

Covenants Not To Compete Revisited

September 2008
By Olivia Goodkin

The California Supreme Court recently confirmed the strong state policy supporting the prohibition against covenants not to compete. In *Edwards v. Arthur Andersen*, the court held that various provisions in an employment agreement that barred Edwards from working for any clients of the accounting firm Arthur Anderson for a period of time after his employment ended violated the California statute proscribing non-competition clauses. The court rejected Arthur Andersen's attempts to find carve-outs or exceptions to the California statute prohibiting covenants not to compete that do not already exist in the statutory scheme.

California's Statutes that Address Covenants Not to Compete

California Business & Professions Code Section 16600 states: "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 exceptions to Section 16600 are non-competition agreements in the context of a sale or dissolution of corporations (§ 16601), partnerships (§ 16602), and limited liability corporations (§ 16602.5). More specifically, if the person leaving the corporation, partnership or limited liability corporation possessed a material ownership interest in the company that he left, and sold the interest in connection with leaving, then a covenant not to compete with the business being sold is enforceable.

The Facts of the *Edwards v. Arthur Andersen* Case

Edwards was a certified public accountant with the Los Angeles office of Arthur Andersen, the former accounting firm giant. As a condition of his employment, he had signed a non-competition agreement, which provided, in relevant part: "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. [¶] You agree not to solicit away from the Firm any of its professional personnel for eighteen months after release or resignation."

In May 2002, HSBC USA, Inc. (a New York-based banking corporation) purchased a portion of Arthur Andersen's tax practice, including Edwards' group. HSBC required that Arthur Andersen provide it with a completed "Termination of Non-Compete Agreement" (TONC) signed by Edwards and other employees before the deal went through. Arthur Andersen would not release Edwards, or any other employee, from the non-competition agreement unless that employee signed the TONC.

Edwards refused to sign the TONC because, among other things, he believed it contained an illegally broad release of claims. In response, Arthur Andersen terminated Edwards's employment and withheld severance benefits, and HSBC withdrew its offer of employment to Edwards.

Edwards sued Andersen, HSBC and its subsidiary for intentional interference with prospective economic advantage and anticompetitive business practices. Edwards alleged that the Arthur Andersen non-competition agreement violated section 16600 and, therefore, requiring him to abide by that agreement and sign a release of that agreement in order to be employed interfered with his ability to practice his profession.

The California Supreme Court Agreed with Edwards that his Non-Competition Agreement was Illegal and Void

The court said, in reference to Business & Professions Code Section 16600, "Under the statute's plain meaning, therefore, an employer cannot by contract restrain a former employee from engaging in his or her profession, trade, or business unless the agreement falls within one of the exceptions to the rule. (§ 16600.)" The court noted that the Edwards' non-competition agreement prohibited him, for an 18-month period, from performing professional services of the type he had provided while at Andersen, for any client on whose account he had worked during 18 months prior to his termination. The agreement also barred Edwards, for a year after termination, from "soliciting," which was defined by the agreement as providing professional services to any client of Andersen's Los Angeles office.

Because the agreement restricted Edwards from performing work for Arthur Andersen's Los Angeles clients and therefore restricted his ability to practice his accounting profession, it was a restraint of trade under Section 16600.

The court rejected Arthur Andersen's argument that the term "restrain" under Section 16600 means to completely "prohibit" a person from engaging in his or her profession, trade, or business. The court made clear that it was rejecting prior lower court cases in which narrow exceptions to Section 16600 were upheld, such as the situation where an agreement restricted an employee from working for only one customer after termination of employment.

As an Employer, Can you Prevent Business from Leaving with a Departed Employee?

Although covenants not to compete generally are unenforceable, employers may restrict departed employees from soliciting customers of the company. However, nonsolicitation-of-customer covenants are also subject to scrutiny under Section 16600. As seen in the *Edwards* case, if the nonsolicitation covenant in some manner unduly restrains the employee from engaging in his business or trade, it will be deemed illegal. In the 2003 case of *Thompson v. Impaxx, Inc.*, the court of appeals held that all forms of restrictive covenants must be evaluated under Section 16600 and will not be enforced except to the extent that enforcement is necessary to protect trade secrets. Whether information is a trade secret is a question of fact.

Thus, the only way to restrict a former employee from soliciting a customer of your company is to have in place a trade secrets program whereby it is made abundantly clear to the employee that the identity of the customer and/or pertinent customer information is considered proprietary. The company must take steps to ensure that the trade secret information is kept secret. One way to do so is to have every employee sign a confidentiality agreement that references customer information as a trade secret. However, the employer cannot then arbitrarily disclose the information to persons who do not need to know the information. Moreover, information in the public domain, or obtained outside of the scope of the workplace, is not considered confidential.

We recommend that companies review their policies regarding what information is considered proprietary and confidential, and ensure that appropriate procedures are in place for enforcing the policies.

ABOUT OLIVIA GOODKIN



Olivia Goodkin has over two decades of experience representing corporations, individuals and closely-held businesses in employment law and business litigation. She advises on the termination of employees, wage and hour laws, employment contracts and other employment issues, and she defends companies in wrongful termination lawsuits. Olivia also creates trade secret programs for companies seeking to protect their valuable intellectual property. *Olivia can be reached at ogoodkin@rutterhobbs.com, or by telephone at 310.286.1700.*

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