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The Uncertain State of Employee Nonsolicitation Clauses in California

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Abstract

Employee nonsolicitation clauses continue to be a common feature of employment agreements in California. While Section 16600 of the California Business and Professions Code prohibits contractual restraints on the practice of a lawful profession, trade or business, in 1985, the California Court of Appeal held that employee nonsolicitation clauses do not violate Section 16600 because they do not significantly affect employees’ ability to engage in a lawful profession, trade or business. In a recent decision, however, the California Supreme Court pronounced that Section 16600 is violated even if a covenant does not completely preclude one from engaging in a lawful profession, trade or business, and invalidated a noncompetition clause at stake in that case. The Supreme Court’s decision raises questions about the continued validity of nonsolicitation clauses, as well as the so-called trade secret “exception” to covenants restricting trade. This article attempts to answer the question whether employee nonsolicitation clauses continue to be valid in light of the California Supreme Court’s decision and the evolution of the law of restrictive covenants over the past twenty-five years.

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I. Introduction

In *Edwards v. Arthur Andersen LLP*,\(^1\) the California Supreme Court held that noncompete agreements are invalid under Section 16600 of the California Business and Professions Code and rejected the Ninth Circuit’s “narrow restraint” doctrine that allows such agreements if they are narrowly drawn. While the decision has marked a consensus on the general invalidity of noncompetition agreements, disagreement remains as to the impact of that decision on other restrictive covenants, and in particular on employee nonsolicitation clauses, also known as “anti-raiding” clauses. The Supreme Court has offered no clear guidance directly on the issue and very few court decisions have addressed the validity of employee nonsolicitation agreements at all.

Due to the dearth of judicial guidance as to the validity of employee nonsolicitation clauses, employers continue to include these clauses in employment agreements. There is reason to believe, however, that such clauses are no longer valid in California. This article analyzes the extent to which employee nonsolicitation clauses remain enforceable in California post-*Edwards*, and concludes that *Edwards* likely vitiated earlier caselaw upholding employee nonsolicitation clauses such as *Loral Corp. v. Moyes.*\(^2\) If and when the Supreme Court chooses to opine on the validity of such clauses, it will likely hold that they have been rendered unenforceable by Section 16600.

Another unresolved issue left by *Edwards*, is the continued validity of the so-called trade secret “exception,” a judicially created doctrine, according to which restrictive covenants could be valid if they are necessary to protect employer’s trade secrets. To the extent that the “trade secret” exception is still alive, employee nonsolicitation clauses may be valid if they are carefully drawn to restrict solicitation of employees, whose identities – a very rare circumstance in practice – constitute a trade secret.

II. Section 16600 and Its Interpretations

Restrictive covenants have traditionally been tested under Section 16600 of the California Business and Professions Code, which derives from a statute enacted in 1872. Section 16600 provides:

> 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.

The chapter excepts noncompetition agreements in the sale or dissolution of corporations,\(^3\) partnerships,\(^4\) and limited liability corporations.\(^5\) Section 16600 “expresses California’s strong public policy of protecting the right of its citizens to pursue any lawful employment and enterprise of their choice.”\(^6\) In enacting Section 16600, California rejected the so-called “rule of reasonableness” enforced by many states according to which a restraint on the practice of a trade or occupation is valid if reasonable.

The enactment of Section 16600 did not, however, solve the issue of restrictive covenants as completely as the legislature may have hoped. Courts disagreed as to what agreements were subject
to Section 16600, whether restrictive covenants limited in their terms nonetheless passed muster under Section 16600, and whether there were exceptions to the rule. Some California courts distinguished between noncompetition agreements -- generally held invalid -- and nonsolicitation agreements -- held valid if reasonable in terms of time, activity and territory to protect the buyer’s interest. Other, more recent cases, have tended to view noncompetition and nonsolicitation agreements as two sides of the same coin, all subject to Section 16600, and invalid unless necessary to protect an employer’s trade secrets.

Yet other California courts embraced the “narrow restraint” doctrine adopted by the Ninth Circuit in applying California law. The “narrow restraint” doctrine accepts that the reasonableness analysis has no application when a covenant restrains trade, and instead focuses on what constitutes one’s trade and profession. Restraints that do not completely preclude one from engaging in a lawful profession, trade or business are enforceable.

III. Key Decisions on Employee Nonsolicitation Clauses

a. Loral Corp. v. Moyes

The validity of an employee nonsolicitation agreement under Section 16600 was established in Loral Corp. v. Moyes, which remains the only published California case on the issue. In Loral, plaintiff Loral Corporation and its subsidiary brought suit against former executive officer Robert Moyes for breach of his termination agreement, claiming that he induced other Loral employees to work for Moyes’s new employer. The agreement in question provided for preservation of the confidentiality of all trade secrets and other confidential information of Loral Corporation and its subsidiaries, and further provided that Moyes:

“... will not now or in the future disrupt, damage, impair or interfere with the business of Conic Corporation, or its TerraCom Division whether by way of interfering with or raiding its employees, disrupting its relationships with customers, agents, representatives or vendors or otherwise. You are not however, restricted from being employed by or engaged in a competing business.”

