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New Risks for California Businesses in Drafting and Enforcing Customer and Employee Non-Solicitation Agreements

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I. Introduction

Employment agreements, separation agreements, and contracts to sell a business often contain provisions limiting a party's right to solicit customers or employees, at least for a fixed period of time. Two recent decisions from the California Court of Appeal, *Edwards v. Arthur Andersen LLP*[1] and *Strategix, Ltd. v. Infocrossing West, Inc.*[2], increase the risk that such provisions will be unenforceable, or even that including such restrictions in an agreement can give rise to tort liability. Understanding the new framework is vital for attorneys and business people involved in California transactions containing any restriction on competition.

As a general rule, California law prohibits "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind."[3] The Legislature has created exceptions for restrictions on competition contained in agreements relating to the sale of the goodwill of a business or the dissolution of a partnership or limited liability company.[4] The courts have long recognized a third exception: agreements restraining competition may be enforced to the extent necessary to protect trade secrets.[5] The *Edwards* and *Strategix* decisions narrow the scope of these exceptions and impose important new limitations on agreements restricting solicitations of customers and employees.

II. Edwards v. Arthur Andersen LLP

In the *Edwards* case, which the California Supreme Court has agreed to Review, the Court of Appeal for the Second Appellate District considered whether California's statutory prohibitions on non-competition agreements were subject to a "narrow restraint exception," as some federal cases had held.[6] *Edwards* arose from the demise of Arthur Andersen LLP. Edwards was a tax manager who, as a condition of his employment with Andersen, had signed Andersen's standard non-competition agreement. This agreement contained three key provisions, prohibiting Edwards from (1) performing services for 18 months after employment termination for any Andersen clients for whom he worked in the 18 months before his termination; (2) soliciting for 12 months after termination any clients of the Andersen office to which Edwards was assigned in the 18 months before his termination; and (3) soliciting for 18 months after termination any professional personnel of Andersen.

When Andersen went out of business, it sold its Los Angeles tax practice to HSBC, which then extended offers of employment to Andersen's personnel, including Edwards. As a condition to releasing Edwards and others from their non-compete agreements, Andersen required them to sign a "Termination of Non-Compete Agreement" (the "TONC"), which contained a broad release of claims against Andersen. When Edwards refused to sign the TONC, HSBC withdrew its offer of employment. Edwards then sued Andersen, alleging that Andersen had interfered with his prospective economic advantage by refusing to release him from the non-compete agreement. The case turned on whether Andersen's refusal was a "wrongful" act of interference.

The Court of Appeal held that Edwards stated an actionable claim, reasoning that the provisions of the non-compete prohibiting Edwards from soliciting Andersen clients were unenforceable under California law,[7] and it was therefore wrongful for Andersen to use them as leverage to obtain a release. The court rejected Andersen's argument that the non-solicitation provisions were enforceable because

they were narrowly tailored in time and scope and left a substantial portion of the market available to the employee (i.e.,every potential client for tax services, including some Andersen clients). The court held that the federal court's "narrow restraint" exception to California's prohibition on non-compete agreements "is a misapplication of California law when applied to an employee's non-competition agreement."[8]

The court reasoned that there was no indication of any legislative intent to permit a "narrow restraint" exception and that public policy concerns militated against creating one. In the court's view, under "the narrow restraint exception, employers have an incentive to draft non-competition agreements that push the envelope of the 'narrowness' requirement" and "burden a terminated employee with the task of guessing, at his or her peril, whether a court might find particular restrictions sufficiently narrow or overly broad."[9] The court noted that employees "are likely to assume contractual terms proposed by their employer are legal and, in any event, will be reluctant to commit the energy and resources to challenging a non-competition agreement in court."[10]

Edwards also held that the release Andersen demanded from Edwards was also wrongful because it was too broad. The Andersen release was a typical general release of "any and all actions, causes of actions, claims . . . of any nature whatsoever . . . that Employee now has . . . ."[11] The release did not contain an exception for an employee's statutory right to be indemnified by his or employer "for all necessary expenditures or losses incurred by the employee in discharge of his or her duties, or of his or her obedience to the directions of the employer."[12] Even though, by statute, any agreement by an employee to waive this right to indemnity is void,[13] the court held that Andersen's insistence on obtaining a release that purported to do so was wrongful. Again the court's reasoning is grounded in public policy and the realities of the marketplace, where "'the *in terrorem* effect of the Agreement will tend to secure employee compliance with its illegal terms in the vast majority of cases.'"[14]

One other aspect of the *Edwards* case is worthy of note, in light of the *Strategix* opinion issued shortly thereafter. In *Edwards*, Andersen argued that its use of the non-compete agreement was not wrongful, even if the provisions prohibiting solicitation of its *clients* were unenforceable, because the provision prohibiting solicitation of its *employees* was enforceable. The *Edwards* court cites California case law holding that anti-raiding provisions are not invalid under California's prohibition on non-compete agreements, but does so without comment. [15] Nevertheless, the court rejected Andersen's argument on the grounds of well-established public policy: "Andersen's argument implicitly rests on the assumption that the invalid non-competition provisions can be severed from the anti-raiding provision. We and other courts have rejected this approach. As we have explained, an employer cannot lawfully make an employee's signing of an employment agreement containing an unenforceable covenant not to compete a condition of continued employment, 'even if such agreement contains choice of law or severability provisions which would enable the employer to enforce the other provisions of the employment agreement.'"[16] The court concluded that "[s]evering the non-competition and anti-raiding provisions" in the Andersen agreement would not serve the public policy expressed in California's statutory prohibition on agreements restraining competition.

