



Recent Developments in California Law Regarding Noncompetition Agreements

By Steven M. Zdravec, Michael I. Katz, and Erika L. Beecham

In many states, restraints on the practice of a trade or business (i.e., noncompetition agreements) are valid if reasonable and geographically limited. In these states, employers have some ability to prevent former employees from engaging in certain forms of competition after the employment relationship has ended. California, however, has a long-standing public policy prohibiting restraints on trade. California's policy is embodied in California Business and Professions Code Section 16600 ("Section 16600"), which states: "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."

Of course, exceptions to Section 16600 do exist. In particular, the Legislature has created statutory exceptions that validate contracts restraining competition when those contracts relate to the sale of a business, the dissolution of a partnership, or the sale or disposition of a stockholder's stock in a corporation. Over the years, the courts too have created exceptions to Section 16600. For example, courts have sanctioned the use of noncompetition agreements to the extent necessary to protect trade secrets and permitted the use of noncompetition agreements that only "narrowly restrain" an employee's ability to work for a competitor.

The California Court of Appeal has now addressed two exceptions to Section 16600: the "narrow restraint" exception to noncompetition agreements and the scope of noncompetition agreements permitted in connection with the sale of a business. In August 2006, the Second Appellate District rejected the judicially-created "narrow restraint" exception to Section 16600 in *Edwards v. Arthur Andersen LLP*.¹ One month later in September 2006, the Fourth Appellate District in a decision entitled *Strategix v. Infocrossing West, Inc.*² struck down a noncompetition agreement that was negotiated as part of a "sale of business" because the scope of the agreement prevented the selling company from soliciting the buyer's employees and customers rather than more narrowly prohibiting the selling company from soliciting the customers of the sold business and former employees of the seller. We discuss both decisions in further detail below.

EDWARDS V. ARTHUR ANDERSEN LLP

In *General Commercial Packaging v. TPS Package*,³ *International Business Machines Corp. v. Bajorek*,⁴ and *Latona v. Aetna U.S. Healthcare Inc.*⁵ the Ninth Circuit Court of Appeal created what has been known as the "narrow restraint" exception to Section

16600. Under this exception, courts have enforced certain narrowly tailored noncompetition agreements that were designed to prevent terminated employees from working for their former employees' direct competitors, at least so long as the agreements did not prevent the former employees from working in some other "substantial part" of the market. For example, in *Bajorek*, the Ninth Circuit upheld an agreement that required an employee to forfeit stock options if that employee decided to work for a competitor within six months of leaving IBM. The Ninth Circuit Court of Appeal concluded that the agreement IBM forced its employee to sign did not violate Section 16600 because, among other things, it prevented the employee from working in only "one small corner of the market," it related only to direct competitors of IBM, and the restraint lasted only six months.⁶ California appellate courts had not addressed the validity of the narrow restraint exception until, as explained below, the *Edwards* court rejected it.

The plaintiff in *Edwards*, Raymond Edwards II, was a former employee who worked in the tax group of Arthur Andersen's Los Angeles office. Edwards signed an employment agreement when he began working for Arthur Andersen that included a term prohibiting him from soliciting Arthur Andersen's clients for twelve months after his employment with the company ended. Additionally, the agreement prevented Edwards from servicing any clients that he had worked with while employed by Arthur Andersen for a period of eighteen months after his employment was terminated or his resignation.⁷

After the Enron accounting scandal, Arthur Andersen sold its Los Angeles tax practice to HSBC. As part of the sale, HSBC offered Edwards a job, but conditioned its offer on Arthur Andersen releasing Edwards from his noncompetition agreement. In turn, as a condition for releasing Edwards from the noncompetition agreement, Arthur Andersen demanded that Edwards execute a Termination of Non-Compete Agreement. The Termination of Non-Compete Agreement required Edwards to, among other things, continue to preserve confidential information and trade secrets, and to release all claims that he might have against Arthur Andersen relating to his employment. When Edwards refused to sign the Termination of Non-Compete Agreement, Arthur Andersen refused to release Edwards from his prior commitments and HSBC withdrew Edwards's offer of employment.

Edwards sued Arthur Andersen alleging, among other things, intentional interference with prospective economic advantage. Edwards claimed that Arthur Andersen required him to sign an unenforceable noncompetition agreement, and forced HSBC to withdraw its offer when Edwards refused to sign the Termination of Non-Competition Agreement. Before trial, Arthur Andersen asked for a separate hearing to address the enforceability of its noncompetition agreement. During that hearing, the trial court determined that Arthur Andersen's noncompetition agreement was valid based on the "narrow restraint" exception:

In the trial court's view, Andersen's noncompetition agreement fell

within [the narrow restraint] exception: It placed only a narrow restriction on Edwards's ability to engage in his profession. The trial court pointed out that there were more than enough of these wealthy folks . . . in L.A. for all CPA's to do the kind of work [Edwards] was doing. So there wasn't any significant restriction on his ability to work. There wasn't even perhaps any minimal restriction on his ability to work.⁸

Based on this reasoning, the trial court granted judgment in favor of Arthur Andersen on the interference claim. Edwards appealed that judgment.

