that any restraint is void and that section "represents a strong public policy of the state which should not be diluted by judicial fiat."[11] Thus, there can be no judicial exceptions to the strong public policy of section 16600. Unlike other states, there is no "rule of reason" and no "balancing of hardships." This reasoning has been followed in decisions since *Edwards*, sometimes to surprising effect.

The Death of the Common Law Trade Secret Exception?

Before *Edwards*, several California courts had expressed that covenants not to compete are void in California except to the extent needed to protect trade secrets.[12] However, no court decision had defined the scope of this so-called "trade secret exception." Does it mean that the misappropriation of trade secrets could justify a covenant not to compete or does it merely mean that the only type of injunctive relief available in California is an injunction against the misappropriation of trade secrets? The court in *Edwards* declined to address the issue of whether the protection of trade secret information could validate a post-termination restrictive covenant.

Subsequent cases have also declined to directly address the issue while they have seemingly eviscerated the exception. Following the decision in *Edwards*, the court in *The Retirement Group, Inc. v. Galante*[13] reviewed an injunction entered by the trial court to prevent the misappropriation of The Retirement Group's (TRG) trade secrets. TRG alleged that its former employees had misappropriated trade secrets and were using them to solicit customers. The trial court entered a preliminary injunction that enjoined the defendants from several categories of conduct including "directly or indirectly soliciting any current TRG [customers] to transfer any securities account or relationship from TRG to [defendants] or any broker-dealer or registered investment advisor other than TRG . . ."

On appeal, the court ruled that the nonsolicitation element of the injunction violated the rules established by the California Supreme Court in *Edwards* and was beyond the relief authorized by California law. The court's reasoning is curious. By its own terms, section 16600 only applies to contracts, not to orders issued by a trial court to prevent the misappropriation of trade secrets. Traditionally, trial courts have had the authority to fashion injunctive relief to prevent harm. The court, however, in *The Retirement Group* held that the trial courts have no power to enter an injunction under the California Trade Secret Act, which is inconsistent with section 16600. Even though there was a proven misappropriation of trade secrets (otherwise the court could not have affirmed the other elements of the injunction), the injunctive remedies available to prevent the harm caused by that misappropriation were limited by section 16600.

Following the logic of the decision in *The Retirement Group* to its inevitable end, this would mean there can be no injunctions preventing an employee from working for a competitor, no injunctions preventing solicitation of customers, and no injunction preventing an employee from doing business with customers. Under this reasoning, it is difficult to see how any employer in California can obtain an injunction that is not limited to a simple prohibition against the misappropriation of trade secret information.

The court also reiterated that under California law, customer nonsolicitation clauses are enforceable only where the customer identities are entitled to protection as trade secrets. This seems to provide small solace to employers. As the court pointed out, "it is not the solicitation of customers but instead the unfair competition or misuse of trade secret information that may be enjoined."[14] If the identities of the customers can be protected from misuse as a trade secret, then any prohibition on "solicitation" is redundant for the simple reason that solicitation is a form of misappropriation. An injunction that prohibits misappropriation of trade secrets to solicit customers may be more specific, but it provides no more protection than a simple injunction that prohibits the misappropriation of trade secrets.

So what is left, if anything, of the common law trade secret exception? California courts have already rejected the "inevitable disclosure" doctrine on the grounds that any injunction based on a presumption of a threatened misappropriation under the Trade Secret Act is antithetical to section 16600.[15] As the court in *Dowell v. Biosense Webster, Inc.* noted post-Edwards and post-*The Retirement Group, Inc.*, there may be nothing left to the trade secret exception.[16]

In *Dowell*, the court affirmed a summary judgment on the claims that the noncompete and nonsolicitation clauses in Biosense's agreements were void as a matter of public policy under section 16600 and under Business and Professions Code section 17200. The court in *Dowell* held:

> The broadly worded noncompete clause prevents [plaintiffs] for a period of eighteen months after termination of employment with Biosense from rendering services, directly or indirectly to any competitor in which the services they may provide can enhance the use or marketability of a conflicting product by application of confidential information which the employee had access during employment. Similarly, [the] broadly worded nonsolicitation clause prevents the employees for a period of eighteen months post-employment from soliciting any business from, selling to or rendering any service directly or indirectly to any of the accounts, customers or clients with whom they had contact during the last twelve months of their employment. Ultimately these provisions restrain the employee from practicing their chosen profession.*17*

Given the decision in *Edwards*, it is not surprising that the court in Dowell would hold that section 16600 voids any clause that prohibits solicitation of business, selling to customers or rendering any service for customers. However, the prohibition against using confidential information to render services toward a competing product would seem to be the type of covenant specifically drafted to fall within the so-called trade secret exception. That this clause was also declared void makes it difficult for anyone drafting agreements to find language that would fall into any meaningful trade secret exception.

At this point, the recent California decisions pay lip service to noncompete and nonsolicitation clauses that are "narrowly tailored or carefully limited to the protection of trade secrets" but have emptied that exception of any meaning. Obviously, there will be more court cases to test these limits. But it is hard to predict that any restrictive covenant, other than a simple nondisclosure of trade secrets covenant, would be enforceable.