The trial court granted Moyes’s judgment of nonsuit, but the Court of Appeal reversed in part, holding that the agreement did not on its face violate Section 16600. To reach that conclusion, the Court considered whether the employee nonsolicitation agreement “is more like a noncompetition agreement,” that penalizes a former employee for obtaining employment with a competitor, and is invalid (unless necessary to protect employer’s trade secrets); or “a nondisclosure agreement or nonsolicitation agreement,” that only “delimit[] how [an employee] may compete,” and “may be valid.”

While the court concluded that the employee nonsolicitation clause was similar to customer solicitation and nondisclosure clauses, it refused to adopt the holding of Hollingsworth Solderless Terminal Co. v. Turley, a federal case relied on by Moyes, that also concerned a customer nonsolicitation clause. Hollingsworth held that under California law, the “employer will be able to
restrain by contract only that conduct of the former employee that would have been subject to judicial restraint under the law of unfair competition or trade secrets, absent the contract.”

Instead of Hollingsworth, the court relied on two Georgia cases, Lane Co. v. Taylor,17 and Harrison v. Sarah Coventry, Inc.18 In Lane, the court approved an employee no-hiring clause, i.e., a clause that prohibits a former employee from hiring away personnel of the company, because it was “reasonable and ‘needed to protect legitimate business interests.’”19 In Harrison, the court found no restraint of trade because the employee nonsolicitation clause allowed the defendants to work for a competitor, so long as they did not interfere with their former employer’s contractual relationships or divulged the names of former co-workers.

Drawing from Lane and Harrison, Loral concluded that the impact on trade must be considered before invalidating an employee nonsolicitation agreement. The court found that the impact of the agreement before it was no more significant than “a restraint on solicitation of customers or on disclosure of confidential information.” The agreement permitted Moyes to be employed by or engage in a competing business. Plaintiff’s employees were also only slightly affected by the restriction: they were not hampered from seeking employment with Moyes’s new employer, nor from contacting Moyes; all they lost was the possibility of being contacted by him first. The court observed that while the agreement had the apparent impact of limiting Moyes’s new employer’s business practice in a small way to promote his old employer’s business practice, it had “no overall negative impact on trade or business.”

One reading of Loral is that employee nonsolicitation clauses are restrictive covenants that are enforceable if the restraint is reasonable, “evaluated in terms of the employer, the employee, and the public.”21 However, this reading is probably not a correct one because the Loral court could not have applied the rule of reasonableness that has been rejected in California when California enacted Section 16600. Another, more probable, reading of Loral is that employee nonsolicitation clauses are not covenants restraining trade implicating Section 16600 so long as the clause is reasonable in its terms. Under both readings, Loral stands for the proposition that an employee nonsolicitation clause may be broader than what the law of the market would otherwise prohibit, i.e., the clause may be broader than what is necessary to protect employer’s trade secrets.

The Loral court justified the nonsolicitation agreement in part because it did not restrain Plaintiff’s employees from being employed by the defendant’s new employer. Somewhat paradoxically, because the court relied on Lane Co. v. Taylor, upholding a no-hire clause, the Loral decision suggested that a no-hire clause would not have been valid.22

b. Cases After Loral Corp. v. Moyes

Loral’s holding has generally been approved by the few courts that have dealt with the validity of the employee nonsolicitation clauses and continues to be held out as the law of the state.23 At the same time, the last decade has been marked by a progressive narrowing of permissible restrictive covenants. In Thompson v. Impaxx, Inc.,24 for example, the court held that “a mere limited restrictive covenant not to solicit” customers was, like a noncompetition clause, subject to Section 16600. The court rejected the same arguments in support of the validity of the customer
nonsolicitation clause that were successfully advanced in *Loral* in support of the employee nonsolicitation clause -- that the covenant was limited in time; that it did not prevent the former employee from working for a competitor or a former customer; and that it did not prevent the former employee from soliciting customers with whom he had no prior dealings.

Further, in *VL Systems, Inc. v. Unisen Inc.*,\(^25\) the court held that a broad no-hire clause was unenforceable.

c. **Edwards v. Arthur Andersen LLP**

In 2009, the California Supreme Court issued *Edwards v. Arthur Andersen LLP*,\(^26\) in which it rejected the Ninth Circuit’s narrow restraint doctrine and held that noncompetition agreements are invalid under Section 16600. In that case, Edwards, a certified public accountant, signed as a condition of employment with Arthur Andersen an 18-month noncompetition and customer nonsolicitation agreement. The agreement also contained an employee nonsolicitation clause.

