
California Supreme Court Strictly Interprets Statute Restricting Non-Compete Agreements

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Introduction

The California Supreme Court's recent decision in *Edwards v. Arthur Andersen LLP* ("Andersen")¹ brought long-awaited clarity to an employment law issue that has nagged practitioners for years. In a unanimous decision, the Supreme Court ruled that the prohibition against noncompetition agreements in Business & Professions Code section 16600 applies to all restraints (even narrowly tailored restraints) not falling within specified statutory exceptions.²

Until this decision, many practitioners have been rightfully confused as to whether an employee's noncompetition agreement that is narrowly drafted to reasonably limit competition is enforceable under section 16600 as a result of two California courts of appeal decisions and a Ninth Circuit decision on the subject.³ Reasonable limitations thought by some to be enforceable included restrictions narrowed in time and narrowed to customer/s/clients of the employer. For example, one of the competition restrictions at issue in *Andersen* was limited to a 12 month period and it only prohibited solicitation of clients that the employee did work for during the last 18 months of employment.

¹ 44 Cal.4th 937, 2008 Cal. LEXIS 9618 (2008).

² It is important to note that the Court in *Andersen* focused on *non-compete* agreements. Agreements precluding an employee from disclosing trade secrets or from soliciting employees of his or her former employer are not at issue in the case.

³ See discussion below of *South Bay Radiology Medical Associates v. Asher*, 220 Cal.App.3d 1074, 1990 Cal.App. LEXIS 389 (1990); *Vacco Industries, Inc. v. Van Den Berg* 5 Cal.App.4th 34, 1992 Cal.App. LEXIS 455 (1992), and *Campbell v. Trustees of Leland Stanford Jr. Univ.* 817 F.2d 499, 1987 U.S. App. LEXIS 6277 (9th Cir. 1987).

The California Supreme Court held that section 16600 prohibits *any* restraint, and there is no exception for narrowly tailored restraints. The only exceptions are those that are authorized by statute under sections 16602 and 16602.5, which provide exceptions for the sale or dissolution of a corporation, partnership, or limited liability company. All other restraints on an employee arising from a noncompetition agreement are unlawful.

This article discusses this important development in the enforceability of noncompetition agreements and also discusses the holding in *Andersen* as it relates to employee release agreements.⁴

Facts

Raymond Edwards II ("Edwards"), a certified public accountant, was hired as a tax manager in January 1997 by the accounting firm of Arthur Andersen LLP ("Arthur Andersen"). As with all managers, Edwards was required as a condition of employment to sign a noncompetition agreement. The agreement prohibited him from working for or soliciting certain Arthur Andersen clients for limited periods following termination.⁵

After the United States indicted Arthur Andersen in March of 2002, it began selling off its practice groups as part of its plan to cease operations in the United States. HSBC USA ("HSBC") agreed to purchase the practice group where Edwards worked.

As a condition to hiring Arthur Andersen's employees, HSBC required them to sign a "Termination of Non-Compete Agreement" ("TONC"). Among other things, the TONC required the employees to (1) voluntarily resign from Arthur Andersen and (2) release the

⁴ The *Andersen* decision addressed a second issue; that being whether a broad waiver by an employee of "any and all" claims against an employer violated Labor Code sections 2802 and 2804. The waiver issue is discussed below; however it does not spark the same level of interest to practitioners as does the noncompetition issue. The noncompetition issue is one that needed clarity, and so the commentary in this article addresses only that issue.

⁵ Relevant portions read: "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."

company from “any and all” claims arising out of the employment at Arthur Andersen. In exchange, Arthur Andersen would agree to release the employee from the noncompetition agreement.

Edwards refused to sign the TONC because he was concerned that the release language forfeited his right of indemnification by Arthur Andersen in the event the United States government or a private client brought action against Edwards. Due to Edwards’ refusal to sign the TONC, he was terminated by Arthur Andersen, his severance was withheld, and HSBC refused to hire him.