It appears, as one court observed that "any attempt to restrict competition by the former employee by contract appears likely to be doomed under section 16600 . . . it seems that the employer will be able to restrain by contract only that conduct of the former employee that would have been subjected to judicial restraint under the law of unfair competition, absent the contract."[18] Unfair competition claims in California against former employees are now limited almost exclusively to the field of trade secret law.

What Is an Out-of State Employer To Do?

The essential question becomes: "How do out-of-state employers respond to the inhospitable California legal landscape?" For those employers with operations in California, there are some basic steps.

Employers must recognize that their standard nondisclosure agreement, which may include restrictive covenants, will simply not work in California. For its California operations, the company has to carve out an agreement that complies with California law. Those willing to assume the risk may still take an aggressive position in the hope of finding what may turn out to be the mythical covenant that is enforceable in California. However, employers should not assume, simply because they do not use noncompetes, that their nonsolicitation restrictive covenants are enforceable. Such agreements should be carefully vetted for specific California issues.

Employers headquartered outside of California may wish to include choice of law and forum selection clauses in all of their agreements. California courts will generally not enforce such provisions.[19] The employer may, however, be able to enforce such claims in their home state. This may also lead to messy, and expensive, litigation in two states. California courts do not have the authority to enjoin or in any way interfere with litigation on the same subject matter occurring in other states.[20] While an employer may be able to obtain a favorable result in its home state, this strategy may not be viable in all cases, nor will it be worth the cost for all employees.

There are other alternatives, generally better suited for higher level employees, particularly those whose authority may encompass a larger territory than just California. If the company already has certain types of deferred compensation in a retirement plan for its executives, an employer may be able to treat such a plan as a benefit plan subject to the Employee Retirement Income Security Act (ERISA). Thus far, such plans, including any noncompetes or restrictive covenants in the plan, have been held to be enforceable under ERISA. Because ERISA is a federal law, it pre-empts state laws, including California's non-restrictive covenant laws.[21]

If a company uses executive employment agreements, it may wish to include severance or other types of arrangements that are paid, only so long as the employee does not obtain comparable employment. This type of agreement, which is in essence a "garden leave" plan, is yet untested in California. It can be argued, however, that the garden leave clauses are not restraints on someone's profession, but merely agreements to compensate someone so long as they are not employed in that particular profession. The employee is free to forego the severance-based compensation to pursue their chosen profession. It is, in essence, an incentive as opposed to a restriction. Any such arrangements must be structured carefully so as to comply with applicable tax rules (including Section 409A of the Internal Revenue Code, which establishes rules for forms of "nonqualified deferred compensation" which can include arrangements of this type).

While most management-side employment lawyers recommend at-will agreements, a fixed term contract may provide some stability and can provide some advance notice for a departing employee.

None of these alternatives are without risk. However, an employer can plan and implement a strategy that can help it get the maximum amount of protection with the least amount of risk. Conversely, implementing agreements, without taking into consideration the current state of California law, can only lead to disaster.

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[1] *Application Group, Inc. v. Hunter Group*, 61 Cal. App. 4th 881, 900 (1998).

[2] *Id.; KGB, Inc. v. Giannoulas*, 104 Cal. App. 3d 844 (1980).

[3] *Application Group, Inc.*, 61 Cal. App. 4th 881.

[4] *See Application Group*, 61 Cal. App. 4th at 899-905.

[5] 82 F. Supp. 2d 1089 (C.D. Cal. 1999).

[6] *D'Sa v. Playhut, Inc.*, 85 Cal. App. 4th 927 (2000).

[7] 44 Cal. 4th 937 (2008).

[8] The statutory exceptions include the sale of business and dissolution of partnerships, among others.

[9] *Edwards*, 44 Cal. 4th at 942.

[10] One issue not decided by the California Supreme Court was the enforceability of employee nonsolicitation clauses. Generally, a clause that prohibits solicitation of employees in enforceable, but one that prohibits hiring is unenforceable. *Loral Corp. v. Moyes*, 174 Cal. App. 3d 268 (1985).

[11] *Edwards*, 44 Cal. 4th at 949.

[12] See *Muggill v. Reuben H. Donnelly Corp.*, 62 Cal. 2d 239 (1965); *Metro Traffic Control, Inc. v. Shadow Network*, 22 Cal. App. 4th 853 (1994).

[13] 176 Cal. App. 4th 1226 (2009).

[14] *Id.* at 1239-40.

[15] *Whyte v. Schlage Lock Company*, 101 Cal. App. 4th 1443, 1462 (2002).

[16] *Dowell v. Biosense Webster, Inc.*, 179 Cal. App. 4th 564 (2009).

[17] *Dowell*, 179 Cal. App. 4th at 575.

[18] *Metro Traffic Control v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 861 (1994).

[19] *See Application Group*, 61 Cal. App. 4th at 881 (California public policy overrides foreign states' interests in having its own law apply to noncompetes in California).

[20] *See Advanced Bionic Comp. v. Medtronic Inc.*, 29 Cal. 4th 697 (2002).

[21] *See Lojeck v. Thomas*, 716 F.2d 675 (9th Cir. 1983).