The California Court of Appeal for the Second District did not agree with the trial court's ruling in the underlying case. The Court of Appeal concluded that courts have enforced noncompetition agreements only in limited circumstances. Those circumstances involved: (1) noncompetition agreements necessary to protect trade secrets or prevent unfair competition; and (2) noncompetition agreements authorized by California Business & Professions Code Section 16601 ("Section 16601"), which permits certain agreements restraining competition in connection with the sale of a business, dissolution of a partnership, or the sale or disposition of all of a stockholder's stock in a corporation. The Court of Appeal found that none of the statutory exceptions applied to the noncompetition agreement Edwards signed, and held that the agreement was invalid unless, on remand, Arthur Andersen could prove the agreement

was necessary to protect its trade secrets.

Significantly, in reaching its decision, the Court of Appeal rejected Arthur Andersen's argument that the noncompetition agreement fell within the "narrow restraint" exception to Section 16600. The court concluded that, because the Legislature enacted statutory exceptions to Section 16600, as set forth in Section 16601, by implication the Legislature did not intend to authorize other exceptions to Section 16600, including exceptions for "reasonable, partial, or narrow restraints." Furthermore, the Court of Appeal found that the narrow restraint doctrine raised public policy concerns because it encouraged employers to push the boundaries of the "narrowness" requirement and, at the same time, burdened employees with having to guess whether a particular noncompetition restriction was valid. The Court of Appeal explained that a prospective future employer would be reluctant to hire an employee who had signed a questionable noncompetition agreement for fear of defending a lawsuit.

The court expressly limited its holding to employee noncompetition agreements, noting that its decision did not extend to exclusivity contracts (i.e. a hospital contract to exclusively use one radiology group or a lease providing that the lessee had the exclusive right to operate a restaurant in a hotel).

STRATEGIX V. INFOCROSSING WEST, INC.

Under California law, broad nonsolicitation agreements that

prevent persons from doing business with clients of their former employer may be considered an impermissible noncompetition agreement that violates Section 16600. In the context of a sale of a business, however, noncompetition agreements are specifically sanctioned. *See* Cal. Bus. & Prof. Code § 16601. Section 16601 states in relevant part as follows:

Any person who sells the goodwill of a business . . . may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold . . . has been carried on, so long as the buyer . . . carries on a like business therein.

The Fourth District in *Strategix* addressed the scope of restraints on competition authorized under Section 16601 in the context of a sale of a business.

The facts of the *Strategix* case are as follows. The plaintiff, Strategix, sold its goodwill and most of its assets to a company named Infocrossing. The parties entered into an agreement that barred Strategix from soliciting *all* of Infocrossing's employees or customers for one year.

After the purchase deal between Strategix and Infocrossing fell apart, Strategix sued Infocrossing asserting claims that included breach of contract. In response, Infocrossing sued Strategix for breaching the nonsolicitation agreement signed in connection with the sale transaction. Infocrossing also moved for and obtained a preliminary injunction enjoining Strategix from

soliciting any of Infocrossing's customers and employees.

Strategix appealed the issuance of the preliminary injunction arguing that the nonsolicitation agreement was unenforceable under Section 16600. Infocrossing argued that the nonsolicitation agreement was enforceable because it fell within the sale of business exception provided in Section 16601. The Court of Appeal agreed with Strategix.

The Court of Appeal found Infocrossing's nonsolicitation agreement unenforceable because the nonsolicitation covenant was not tied directly to the assets of Strategix's business. The court focused on the fact that the covenant barred Strategix from soliciting *all* of Infocrossing's employees and customers, rather than only the former employees and customers of Strategix – the "sold business." It reasoned a restriction of this nature went beyond the restraints permitted by Section 16601:

[C]ourts may enforce nonsolicitation covenants barring the seller from soliciting *the sold business's* employees and customers. These covenants prevent the seller from unfairly depriving the buyer of the full value of its acquisition, including goodwill. The sold business's goodwill is the "expectation of . . . that patronage which has become an asset of the business On the other hand, nonsolicitation covenants barring a seller from soliciting *all* employees and customers of the buyer, even those who were not former employees or customers

This newsletter addresses recent employment law developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Editor: Lloyd W. Aubry, Jr., (415) 268-6558

