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California Supreme Court Nixes Most Non-Compete Agreements

EMPLOYMENT LAW

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When it comes to employment laws, California is among the most employee friendly jurisdictions anywhere. A recent landmark ruling by the state's Supreme Court involving non-compete agreements has served to reinforce that reputation.

In a widely watched decision involving the now defunct accountancy practice of Arthur Andersen, the Supreme Court invalidated any agreement that seeks to restrict the right of an employee to go to work for a competitor or solicit a former employer's customers using non trade secret information.

The case, called Edwards v. Arthur Andersen, LLC , is welcome news for employees and the competitor businesses that hire them away.

From the employee's perspective, the Court confirmed that agreements which prevent employees from going to work for a competitor violate California law.

From the new employer's perspective, the case allows the company to ignore any such contractual restrictions that the new employee may have signed.

Although the Court invalidated agreements which restrict employee movement, it left intact another provision of California law that permits non-compete agreements in certain non-employment settings such as between the buyer and seller of a business, among partners dissolving their partnership or when obtained in connection with the acquisition of a company's stock.

Notably, the decision also did not disturb longstanding laws that permit a business owner to protect its valuable trade secrets.

Agreements which seek to protect a company's trade secrets are not affected by the Court's ruling at all. Thus, employees who misappropriate the company's trade secrets when they go to work for a competitor still may be sued for damages and injunctive relief.

Background: Section 16000 of the State's Business and Professions Code 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."

Some courts had held that this means any post employment restriction whatsoever would be illegal. Others ruled that such agreements would pass muster under state law so long as they were narrowly tailored (i.e., limited as to duration, scope or geography). The Supreme Court accepted the Edwards case to resolve which view was correct.

Raymond Edwards went to work for Arthur Andersen as a tax manager in its Los Angeles office. Arthur Andersen required him to sign their standard non-compete agreement which stated:

"If you leave the Firm, for 18 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 18 month period prior to release or resignation…"

After Mr. Edwards left Arthur Andersen, he sued to invalidate the non-compete agreement. Arthur Andersen argued that the agreement was fine because it was narrowly tailored and only prevented Edwards from servicing certain clients. He could still be an accountant, they argued. Edwards argued that even a narrowly tailored agreement such as this ran afoul of the Business and Professions code.

The Supreme Court took this opportunity to emphatically state that all non-compete agreements in the employment setting are invalid, no matter how narrowly tailored.

The only exceptions to the court's ruling are set forth in the companion statute governing the purchase of a business, dissolution of a partnership or the acquisition of significant percentage of a company's stock.

Practical Implications: Some commentators are suggesting that employers retain the illegal provisions as a prophylactic, hoping that departing employees may adhere to the unenforceable restriction out of ignorance. We do not think this is a good idea for several reasons.

For example, it is illegal in California for an employer to insist that a job applicant or an employee sign a contract or policy containing an illegal provision.

In light of the Court's ruling, business owners should consider taking the following steps:

• Review existing employment agreements or company policies for any provision that restricts employee movement post employment. Have them reviewed by your labor attorney if you have any questions about whether the provision is still lawful.

• Take this opportunity to enhance existing policies and agreements designed to protect company trade secrets. If you don't have one, or you don't routinely ask employees to sign the one you do have, now is an excellent time to reduce your vulnerability to trade secret theft.

• State trade secret laws require more than simply calling something a trade secret in a document. Consult your labor attorney to learn what types of information qualify as a trade secret and what steps are essential for insuring that trade secret information will be protected.

• Employers may still have restrictions that preclude ex-employees from hiring away employees or soliciting them to leave the company. Consider adding these protections.

• Some commentators suggest that you can get around the new ruling by putting the non-compete in a retirement plan contract. By doing so, the departing employees will jeopardize their retirement benefits if they don't adhere to the non-compete. This suggestion is premised upon the theory that retirement plans are covered exclusively by federal benefits law (ERISA), and thus cannot be regulated by state law. Since this is an untested theory, review this strategy with legal counsel.

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