NON-COMPETITION AGREEMENTS IN CALIFORNIA: THE FINE LINE BETWEEN GOOD AND BAD

by JAME P. MASCARO

Look through any news source and you can probably find a story about companies fighting over product ideas, customers, or employees. Competition is fierce. It stands to get only more fierce as information becomes more easily transferable, customers more demanding, and employees more mobile. To protect themselves from increasing competition, businesses often use non-competition agreements to prevent former employees from taking information and customers to their competitors. Many business owners may be surprised to find, however, that non-competition agreements—otherwise known as "covenants not to compete"—generally are illegal in California. But like most general rules, this one has exceptions. This article will summarize the current state of the law, provide a brief overview of some exceptions that allow non-competition agreements, and highlight some of the problems that face companies that use employment contracts to protect themselves against competition.

The prohibition against non-competition agreements is not new.

In 1872, the California legislature enacted Civil Code section 1673. That law was the predecessor to Business and Professions Code section 16600, and has remained unchanged since its inception. Section 16600 provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." This general rule reflects the long-standing "legislative policy in favor of open competition and employee mobility." *Edwards v. Arthur Anderson LLP*, 44 Cal. 4th 937, 946 (2008). The relatively recent *Edwards* case is considered by many to be a landmark ruling that abolished the "rule of reasonableness" that allowed common law exceptions to the prohibition against covenants not to compete. In fact, the case merely affirmed that specific statutory exceptions are the only way around section 16600.

The *Edwards* case concerned a non-competition agreement Edwards signed when he went to work as an accountant for Anderson. The agreement prohibited Edwards from working for a competitor for a period of eighteen months following his separation. After the Justice Department indicted Anderson for its role in the Enron scandal, HSBC agreed to purchase several work groups from Anderson and offered Edwards a job. As a condition of his employment with HSBC, the company (and Anderson) demanded that Edwards sign a Termination of Non-Competition Agreement (TONC) that included a release of all possible claims against Anderson. When Edwards refused to sign the TONC, Anderson terminated his employment, and HSBC withdrew its job offer. Edwards then sued Anderson for intentionally interfering with his employment contract with HSBC. An essential element of the claim was that the non-competition agreement was illegal. The trial court entered judgment against Edwards, finding that the narrowly tailored non-competition agreement was enforceable because it was reasonable in scope and duration.

Edwards argued in the Supreme Court that it was unlawful for Anderson to demand consideration for a release from an illegal non-competition agreement. Anderson argued that the agreement was legal because it was narrowly tailored and did not totally prohibit Edwards from working as an accountant. While reiterating the long-standing California tradition prohibiting covenants not to compete, and rejecting any notion that narrowly tailored common law exceptions are permitted, the *Edwards* court made clear that the only exceptions to section 16600 are statutory. "Noncompetition agreements are invalid under section 16600 in California, even if narrowly drawn, unless they fall within the applicable statutory exceptions of sections 16601, 16602, or 16602.5." *Edwards*, 44 Cal. 4th at 955. After *Edwards*, there should be no doubt that the only exceptions to section 16600 are statutory and narrow.

The primary exception applies to agreements for the sale of the goodwill of a business.

Section 16601 provides the primary exceptions to section 16600. The statute states, in pertinent part, that:

> [a]ny person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity . . . may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold . . . has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein.

Courts will not enjoin a competitor's use of valuable or important information that does not qualify as a legally protectable trade secret.

The section defines "business entity" to include a corporation, limited liability company, or partnership.

The exception can significantly impact a closely held business that relies upon the expertise, experience, or both, of key employees. Typically, small business founders execute redemption agreements that allow or require the company to repurchase a departing stakeholder's interest. These agreements are usually accompanied by non-competition agreements. When these redemption agreements are triggered—oftentimes when a minority stakeholder recognizes a better opportunity with a competitor—the non-competition agreement prevents the selling stakeholder from leaving to compete against his or her former company. Section 16601 permits this arrangement, but the exception is not without potential problems.

Redemption agreements usually include formulas for calculating a purchase price. Although the redeeming company may find it attractive to negotiate the lowest possible redemption price, companies must be careful to ensure the price includes goodwill. "Simply selling shares to an individual vendee or back to the corporation does not necessarily demonstrate that goodwill is part of the agreement." *Hill Med. Corp. v. Wycoff*, 86 Cal. App. 4th 895, 904 (2001). Not including goodwill in the redemption would undermine the exception's purpose by permitting the selling entity to have its cake and eat it too. It would be permitted to retain the value of its goodwill, prevent the former stakeholder from receiving the full benefit of the sale, and prohibit the seller from engaging in his or her chosen professional endeavor. Despite all this, even a minority shareholder—no matter how small—may be bound by a covenant not to compete with the purchaser where the redemption price is at arm's length and includes goodwill. *Vacco Indus., Inc. v. Van Den Berg*, 5 Cal. App. 4th 34 (1992). To ensure compliance with section 16601, parties should record all the details of the sale, retain independent valuation experts, and ensure the sales price is fairly calculated and includes goodwill. Otherwise, a court might conclude the relevant agreement was a sham designed to circumvent section 16600. *See Bosley Med. Corp. v. Abramson*, 161 Cal. App. 3d 284 (1984).