Procedural History

Edwards filed a complaint against Arthur Andersen and HSBC, which included a cause of action for intentional interference with prospective economic advantage. To satisfy the element of independent wrongfulness,⁶ Edwards asserted: (1) the noncompetition agreement was illegal under Business & Professions Code section 16600 and (2) that the TONC’s release language violated Labor Code sections 2802 and 2804 because the phrase “any and all” included a waiver of indemnity rights, which these Labor Code sections prohibit.

The trial court ruled as a matter of law in favor of Arthur Andersen. The trial court held: (1) the noncompetition agreement did not violate section 16600 because it was narrowly tailored and did not deprive Edwards of his right to pursue his profession and (2) the TONC did not purport to waive Edwards’ right to indemnification. Thus, requiring Edwards to sign the TONC was not unlawful.

The Court of Appeal reversed and held in the published part of its opinion that: (1) the noncompetition agreement was invalid under section 16600, and requiring Edwards to sign the TONC as a condition of release from the noncompetition agreement was an independently wrongful act; and (2) the TONC purported to waive Edwards’ indemnification rights under the Labor Code and was also an independently wrongful act.

⁶ One of the required elements of a cause of action for intentional interference with prospective economic advantage is that the interfering act is independently wrongful, that is wrongfulness independent of its interfering character. *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* 11 Cal.4th 376, 392–393, 1995 Cal. LEXIS 5960 (1995). An act is independently wrongful if it is proscribed by a constitutional, statutory, regulatory, common law, or other determinable legal standard. *Korea Supply Co. v. Lockheed Martin Corp.* 29 Cal.4th 1134, 1159, 2003 Cal. LEXIS 1301 (March 3, 2003).

The Opinion of the California Supreme Court

Noncompetition Agreement

In reaching its decision on the enforceability of the noncompetition agreement, the California Supreme Court reviewed the extensive history of California’s law prohibiting restraints on trade. At common law, and in California’s early history, the “rule of reasonableness” governed noncompetition agreements.⁷ Under the “rule of reasonableness,” contractual restraints were valid so long as they were reasonably imposed.⁸ This was the law in California until 1872.⁹

In 1872, California established a prohibition of any restraints on trade as a matter of public policy, subject to a few limited exceptions, and expressly rejected the “rule of reasonableness” in favor of open competition.¹⁰ Today, that public policy is embodied in section 16600 of the Business & Professions Code.

Section 16600 provides:

Except as provided in 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 chapter provides for three exceptions. Section 16601 excepts noncompetition agreements entered into as part of the sale or dissolution of corporations. Sections 16602 and 16602.5 provide similar exceptions for noncompetition agreements entered into as part of the sale or dissolution of partnerships and limited liability companies, respectively. No other statutory exceptions have been adopted nor have any other exceptions been recognized by California state courts. To the contrary, the Supreme Court noted that “our courts have consistently affirmed that section 16600 evinces a settled legislative policy in favor of open competition and employee mobility.”¹¹

⁷ *Wright v. Ryder* 36 Cal. 342, 357, 1868 Cal. LEXIS 203 (1868).

⁸ *Bosley Medical Group v. Abramson* 161 Cal.App.3d 284, 288, 1984 Cal.App. LEXIS 2657 (1984).

⁹ *Bosley Medical Group v. Abramson* 161 Cal.App.3d 284, 288.

¹⁰ Former code section 1673, repealed by Stats. 1941, ch. 526, section 2, p. 1847, and enacted as Business & Professions Code section 16600, Stats. 1941, ch. 526, section 1, p. 1834.

¹¹ *Andersen*, 44 Cal.4th at 946 (citing *D’sa v. Playhut, Inc.*, 85 Cal.App.4th 927, 933, 2000 Cal. App. LEXIS 982 (December 21, 2000)).