III. Strategix v. Infocrossing

Less than two weeks after *Edwards*, the Court of Appeal for the Fourth Appellate District decided *Strategix*. The case arose from a routine transaction: Strategix sold its goodwill and substantially all of its assets to Infocrossing. In connection with the sale, the parties entered into a consulting agreement containing two key restrictions. The first prohibited Strategix from soliciting Infocrossing's customers for one year after the end of consulting relationship. The second prohibited Strategix from soliciting Infocrossing's employees for the same period. Strategix (the seller) soon rescinded the agreements and filed suit against Infocrossing (the buyer), alleging that Infocrossing breached the consulting agreement and caused a failure of consideration. Infocrossing countersued, alleging that Strategix had breached the nonsolicitation provisions of the consulting agreement. Enforcing these provisions, the trial court issued a preliminary injunction barring Strategix from soliciting Infocrossing's employees or customers.

The Court of Appeal reversed. Although California Business and Professions Code section 16601 expressly allows restraints on competition in connection with the sale of the goodwill of a business, the appellate court held that the nonsolicitation covenants were "broader than permitted by the statute that authorizes noncompetition covenants reached in connection with the sale of a business."[17] Specifically, the court found that the covenants "wrongly barred [the seller] from soliciting *the buyer's* employees and customers, rather than the former employees and customers of the seller."[18] As a result, the court found that the provisions were unenforceable, in their entirety.

In holding that an agreement may not lawfully prohibit a seller from soliciting those who were not customers of the business being sold, *Strategix* significantly narrowed the scope of section 16601. On its face, section 16601 appears to permit any agreement prohibiting the seller from "carrying on a similar business" in a specified geographic area. Nonetheless, the court reasoned that the purpose of section 16601 is "to permit the purchaser of a business to protect himself or itself against competition from the seller which competition would have the effect of reducing the value of the property right that was acquired."[19] Because the prohibitions at issue in *Strategix* extended to customers and employees who were not associated with the business being sold, the restrictions were not necessary to protect the value of the assets that the buyer had purchased.

Perhaps more significantly, *Strategix* held that the consulting agreement at issue also unlawfully restrained competition by prohibiting the seller from soliciting the buyer's employees. California courts have frequently invalidated contracts restricting solicitations of a competitor's customers.[20] Yet previous case law declined to hold that provisions precluding solicitation of *employees* violate California's restrictions on non-competition agreements.[21] Now, based on *Strategix*, it appears that restrictions on employee solicitations may be subjected to the same scrutiny applied to restrictions on customer solicitations.

Finally, as in *Edwards*, the *Strategix* court held that the presence of overbroad restrictions precluded enforcement of more narrow limitations on competition. The court found that the parties could lawfully have agreed to prevent the seller from soliciting its own former employees and former customers following the sale of the business. Furthermore, the court recognized that other courts have "blue penciled" overbroad non-competition agreements to make them enforceable. Yet the court "decline[d] to rewrite the overbroad covenants" to which the parties in *Strategix* had actually agreed. The court held, "[h]ad the parties intended to reach such limited – and enforceable – covenants, they could have negotiated for them. We will not do so for the parties now."[22]

IV. Implications of Edwards and Strategix

The *Edwards* and *Strategix* decisions are important for several reasons. First, both cases emphasize that any agreement restraining competition will be subjected to strict judicial scrutiny, no matter how slight the impact on competition. *Edwards* rejects as a "misapplication of California law" the "narrow restraint" exception created by federal courts to California's prohibition on agreements prohibiting former employees from soliciting the clients or customers of their former employer.[23] The decision makes it clear that such provisions, no matter how restricted in time or scope, are unenforceable unless one of the statutory or judicial exceptions applies. Likewise, *Strategix* demonstrates that, even when such an exception applies, an agreement's limitation on competition may be no greater than what is required to serve the public policy underlying the exception.

Second, the cases have far reaching implications for agreements between employers and their employees. *Edwards* held that employers may be subject to tort liability if they attempt to enforce unlawful non-compete agreements or if they seek broad general releases from employees, unless those releases expressly make an exception for an employee's statutory right to be indemnified by the employer for any losses or expenses the employee incurs arising out of the employment. *Strategix* held that agreements restricting solicitations of employees may be subjected to the same scrutiny applied to agreements restricting solicitations of customers. Because prior California case law held such provisions to be enforceable, employment agreements often contain provisions preventing employees from "raiding" their former co-workers for a period of time after their employment ends. Such provisions also appear in other contexts, including non-disclosure agreements, separation agreements, and settlements. All these agreements are now vulnerable to challenge, unless they are carefully drafted to fall within an exception to California's prohibition on restraints on competition.[24]

