

Limiting the Adverse Effects of Employee Competition Following California's Invalidation of Noncompetition Agreements

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WHEN CONSIDERING THE ISSUE of how to prevent former employees from competing with an employer, the average employer seeks to draft an agreement that simultaneously prohibits former employees from: 1) working for the employer's competitors; 2) soliciting the employer's clients and employees; and 3) divulging the employer's trade secrets and other confidential information. However, as has become apparent to California employers, not only would such an agreement *not* be enforced in California, but the employer may also be subject to liability for the attempted enforcement of such an agreement. On August 7, 2008, the California Supreme Court (the "Court") issued its seemingly sweeping opinion in *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937 (Cal. 2008), which considered and reviewed the state of noncompetition agreements in California. Although the Court did not tackle the enforceability of all of the employer's objectives enumerated above, the Court was unambiguous in its holding: Unless a specific statutory exception exists, noncompetition agreements that restrain competition in any way are strictly unenforceable. In the wake of the Court's holding in *Edwards*, California employers

have been left to wonder what they can do in order to limit the adverse effects of employee competition. Thankfully, for the average California employer, not all hope is lost.

PRE-EDWARDS

Prior to the *Edwards* decision, California state courts had routinely found non-compete and nonsolicitation clauses to be unenforceable. Section 16600 of the California Business and Professions Code, which was enacted in 1872, provides that, "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." California state courts had consistently interpreted section 16600 as promoting the ideals of a free market with open competition and employee mobility. However, unlike California state courts, California federal courts had adopted the limited or "narrow-restraint" test that states that noncompetition agreements which only narrowly restrain competition are enforceable. [See *Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499 (9th Cir. 1987); *General Commercial Packaging v. TPS Package*, 123 F.3d 1131 (9th Cir. 1997).]

THE EDWARDS DECISION

In *Edwards*, the Court considered the validity of a noncompetition agreement, which defendant Arthur Andersen required plaintiff Raymond Edwards II, a CPA, to sign upon employment. The subject non-competition agreement prohibited Edwards from: 1) providing accounting services to the clients with whom he worked while at Arthur Andersen; 2) soliciting Arthur Andersen clients; and 3) hiring away any Arthur Andersen employees, for periods ranging from one year to 18 months following termination of his employment relationship.

The Court held that enforcing the noncompetition agreement was unlawful under §16600 because by restricting Edwards from performing accounting services for Arthur Andersen's clients, Arthur Andersen was restricting Edwards' ability to engage in a lawful profession. The Court also held that the enforcement of the agreement was a wrongful act that could lead to liability on the part of Arthur Andersen for interference with Edwards' prospective economic advantage. The Court stated unequivocally, "Section 16600 prohibits employee noncompetition agreements unless the agreement falls within a statutory exception" [44 Cal. 4th at 942]. Such

statutory exceptions, contained in the Business and Professions Code, include the enforceability of noncompetition agreements in the sale of a business (§16601), dissolution of a partnership (§16602) or in the termination of a member's interest in a limited liability company (§16602.5). The Court held not only that the non-compete clause was void under §16600, but also specifically rejected the Ninth Circuit's line of cases, which had established and upheld noncompetition agreements that were limited in nature or narrowly tailored. Finally, although the Court did not specifically address the enforceability of the clause by which Edwards was prohibited from soliciting any Arthur Andersen employees, the Court's invalidation of the agreement as a whole presumably upheld the line of cases decided by California state courts, which had previously held that the solicitation of former co-workers was permissible.

LIMITING THE ADVERSE EFFECTS OF EMPLOYEE COMPETITION

Even though *Edwards* confirms that non-compete and nonsolicitation clauses are unenforceable as to former employees under California law, California employers are not without options.

TRADE SECRETS

Although not codified in the Business and Professions Code, there has long existed a "trade secret" exception to the unenforceability of noncompetition agreements, whereby employers may enforce agreements under which an employee agrees not to use an employer's trade secrets after termination of his/her employment. The *Edwards* Court chose not to address this issue in its opinion. In a footnote, the Court observed that, "We do not here address the applicability of the so-called trade secret exception to section 16600 as *Edwards* does not dispute that portion of his agreement or contend that the provision of the non-compete agreement prohibiting him from recruiting Andersen's employees violated section 16600" [44 Cal. 4th at 946 n. 4]. As such, for the time being, the "trade secret" exception remains in force.

The "trade secret" exception applies only to "trade secrets," as specifically defined in the Uniform Trade Secrets Act. As such, not all confidential information is protected by the "trade secret" exception. In order to protect its trade secrets, employers should draft nondisclosure and nonsolicitation clauses that are narrowly tailored and clearly evince the intention to protect their trade secrets in order to maintain compliance with §16600.

DETERRENCE FROM LEAVING EMPLOYMENT

In order to deter employees from not only leaving and competing with its company but also from soliciting its clients and other employees, an employer may consider including disincentives to leaving the employer in an employment agreement. For example, California courts have upheld agreements that require the reimbursement of certain training and relocation costs that the employer paid in cases where the employee leaves the company prior to a certain length of time, such as one or even five years.

RECOUPMENT OF WAGES ALREADY EARNED

Is an employer completely without remedy should it discover that a former employee, who is now competing with the employer, commenced his/her competing activities while employed by the employer? The answer to that question is a resounding "No."

The "faithless servant doctrine" provides that an employer may recoup wages and benefits earned by a disloyal employee. Under the tenets of the employer-employee relationship, an employee owes undivided loyalty to his current employer. In *Service Employees International Union, Local 250 v. Colcord*, 160 Cal.App.4th 362 (2008), California's First District Court of Appeal allowed an employer to recover salary and benefits that the employer had paid to an employee who breached his fiduciary duties by secretly competing with his employer.

Although the "faithless servant doctrine" has long been recognized in California state courts, *Colcord* is the first case in which a court clarifies that

employers are permitted to recoup wages from employees for faithfully completed work, as well as for work completed during periods of disloyalty. The *Colcord* court clarifies that disloyal employees must forfeit all compensation received from the employer after the first moment of disloyalty.

As evidenced by *Colcord*, if an employee operates a competing business or makes arrangements to work for his employer's competitor while employed, such conduct is considered disloyal. *Colcord* makes it clear that the employer may recoup wages paid to an employee if the employee began his/her disloyalty while still employed by the employer.

CONCLUSION

Although *Edwards* significantly limits a California employer's options in protecting itself from former employee competition, California employers have the option of drafting nondisclosure and nonsolicitation clauses that are narrowly tailored to protect trade secrets and drafting employment agreements that provide for the reimbursement of the employer's costs following the early resignation of an employee. Finally, if an employer has a disloyal employee, California law provides for the recovery of wages and salary paid to such disloyal employees. Nevertheless, in light of the liability that *Edwards* places on employers for the attempted enforcement of noncompetition agreements, California employers should arrange promptly for a review of all employee manuals, existing employment agreements, confidentiality agreements and employment policies, and related forms and documents to ensure that all such documents are in accordance with §16600. ♦

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