Consistent with that policy, the Supreme Court previously invalidated a narrowly tailored agreement in *Muggill v. Reuben H. Donnelley Corp.* (“*Muggill*”).¹² In *Muggill*, at issue was a pension agreement that contained a provision terminating retirement plan benefits in the event the retiree went to work for a competitor. The Supreme Court invalidated that agreement on the grounds that such a restraint on trade was invalid under section 16600 unless necessary to protect the employer’s trade secrets.¹³ In invalidating the noncompetition agreement in *Andersen*, the Supreme Court noted its previous holding in *Muggill* and also noted that it more recently condemned such restraints on trade as “illegal” in *Armendariz v. Foundation Health Psychcare Services, Inc.*¹⁴

Nevertheless, Arthur Andersen argued that the term “restraint” under section 16600 should be defined as meaning “prohibit” rather than merely limit employee competition. In support of this argument, Arthur Andersen cited *South Bay Radiology Medical Associates v. Asher* (“*South Bay*”)¹⁵ and *Vacco Industries, Inc. v. Van Den Berg* (“*Vacco Industries*”),¹⁶ contending that these cases reflect that section 16600 has been interpreted by at least some California courts as “the statutory embodiment of prior common law” and, as such, incorporating the “rule of reasonableness” into that statute.¹⁷

The Supreme Court in *Andersen* flatly rejected this argument.¹⁸ Relying upon “the statute’s plain meaning,” the Supreme Court held that section 16600 renders all restraints on trade unenforceable unless one of the statutory exceptions applies.¹⁹ In support of this conclusion, the Court noted that both cases upon which Arthur Andersen relied, *South Bay* and *Vacco Industries* recognized that the statutory exceptions to section 16600 were exceptions also recognized at common law.²⁰ *South Bay* involved the dissolution of a partnership, and *Vacco Industries* involved the sale of the shares of a business. Accordingly, the Supreme Court rejected the argument that section 16600 should be read as only applying to noncompetition agree-

ments that completely prohibit an employee from engaging in a profession, trade, or business.²¹

Because the Arthur Andersen noncompetition agreement prohibited Edwards from performing any professional services of the type he had provided for Arthur Andersen for an 18 month period, thereby restricting his ability to practice his accounting profession, the Supreme Court held the agreement was invalid under section 16600.²² In reaching this conclusion, the Supreme Court refused to adopt the “narrow-restraint exception” that had been recognized by the Ninth Circuit Court of Appeal in *Campbell v. Trustees of Leland Stanford Jr. University* (“*Campbell*”).²³ In *Campbell* the district court had upheld a noncompetition agreement a California employer had sought to enforce on the grounds that it contained a very narrow restraint on trade. The Ninth Circuit recognized that California had rejected the “rule of reasonableness” in its adoption of section 16600, but held that the statute only applied to agreements that preclude an employee from engaging in a lawful profession, trade, or business.²⁴ Two subsequent cases followed suit. *IBM Corp. v. Bajorek* (“*IBM*”)²⁵ and *General Commercial Packaging v. TPS Package* (“*General Commercial*”)²⁶ both upheld noncompetition agreements that restricted a former employee’s ability to go to work for a single competitor.

The Supreme Court in *Andersen* noted that the confusion concerning this “narrow-restraint exception” appears to stem from the language in *Campbell* in which the Ninth Circuit indicated that the California state courts have recognized an exception to section 16600 “where one is barred from pursuing only a small or limited part of the business, trade or profession.”²⁷ The state court cases cited by the Ninth Circuit in *Campbell* were *Boughton v. Socony Mobil Oil Co.* (“*Boughton*”)²⁸ and *King v. Gerold* (“*King*”).²⁹ The Supreme Court in *Andersen* held that

¹² *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal.2d 239, 1965 Cal. LEXIS 245 (January 19, 1965).

¹³ 62 Cal.2d at 242.

¹⁴ 62 Cal.2d at 242 (citing *Armendariz v. Foundation Health Psychcare Services, Inc.* 24 Cal.4th 83, 123, fn. 12, 2000 Cal. LEXIS 6120 (August 24, 2000)).

¹⁵ 220 Cal.App.3d 1074, 1990 Cal. App. LEXIS 389 (April 24, 1990).