Finally, *Edwards* and *Strategix* make it clear that courts will not sanction overreaching in non-competition agreements. Even though the *Edwards* court found nothing wrong with the underlying agreement's restrictions on employee solicitations, it nonetheless found the employer's enforcement of the non-compete agreement to be wrongful because it also included improper restrictions on customer solicitations. Likewise, the *Strategix* court refused to enforce even those aspects of the non-competition provisions that it determined were valid, declining to "strike a new bargain 'for purposes of saving an illegal contract.'"[25] Like the *Edwards* decision, *Strategix* demonstrates judicial intolerance for employers' inclusion of overbroad non-competition provisions in otherwise permissible agreements. At a minimum, the cases illustrate the risk that, by including such provisions, a party may forfeit the right to enforce more narrow restraints. Courts may choose not to assist employers by severing unenforceable provisions from enforceable provisions, and may even impose tort liability on employers who attempt to use unenforceable provisions to their advantage.

V. Lessons for Practitioners

Attorneys negotiating or drafting agreements restricting solicitation of employees or customers should be mindful of the limitations that the *Edwards* and *Strategix* courts have imposed. At the same time, the decisions provide guidelines that can help minimize the risk that such agreements will be invalidated:

1. Non-solicitation provisions connected with the sale of a business should be limited to the customers of the business being sold.
2. Employee non-solicitation provisions should be tailored to fit into one of the recognized exceptions to Business and Professions Code section 16600.
3. Restrictions on solicitation of employees or customers should be limited, in time, geography and scope, and expressly tied to the protection of the employer's trade secrets or, in the context of a sale of a business, its goodwill.
4. Including a range of restrictions from broad to narrow coupled with provisions for severability may increase the likelihood a court will enforce provisions it finds lawful, but there is a substantial risk that a court will not do so to better serve California's public policy against restraints on competition.

VI. Conclusion

The *Edwards* and *Strategix* cases create new challenges and risks for employers attempting to prevent former employees and others from soliciting their customers and employees. These risks include judicial refusal to enforce non-solicitation agreements in their entirety if any provision or aspect of such an agreement is deemed unenforceable, and potential tort liability for an employer's attempt to enforce an unenforceable non-solicitation agreement or use it as leverage. These cases mandate caution and greater care than ever before in the drafting and enforcement of agreements restricting the solicitation of customers or employees. ■

Endnotes

[1] (2006) 142 Cal.App. 4th 603 (Sept. 1, 2006; petition for review by Cal. Supreme Court granted Nov. 29, 2006).

[2] (2006) 142 Cal.App. 4th 1068 (Sept. 12, 2006).

[3] Bus. & Prof. Code, § 16600.

[4] Bus. & Prof. Code, §§ 16601-16602.5.

[5] *Muggill v. Reuben H. Donnelley Corp.* (1965) 62 Cal. 2d 239, 242.

[6] See, e.g., *General Commercial Packaging v. TPS Package Engineering, Inc.* (9th Cir. 1997) 126 F.3d 1131, 1134.

[7] Citing Bus. & Prof. Code, § 16600.

[8] *Edwards*, *supra*, (2006) 142 Cal.App. 4th 603 at p. 620.

[9] *Id*. at p. 622.

[10] *Id*.

[11] *Id*. at p. 627.

[12] Lab. Code, § 2802.

[13] Lab. Code, § 2804.

[14] *Edwards*, *supra*, (2006) 142 Cal.App. 4th 603 at p. 632 (citing *Latona v. Aetna U.S. Healthcare Inc*. (C.D. Cal. 1999) 82 F.Supp.2d 1089, 1096).

[15] In support of this argument, Andersen cited *Loral Corp. v. Moyes* (1985) 174 Cal. App. 3d 268, 280 (holding that an anti-raiding provision was not invalid under Business and Professions Code section 16600). See *Edwards*, *supra*, (2006) 142 Cal.App. 4th 603 at p. 625-626.

[16] *Id*. at p. 626 (citing *D'Sa v. Playhut, Inc*. (2000) 85 Cal. App. 4th 927, 929).

[17] *Strategix*, *supra*, (2006) Cal.App. 4that p. 1068.

[18] *Id.* (emphasis in original).

[19] *Id.* at p. 1072.

[20] *See, e.g., Edwards, supra,* (2006) Cal.App. 4th at 614 (discussing cases rejecting provisions restricting customer solicitations).

[21] See, e.g., *Loral Corporation v. Moyes* (1985) 174 Cal.App. 3d 268 (upholding agreement prohibiting former executive from soliciting employees of his former employer).

[22] *Strategix, supra,* (2006) Cal.App. 4th at p. 1074.

[23] *Edwards, supra,* (2006) Cal.App. 4th at p. 624.

[24] Pending action by the California Supreme Court, *Strategix* creates a conflict in California appellate precedent to the extent that it contradicts *Loral, supra,* (1985) 174 Cal.App. 3d.

[25] *Strategix, supra,* (2006) Cal.App. 4th at p. 1024 (quoting *Kolani v. Gluska* (1998) 64 Cal.App. 4th 402, 406).