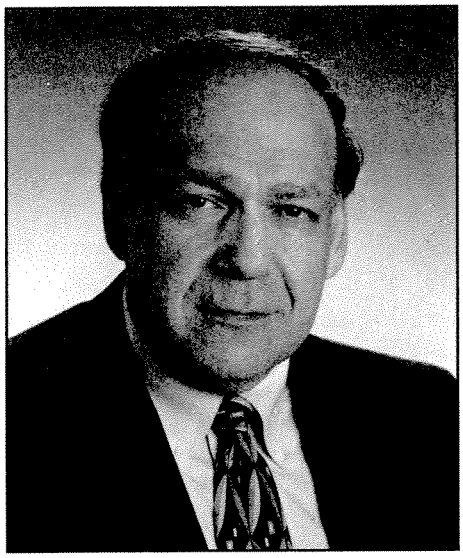
Ninth Circuit Report



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RAYMOND EDWARDS II V. ARTHUR ANDERSEN LLP (CALIFORNIA SUPREME COURT) A FINAL NAIL IN THE COFFIN OF NONCOMPETITION AGREEMENTS IN CALIFORNIA

IN *Raymond Edwards II vs. Arthur Andersen*,[1] the California Supreme Court has broadly interpreted the California Business and Professions Code to further prohibit employee noncompetition agreements which seek to prevent a former employee from working for a competitor, subject to specific statutory exceptions.

California Business and Professions Code § 16600 states 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."

Prior Ninth Circuit decisions, interpreting California cases, had suggested that there was a narrow exception in Section 16600 "where one was barred from pursuing only a small or limited part of the business, trade or profession," but the California Supreme Court disagreed.

Raymond Edwards was an accountant in the Los Angeles office of Arthur Andersen. He had signed a reasonable time noncompetition agreement prohibiting performing of competitor services, solicitation of clients and of soliciting professional personnel, for a year or 18 months.

After the U.S. Government indicted Arthur Andersen in connection with the Enron investigation, Andersen announced that it would cease its accounting practice in the United States, and sold off its tax accounting practice to HSBC. HSBC required its Andersen employees to execute a "Termination of Non-compete Agreement" (TONC). The TONC required employees to "release Andersen from 'any and all claims' including '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, except for a continuing obligation to protect confidential information and trade secrets.

Edwards refused to sign the TONC, because he believed that its "any and all" claims release would waive his rights to indemnification back against Andersen under California Labor Code §§ 2802 and 2804. Labor Code § 2802(a), provides for an employee's right to indemnity. That subdivision reads: "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 of 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 § 2804 voids any agreement to waive the protections of Labor Code § 2802 as against public policy.

Edwards was rightly concerned that waiver of the Labor Code sections would prevent his claim for indemnification for any work he did in discharge of his duties, which he believed to be lawful, but which might be challenged by the U.S. Government in the Enron indictment. He did not want to lose the right to indemnification by Anderson if the government challenged his actions as an employee at Andersen.

Edwards sued for "intentional interference with prospective economic advantage" and anti-competitive business practices under the Cartwright Act, (Bus. & Prof. Code, § 16720 *et seq.*). Edwards alleged that (1) the noncompetition agreement violated § 16600 which states that except for specific exceptions," every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void," and (2) alleged that the TONC's release of "any and all" claims against Anderson violated Labor Code §§ 2802 and 2804, which make an employee's right to indemnification from his or her employer nonwaivable.

The trial court sustained Andersen's demurrer to Edwards Cartwright Act complaint, and after a bifurcated trial on the issue of the validity of the noncompetition agreement and the TONC, the court found both agreements valid as a matter of law, and granted judgment for Andersen. The California Court of Appeals reversed, concluding that both the noncompetition and the TONC were invalid, and that Andersen's actions were therefore wrongful.

The California Supreme Court

The California Court of Appeals reversed as to the non-compete, concluding that Andersen's noncompetition agreement was invalid under § 16000, because it restrained his ability to practice his profession. At issue was whether there remained, as suggested by Ninth

Circuit cases such as *Campbell v. Trustees of Leland Stanford Jr. Univ.*,[2] (*Campbell*), where the Ninth Circuit acknowledged that while California had rejected the common law "rule of reasonableness" with respect to restraints upon the ability of an employee to pursue a profession, it had concluded that § 16600 "only makes illegal those restraints which preclude one from engaging in a lawful profession, trade or business." The Ninth Circuit had interpreted California cases as not prohibiting agreements "where one is barred from pursuing *only a small or limited part of the business*, trade or profession." *Campbell* had been followed in cases which barred, for example, a former employee "from courting a specific named customer" or "mandating that an employee forfeit stock options if employed by a competitor within six months of leaving employment."

The California Supreme Court disagreed with the Ninth Circuit's interpretation, distinguishing these cases. It said that § 16600 represented a strong public policy, which was unambiguous and that there should be no "narrow-restraint exception" to § 16600.

The California Supreme Court specifically disapproved of any interpretation of its prior decisions *Boughton v. Socony Mobil Oil Co.* (*Boughton*)[3] and *King v. Gerold (King)*.[4] And the Court specifically rejected any narrow restraint exception to § 16600. Any restraint, however, narrow, on former employees was void.

Since the majority agreed with the Court of Appeals that the noncompetition was invalid under Business and Professions Code § 16600, it concluded that "to the extent Andersen demanded Edwards execute the TONC as consideration for release of the invalid provisions of the noncompetition agreement, it could be considered a wrongful act for purpose of his claim for interference with prospective economic advantage."

Note that these cases do not detract from trade secret protection as a separate right to prevent use in disclosure, as they only apply to the statutory rule against noncompetition clauses. But the courts will look strictly at such restrictions to make sure that the information is a trade secret and confidential business information, and to assure that such restrictions are not being used as an excuse to prohibit the employee from hired by a competitor.

The TONC is Interpreted Narrowly to Exclude a Release

The California Supreme Court majority also disagreed with the Court of Appeals' conclusion that that the TONC was invalid. It interpreted the TONC's language requiring a release of "any and all claims" to be sufficiently ambiguous so as to be interpreted by the court narrowly, and thus to make the release valid and capable of being carried into effect.

As the majority concluded, the release of "any and all claims" language was not intended to encompass indemnity claims which legally could not be released under the Labor Code. The court interpreted such indemnity claims as being statutorily nonwaivable, and thus merely held that the release language should be interpreted to exclude such indemnity claims.

A concurring and dissenting opinion by Justice Kennard, said that the language of the TONC, while not mentioning the indemnity claims, was more specifically directed at releasing such claims, or at least, giving the employees the impression that such claims had been released, so that they would not seek indemnity. She raised the question of whether such releases were drafted by Andersen in order to lead the employees believe that they had released their indemnity claims, providing an *in terrorem* effect which, under Justice Kennard's view, would be wrongful conduct supporting Edward's claim for intentional interference with prospective economic advantage.

The interpretation of § 16600, and particularly the rejection of any additional, however reasonable, restrictions against former employees competing with an employer, makes it clear that California law is absolute: No restriction, however, limited, will not be tolerated on an employees right to work through a non-competition agreement. ▪

The views expressed in this article are personal to the author and do not necessarily reflect the views of the author's firm, the State Bar of California, or any colleagues, organization, or client.

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Endnotes

1. 44 Cal. 4th 937, 189 P.3d 285, 81 Cal. Rptr. 3d 282 (2008).
2. 817 F.2d 499 (9th Cir. 1987).
3. 231 Cal. App. 2d 188 (1964).
4. 109 Cal. App. 2d 316 (1952).