An enforceable non-competition agreement is limited in scope.

Under section 16601 a non-competition agreement must be limited in scope to the geographic area where the sold business was "carried on." Courts will interpret the scope of the phrase "carried on" to include anywhere the goodwill of the business has been established. The area where a business is "carried on" is more than merely the physical location of the company's offices or production facilities. *See Monogram Indus., Inc. v. Sar Indus., Inc.*, 64 Cal. App. 3d 692, 702 (1976). For example, the non-competition agreement in *Monogram* prohibited the company's former employees from soliciting customers across America. Because the plaintiff had established goodwill throughout the nation, the court found that the scope of the agreement permissible. By contrast, *In re Marriage of Greaux and Mermin*, 223 Cal. App. 4th 1242 (2014) concerned divorce proceedings where the family court awarded the family rum business to the husband and ordered the wife not to work anywhere in the rum industry for five years. The court of appeal allowed the non-competition order, but remanded for further proceedings because the order restraining the wife imposed no geographical restriction. Before drafting or attempting to enforce a non-competition agreement, parties should carefully assess the reach of the seller's goodwill, and make sure the scope of the agreement reaches far enough—but not too far.

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Specific statutory exceptions are the only way around section 16600.

Employing an unenforceable non-competition agreement may be construed as an unlawful, unfair, or fraudulent business practice.

Employers should be warned that attempting to enforce an invalid non-competition agreement can itself spell trouble. At least one court has ruled that using an unenforceable non-competition agreement may constitute "unlawful, unfair or fraudulent business practices" under section 17200. Although perhaps limited to the unique facts of the case, *Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998), provides an instructive warning against being overly aggressive with a covenant not to compete.

In *Hunter Group*, a computer consultant working for a Maryland company accepted a California competitor's job offer. The Maryland company "use[d] the covenant not to compete for the admitted purpose of deterring and preventing the solicitation, recruitment and hiring of [its] employees by its competitors, especially those in California." The California company and the recruited employee sued to establish that the employee's non-competition agreement was unenforceable and could not prevent the California company from soliciting and hiring the California non-resident. The court of appeal affirmed the trial court order finding that the non-competition agreement was unenforceable.

None of this seems extraordinary, but the trial court further concluded that the Maryland company's use of an impermissible non-competition agreement constituted unfair competition under section 17200. The court of appeal agreed, finding that an "employer's business practices concerning its employees are within the scope of section 17200." *Id.* at 907. The opinion suggests that the court's holding was based, in part, on the fact that the Maryland defendant "repeatedly threatened and attempted to 'enforce' the relevant 'contract' against a California company that had no contractual ties to the Maryland company." *Id.* at 904. Despite what appears to be a factually narrow holding, the court said nothing to suggest the holding cannot be widely applied.

The so-called trade secret exception to section 16600 is alive and well.

While it rejected the notion that the common law allows narrowly tailored non-competition agreements, the *Edwards* court noted that it was not considering what many characterize as another common law exception to section 16600—the so-called trade secret exception. It did not need to. It is well settled in California that "former employees may not misappropriate the former employer's trade secrets to unfairly compete with the former employer." *Retirement Group v. Galante*, 176 Cal. App. 4th 1226, 1237 (2009). This so-called exception effectively allows agreements which prohibit employees from misappropriating trade secrets. Strictly speaking, however, this is no exception at all. Courts will enjoin the misappropriation of trade secret information, "*not* because it falls within a judicially-created 'exception' to section 16600's ban on contractual nonsolicitation clauses, but is instead enjoinable because it is wrongful independent of any contractual undertaking." *Id.* at 1238. The ability to prevent the misappropriation of trade secrets by current and former employees is alive and well.

Although businesses should have no trouble convincing a court that trade secret misappropriation is enjoinable, establishing the elements of the claim can present a problem. Courts will not enjoin a competitor's use of valuable or important information that does not qualify as a legally protectable trade secret. "Labeling information as a trade secret or as confidential information does not conclusively establish that the information fits this description." *Thompson v. Impaxx, Inc.*, 113 Cal. App. 4th 1425, 1430 (2003). For example, customer contact information does not necessarily qualify as trade secret unless the information derives independent economic value from being generally unknown to the public or other persons who might find the information valuable, and the information is subject to reasonable attempts to maintain its secrecy. Parties and their counsel would be wise to thoroughly analyze whether information qualifies as a protectable trade secret, or whether it may merely be important information openly available to the market, before rushing into court seeking injunctive relief.

Conclusion

Absent certain limited exceptions, employment contracts designed to prevent former employees from working in competition with their former employers are generally illegal and will not be enforced. However, courts will enforce narrowly tailored covenants not to compete given in conjunction with the sale of the goodwill of a business, and will enjoin current and former employees from misappropriating trade secrets from their employers, whether or not the conduct is prohibited by an employment contract.

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