After the Enron scandal ruined Arthur Anderson’s business, Arthur Andersen sold Edward’s practice group to HSBC USA Inc. HSBC offered Edwards employment, but on the condition that Arthur Andersen terminates the noncompetition and nonsolicitation clauses in Edwards’s employment agreement, which Arthur Anderson was willing to do if Edwards released all claims against it. When Edwards refused to release the claims, he was terminated by Andersen, and HSBC withdrew its offer of employment. Edwards then sued Andersen for, in relevant part, intentional interference with prospective economic advantage and anticompetitive business practices based on violations of Section 16600.

The trial court held as a matter of law that (1) the noncompetition agreement fell within the “narrow restraint” exception to Section 16600, and that (2) the employee nonsolicitation clause was lawful.\(^27\) The Court of Appeal reversed, finding that noncompetition clauses were invalid under Section 16600 unless they fell within the limited statutory exceptions, or unless they protected trade secrets.\(^28\) The court found that the “narrow restraint” doctrine was a misapplication of California law “when applied to employee’s noncompetition agreement.”\(^29\) The court further found that the “customer nonsolicitation” clause clearly restricted Edwards from practicing his profession because the clause prohibited him from rendering services to Andersen’s clients “even if the client approached Edwards and requested his services.”\(^30\)

Edwards did not contend that the employee nonsolicitation clause violated Section 16600 and therefore the Court of Appeal did not consider that issue.\(^31\) Instead, the court focused on the value of the employee nonsolicitation clause for purposes of providing consideration for Edwards’s release of claims against Arthur Andersen. The Court found that because “Andersen was going out of business and selling off its practice groups,” it was not clear whether the employee nonsolicitation clause had any value, and even if it did, it was not severable from the other invalid provisions of the noncompetition clause.\(^32\) Therefore, it was improper for Arthur Andersen to require Edwards to sign the release of claims in exchange of termination of the valueless or invalid provisions.
The Supreme Court affirmed in relevant part. The Court agreed with the Court of Appeals that there is no “narrow restraint” exception in California, and therefore even “narrowly tailored” noncompetition agreements, are invalid. The court also confirmed that the only exceptions to section 16600 are the statutory exceptions. In applying these principles, the court found that the noncompetition and customer nonsolicitation clauses restricted Edwards from performing work for Arthur Andersen’s clients and therefore restricted his ability to practice his accounting profession. Accordingly, the court found these clauses invalid. The court did not address the validity of the anti-raiding clause.

IV. To What Extent is Loral’s Holding Regarding Employee Nonsolicitation Agreements Still Valid?

Neither the Supreme Court nor the Court of Appeal in Edwards discussed the validity of employee nonsolicitation clauses. At the same time, Edwards appears to go beyond the specific clauses at issue in that case and pose general principles concerning clauses restraining trade. The fundamental question then is whether nonsolicitation clauses are clauses that “restrict competition” however narrowly, in which case they are invalid pursuant to Edwards, or whether they are clauses that do not restrict the exercise of one’s trade or profession at all and therefore are not subject to Section 16600, as seems to have concluded Loral.

Thompson v. Impaxx, Inc., holding that customer nonsolicitation agreements were invalid under Section 16600, was cited with approval by the Supreme Court in Edwards. On the other hand, at least one federal court construing California law post-Edwards has held that employee nonsolicitation clauses do not violate Section 16600, but that no-hire clauses do because in California, “restrictions on the solicitation of employees are not necessarily treated in the same way as restrictions on the solicitation of customers.”

It is unquestionable that no-hire clauses are more restrictive than nonsolicitation clauses. To the extent that customer nonsolicitation clauses are invalid, however, it is not clear why employee nonsolicitation agreements should be treated any differently. Both clauses do not entirely prohibit employees from engaging in their profession and both are objectionable in that the restrictions imposed by these agreements affect parties who are not signatories to the underlying contract and in some cases may not even be employees at the time of the agreement.

The distinction between agreements that prohibit or restrict a practice of trade or profession and those that “delimit[] how [an employee] can compete” drawn by Loral also appears artificial. After all, some courts have held that even nondisclosure agreements constitute a restraint on trade. Moreover, the two Georgia cases relied on by Loral are readily distinguishable, making the grounds on which rests Loral even more shaky. Lane Co. v. Taylor concerned an employee no-hiring clause, which today would likely be invalid in California. In Harrison v. Sarah Coventry, Inc., the employee nonsolicitation clause prohibited the former employee from divulging the names of former co-workers, suggesting that the identities of the employees may have been a trade secret. This makes Harrison a poor analogy for Loral where the former employer did not contend that the employee nonsolicitation clause was necessary to protect its trade secrets.
In short, Edwards and the evolution of the law of restrictive covenants since Loral strongly suggest that employee nonsolicitation agreements are no longer valid. This means that many of the considerations relied on prior to Edwards to evaluate the enforceability of such clauses, such as whether the clause covered present or future employees, contract or at will employees, all employees or only those who actually did work for a particular client, have become irrelevant. After Edwards, the only possible limitation on the general invalidity of employee nonsolicitation clauses appears to be whether such clauses are necessary to protect the employer’s trade secrets.