¹⁶ 5 Cal.App.4th 34, 1992 Cal. App. LEXIS 455 (April 2, 1992).

¹⁷ *Andersen*, 44 Cal.4th at 947.

¹⁸ 44 Cal.4th at 948.

¹⁹ 44 Cal.4th at 947–948.

²⁰ 44 Cal.4th at 947–948.

²¹ 44 Cal.4th at 948.

²² 44 Cal.4th at 948.

²³ *Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499, 1987 U.S. App. LEXIS 6277 (1987).

²⁴ 817 F.2d at 502.

²⁵ 191 F.3d 1033, 1999 U.S. App. LEXIS 21949 (9th Cir. 1999).

²⁶ 126 F.3d 1131, 1997 U.S. App. LEXIS 24438 (9th Cir. 1997).

²⁷ *Andersen*, 44 Cal.4th at 948–949.

²⁸ *Boughton v. Socony Mobil Oil Co.*, 231 Cal.App.2d 188, 1964 Cal. App. LEXIS 794 (1964).

²⁹ *King v. Gerold*, 109 Cal.App.2d 316, 1952 Cal. App. LEXIS 1839 (1952).

neither case found a “narrow-restraint exception” to section 16600.³⁰

In *Boughton*, section 16600 was not even applicable to the agreement at issue.³¹ *Boughton* involved a deed to a parcel of land. The deed contained a restrictive covenant that specified the land could not be used as a gasoline service station for a certain period of time. The plaintiff had argued that this constituted an unlawful restraint on trade. Because the deed did not impose a restraint on the plaintiff's profession or trade, however, section 16600 had no application to the restraint contained in the deed.³²

The court in *Boughton* however, relied upon *King* which was an unfair competition case.³³ In *King*, the plaintiff manufactured and sold house trailers and challenged the enforceability of a noncompetition clause of a license agreement. The court in *King* upheld the agreement, but did so on the grounds that it was necessary in order to protect trade secrets, because the plaintiff was allegedly using a trailer design that was substantially similar to the design invented by the licensor.³⁴

Even though the *Campbell* decision has been relied upon in subsequent Ninth Circuit cases, creating a narrow-restraint exception to section 16600 in federal court, the California Supreme Court observed that no reported California state court has adopted this exception and stated:

We are not persuaded that *Boughton* or *King* provide any guidance on the issue of noncompetition agreements, largely because neither involved noncompetition agreements in the employment context. However, to the extent they are inconsistent with our analysis, we disapprove *Boughton v. Socony Mobile Oil Co.*, and *King v. Gerold*.³⁵

In rejecting the narrow-restraint exception, the Supreme Court stated: “Section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect.”³⁶ Accordingly, the Supreme Court rejected Arthur Andersen's contention that it should adopt a narrow-restraint exception to section 16600 and held it would “leave it to the Legislature, if it chooses, either to relax the statutory restrictions

or adopt additional exceptions to the prohibition-against-restraint rule under section 16600.”³⁷

Release of Claims

In addition to challenging the enforceability of the noncompetition agreement, Edwards also contended that the release he was asked to sign violated public policy in that it purported to release “any and all claims,” which, Edwards argued, impliedly included indemnity rights under Labor Code section 2802.³⁸

Labor Code section 2802(a) provides:

An employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful.

Labor Code section 2804 voids any agreement that waives the protections of section 2802.

Edwards relied primarily upon the broad language of the release, which provided that “any and all claims” were included.³⁹ In addition, however, Edwards noted that the agreement provided that the release included “debts, damages, costs, losses, expenses . . . compensation or liabilities of any nature whatsoever,” as well as “claims that in any way arise from or out of, are based upon or relate to Employee's employment by, association with or compensation from [Andersen].”⁴⁰ Edwards argued that these provisions necessarily encompassed his statutory right to indemnity under section 2802(a).⁴¹

The Supreme Court rejected this argument first based on contract interpretation principles. Finding that the language “any and all” is uncertain, the Supreme Court held that it must decide what the phrase means.⁴² Relying upon the general principle that “[i]f a contract is capable of two constructions, courts are bound to give such an interpretation as will make it lawful, operative, definite, reasonable and capable of being carried into effect,” the

³⁰ *Andersen*, 44 Cal.4th at 949.

