THE LEGAL CORNER

COMPETITION STILL THE RULE IN CALIFORNIA – BUT NOT ALWAYS

By Robert Barnes
Kaye Scholer LLP

Recently, in *Edwards v. Arthur Andersen LLP,* 44 Cal. 4th 937 (2008), the California Supreme Court re-affirmed that, outside the context of corporate acquisitions and trade secrets disclosures, all post-employment covenants not to compete entered into by corporations are void. Sophisticated California employers have, however, long responded to this idiosyncratic rule by exploiting its recognized exceptions. This article reviews what is permissible after *Edwards.*

California has voided contractual non-competition restrictions since 1872. California Business and Professions Code Section 16600 is categorical: "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."

As the Supreme Court explained in *Edwards,* Section 16600 reflects "a settled legislative policy in favor of open competition and employee mobility" that "protects the important legal right of persons to engage in businesses and occupations of their own choosing." "In sum, following the Legislature, this Court generally condemns noncompetition agreements." "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." 44 Cal. 4th at 946.

1. Corporate Acquisitions. Section 16601 permits enforcement of a reasonable covenant not to compete as partial consideration for the acquisition of a corporation. This important exception protects a corporate buyer from the seller opening a competing business.

In a *stock sale,* an employee selling *all* of her stock in the acquired corporation "may agree with the buyer to refrain from carrying on a similar business." *Compare Radiant Industries, Inc. v. Skirvin,* 33 Cal. App. 3d 401, 403 (1973) (restriction void because new owner purchased only 82 percent of employees' stock) *with Vacco Industries, Inc. v. Van den Berg,* 5 Cal. App. 4th 34, 48 (1992) (restriction valid because new owner purchased all of employee's 2.7 percent stock interest). The stock transaction must be a genuine arms-length deal, not an artifice. *Bosley Medical Group v. Abramson,* 161 Cal. App. 3d 284, 291 (1984).

In an *assets sale,* a covenant not to compete is enforceable when the buyer purchases "all or substantially all of the operating assets together with the goodwill of the business entity." *Alliant Insurance Services, Inc. v. Gaddy,* 159 Cal. App. 4th 1292, 1300-06 (2008).

The purchase and sale agreement should plainly state that the price is partial consideration for certain employment agreements. The concurrently-signed employment agreements should, in turn, cross-reference the purchase agreement, and then set forth the length and scope of the post-employment restrictions.

2. Partnership and LLC Transactions. Section 16602 permits a partnership agreement to restrict withdrawing partners from competing with the partnership's continuing business. Section 16602.5 applies the partnership exception to limited liability corporations.

Significantly, no payment or goodwill purchase is required to enforce a reasonable covenant not to compete against a former partner or LLC member. *South Bay Radiology Medical Associates v. Asher,* 220 Cal. App. 3d 1074, 1083-84 (1990). A partnership can require a forfeiture (such as withholding the return of capital) from a withdrawing partner moving to a competitor. *Howard v. Babcock,* 6 Cal. 4th 409, 425 (1993).

The less stringent limitations for partnerships and LLCs may offer opportunities to change corporate form and enhance enforceability of post-employment noncompetition restrictions.

3. Trade Secrets. Courts can enjoin ex-employees from disclosing trade secrets, such as a proprietary customer list or confidential pricing information. This effectively stops the ex-employee from working for a competitor. The former employer carries the burden of proving actual disclosure of the secrets. *American Credit Indemnity Co. v. Sacks,* 213 Cal. App. 3d 622, 632-34 (1989).

4. Nonsolicitation restrictions. California courts *will* enforce post-employment solicitation of current *employees. Loral Corp. v. Moyes,* 174 Cal. App. 3d 268, 275 (1985). However, restrictions on soliciting *customers* are unenforceable surrogate covenants not to compete. *Thompson v. Impaxx, Inc.,* 113 Cal. App. 4th 1425, 1429 (2003).

Employee nonsolicitation restrictions are ubiquitous in employment contracts and handbooks. The crucial issue is often whether the former employee affirmatively solicited another employee to join her at a competitor. Current employees answering an ad or approaching a former colleague have probably not been solicited.

5. Choice of law. A covenant not to compete may be void even if the contract fixes the choice of law as another state that enforces restrictions. *Application Group, Inc. v. Hunter Group, Inc.,* 61 Cal. App. 4th 881, 902 (1998). If the employee works in California, California law applies.

When an ex-employee moves to a competitor in California, the former employer could enforce the noncompetition restriction in a *non-California* court. California courts cannot enjoin another state's court from enforcing restrictions. *Advanced Bionics Corp. v. Medtronic, Inc.,* 29 Cal. 4th 697, 708 (2002).

6. Forfeiture provisions. A covenant not to compete cannot be disguised as a penalty for post-employment competition. Pension or option provisions that stop payments if the employee joins a competitor are void. *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239, 242-43 (1965).

7. Narrow Restraints. Until *Edwards,* federal courts upheld covenants not to compete if the restriction was "narrow" and did not "completely constrain" competition. *Edwards* ruled that Section 16600 prohibits *all restrictions* on competition. Indeed, it may be a tort to insist on an unenforceable covenant not to compete. *D'Sa v. Playhut, Inc.,* 85 Cal. App. 4th 927, 933 (2000).

8. Open Issues. At least two issues remain unresolved. First, some employers have written "garden leave" provisions into employment agreements. If the employee quits or is terminated, she continues to receive salary for an extended period when she cannot work for anyone. No court has determined whether garden leave is consistent with Section 16600.

Second, if a noncompetition restriction is in an ERISA plan's documents, federal preemption may override California law. It is unclear whether federal and California law differ before vesting requirements are met.

For employers new to California, the state's broad rejection of noncompetition restrictions may be hard to fathom. However, California employers have learned to live with this constraint and adjust their practices to use the limited exceptions the law allows.

Robert Barnes is a litigation partner in the Los Angeles office of Kaye Scholer LLP, where he represents film studios and other employers in commercial litigation matters. He can be reached at **(310) 788-1180** or **rbarnes@kayescholer.com**

KAYE SCHOLER LLP

1999 AVENUE OF THE STARS, SUITE 1700
LOS ANGELES, CA 90067