San Francisco

Lloyd W. Aubry, Jr. (415) 268-6558
laubry@mofomo.com
James E. Boddy, Jr. (415) 268-7081
jboddy@mofomo.com
James C. Paras (415) 268-7087
jparas@mofomo.com
Linda E. Shostak (415) 268-7202
lshostak@mofomo.com

Palo Alto

David J. Murphy (650) 813-5945
dmurphy@mofomo.com
Eric A. Tate (650) 813-5791
etate@mofomo.com
Raymond L. Wheeler (650) 813-5656
rwheeler@mofomo.com
Tom E. Wilson (650) 813-5604
twilson@mofomo.com

Los Angeles

Sarvenaz Bahar (213) 892-5744
sbahar@mofomo.com
Timothy F. Ryan (213) 892-5388
tryan@mofomo.com
Janie F. Schulman (213) 892-5393
jschulman@mofomo.com
B. Scott Silverman (213) 892-5401
bsilverman@mofomo.com

New York

Miriam H. Wugmeister (212) 506-7213
mwugmeister@mofomo.com

Washington, D.C./Northern Virginia

Ann B. Stevens (703) 760-7336
annstevens@mofomo.com
Daniel P. Westman (703) 760-7795
dwestman@mofomo.com

Orange County

Robert A. Naeve (949) 251-7541
rnaeve@mofomo.com
Steven M. Zdravetz (949) 251-7532
szdravetz@mofomo.com

San Diego

Rick Bergstrom (858) 720-5143
rbergstrom@mofomo.com
Craig A. Schloss (858) 720-5134
cschloss@mofomo.com

Denver

Steven M. Kaufmann (303) 592-2236
skaufmann@mofomo.com

London

Ann Bevitt 44-20-7896-5841
abevitt@mofomo.com

If you have a change of address, please write to Chris Lenwell, Morrison & Foerster LLP, 425 Market Street, San Francisco, California 94105-2482, or e-mail him at clenwell@mofomo.com.

www.mofomo.com

© 2006 Morrison & Foerster LLP. All Rights Reserved.

of the sold business, extend their anticompetitive reach beyond “the business so sold.” They do more than ensure that the buyer receives the full value of the business it bought, whose goodwill does not include “the patronage of the general public.”⁹

Further, the Court of Appeal expressed concern that the nonsolicitation covenant failed to give Strategix adequate notice of what was prohibited because Strategix would likely not know which customers and employees pertained to Infocrossing’s business.

The Court of Appeal made it clear that the nonsolicitation covenant would have been enforceable if it were limited to prohibiting Strategix from soliciting only its own former employees and customers. In light of statements by the Court of Appeal to this effect, Infocrossing requested that the court “blue pencil” the agreement to limit the nonsolicitation provision to just Strategix’s customers and employees. The Court of Appeal refused Infocrossing’s request to blue pencil or rewrite the covenant, ruling that it would not rewrite the terms of an agreement the parties had already negotiated. On this point, the Court of Appeal distinguished other cases where courts have blue penciled noncompetition covenants with overbroad or omitted geographic and time restrictions, explaining that those cases only required the court to narrow the language of an already enforceable covenant. To make the covenant enforceable in this case, the Court of Appeal believed that it would be required to change the basic terms of the parties’ agreement.

Employers should be aware of both *Strategix* and *Edwards* when entering into noncompetition and nonsolicitation agreements in California. Among other concerns, employers should note that at least one Court of Appeals decision in California has rejected the “narrow restraint” exception to Section 16600. Further, in the context of the sale of a business, nonsolicitation agreements that go beyond the assets of a sold business may not be enforceable. ■

¹ 142 Cal. App. 4th 603 (2006).

² 142 Cal. App. 4th 1068 (2006).

³ 126 F. 3d 1131 (9th Cir. 1997).

⁴ 191 F. 3d 1033 (9th Cir. 1999).

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

⁶ *International Business Machines Corp. v. Bajorek*, 191 F. 3d at 1041.

⁷ The relevant portions of the agreement stated: “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.” The agreement also provided: “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.”

⁸ *Edwards v. Arthur Andersen LLP*, 142 Cal. App. 4th at 618.

⁹ *Strategix v. Infocrossing West, Inc.*, 142 Cal. App. 4th at 1073 (emphasis in original).

Steven M. Zdravetz is a partner in our Orange County office and can be reached at (949) 251-7532 or szdravetz@mofomo.com.

Michael I. Katz is a partner in our Orange County office and can be reached at (949) 251-7504 or mkatz@mofomo.com.

Erika L. Beecham is an associate in our Orange County office and can be reached at (949) 251-7526 or ebeecham@mofomo.com.