³¹ *Boughton*, 231 Cal.App.2d 188.

³² 231 Cal.App.2d at 190.

³³ *King*, 109 Cal.App.2d 316.

³⁴ 109 Cal.App.2d at 318.

³⁵ *Andersen*, 44 Cal.4th at 950, fn. 5 (citations omitted).

³⁶ 44 Cal.4th at 950.

³⁷ 44 Cal.4th at 950.

³⁸ Edwards made this argument in support of his Intentional Interference with Prospective Economic Advantage cause of action, contending that Andersen's requirement that he sign the release violated public policy and therefore constituted an independent wrong for purposes of that cause of action.

³⁹ *Andersen*, 44 Cal.4th at 950.

⁴⁰ 44 Cal.4th at 950–951.

⁴¹ 44 Cal.4th at 952.

⁴² 44 Cal.4th at 953.

Supreme Court held that the release should not be construed as including nonwaivable rights of indemnity.⁴³

Even if the contract was not interpreted in accordance with the stated rules of interpretation, the Supreme Court held that it would nevertheless still find that the language “any and all” would not include Edwards’ indemnity rights under section 2802(a), because such rights are statutorily nonwaivable.⁴⁴ As such, the rights could not be impliedly waived because the parties to a contract are presumed to know and have in mind “[a]ll applicable laws in existence when an agreement is made,” and such laws “necessarily enter into the contract and form a part of it, without any stipulations to that effect, as if they were expressly referred to and incorporated.”⁴⁵

Commentary

The *Andersen* decision puts to rest the argument that limited implicit exceptions to section 16600 exist in addition to those specified in the statute. California has been recognized for years as one of the strictest states in the United States with regard to noncompetition agreements, and California employers have struggled with the problem posed by an employee that leaves his or her employer and goes to work for a direct competitor. Most practitioners have relied upon the argument that the defection will jeopardize trade secrets or has been accompanied by the direct solicitation of its employees by the former employee, but this can be a very difficult argument to win, particularly if the employee has not taken any tangible property from his or her former employer or not directly contacted the former employer’s employees.⁴⁶

Until the decision in *Andersen*, attorneys for employers retained a glimmer of hope that the gloss on California

law suggested by the Ninth Circuit’s decisions in *Campbell*, *IBM* and *General Commercial*, would result in the enforcement of “narrowly tailored” restraints against competition by former employees. *Andersen* now precludes that argument, resolving any conflict that may have existed between the state courts of California and the decisions of the Ninth Circuit.

In light of this ruling, all California employers should re-evaluate their employment and noncompetition agreements. It is even more important now to make sure that any such agreements contain adequate protections against the use or disclosure of trade secrets or the solicitation of employees in order to have some protection against unfair business practices when an employee leaves for a competitor. Although it looked as though the courts were moving in the direction of expanding the exceptions to section 16600, *Andersen* leaves no doubt that any such changes to California’s strict law against noncompetition agreements will only come from Sacramento.

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⁴³ 44 Cal.4th at 953–954.

⁴⁴ 44 Cal.4th at 954.

⁴⁵ 44 Cal.4th at 954 (citing *Torrance v. Workers’ Comp. Appeals Bd.*, 32 Cal.3d 371, 378 1982 Cal. LEXIS 226 (1982), quoting *Alpha Beta Food Markets v. Retail Clerks Union* 45 Cal.2d 764, 771, 1955 Cal. LEXIS 365 (1955)).

⁴⁶ As noted above, the California Supreme Court did not address the validity of clauses prohibiting the solicitation of employees or the disclosure of “trade secrets” because Edwards did not dispute the enforceability of those portions of the agreement he had signed while employed by Arthur Andersen. 44 Cal.4th at 946, n.4.