V. Can An Employee Nonsolicitation Clause Be Valid if It Protects Trade Secrets?

Aside from the scope of agreements covered by Edwards, another contentious issue that remains open post-Edwards is whether there is a trade secret “exception” to Section 16600.

While Loral suggested that an employee nonsolicitation clause may be more prohibitive than what is necessary to protect trade secrets, after Loral, a number of California cases limited the validity of customer nonsolicitation covenants only to the extent that “. . . their enforcement is necessary to protect trade secrets.”40 And Edwards may have invalidated the trade secret exception altogether by affirming that Section 16600 has only statutory exceptions. A contractual clause prohibiting theft of trade secrets would thus be invalid, even if the same conduct is prohibited by the Uniform Trade Secrets Act (UTSA). It has also been noted that cases establishing the trade secret exception pre-dated California’s adoption of the UTSA, which eliminated the practical need for such an exception.

On the other hand, the proponents of the trade secret exception point out that Edwards specifically disclaimed ruling on the issue of the trade secret exception.41 It has also been noted that Section 16600 prohibits restraints only on the “lawful” exercise of trade or profession. Because theft of trade secrets is not a lawful exercise of profession, contractual provisions addressing such actions do not contravene Section 16600.42

The post-Edwards decisional law seems to reflect the state of confusion and uncertainty with respect to the existence or the necessity of the trade secret exception left by that decision. Retirement Group v. Galante,43 the first published California decision to discuss Edwards’s reference to the trade secret exception, refused to enforce a contractual clause purporting to ban a former employee from soliciting former customers even where the employer argued that the clause was necessary to protect its trade secrets. In reversing in part the trial court’s ruling on a preliminary injunction, the court found no additional operative value in enjoining solicitations of customers where an injunction already prohibited misappropriation of trade secrets. The court stated that the only reason to enforce the contractual nonsolicitation clause in addition to enjoining misappropriation of trade secrets, would be to bar solicitations not involving trade secrets – “the type of conduct sanctioned by Edwards.”44 Thus, even assuming Galante validates the trade secret exception to nonsolicitation clauses, it calls in question the practical necessity of such clauses.

In another case, Dowell v. Biosense Webster, Inc.,45 the court noted that in light of Edwards and Galante, it doubted “the continued viability of the common law trade secret exception to covenants not to compete.” It further held, “even assuming the exception was still valid,” that the
exception did not apply because the noncompete, customer nonsolicitation and no-hire clauses were “not narrowly tailored or limited to the protection of trade secrets.”\textsuperscript{46} The court held that the broadly worded noncompetition agreement and nonsolicitation agreement restrained the former employees from practicing their professions and therefore were void under Section 16600.

Courts that have assumed the existence of the trade secret exception disagreed on whether it applied to noncompetition agreements or only to customer and employee nonsolicitation agreements.\textsuperscript{47} As to federal courts interpreting California law, they continue to take the position that there is a trade secret exception in California without, however, much analysis of the issue.\textsuperscript{48}

The review of post-\textit{Edwards}’s caselaw shows that if there is a consensus on anything concerning the trade secrets exception, it is that the clause must not be broader than necessary for the protection of trade secrets. To the extent that an employer has trade secret protection law at its disposal, one might ask whether it is worth including employee nonsolicitation clauses in employment agreements given that the legality of such clauses, if at all, depends on the highly factual definition of trade secrets, and the overbreadth of the clause risks invalidation of other potentially valid clauses, such as a nondisclosure provision, that the court might view as unseverable from the unlawful provision.\textsuperscript{49}

The prevailing view, however, is that it is generally advisable to include such clauses in agreements so long as the employer is certain that the information the clause seeks to protect qualifies as trade secrets. This puts the employee on notice and may bolster the employer’s claim that it has afforded the information claimed to be a secret adequate protection.\textsuperscript{50} The inclusion of such a clause in an employment agreement may also bolster the employer’s claim of irreparable harm because there is a threat of a breach of the agreement.

An employment nonsolicitation clause that qualifies for the potential trade secret exception must be such that the act of solicitation itself constitutes a misappropriation of a trade secret. Because California has rejected the inevitable disclosure doctrine that permits an injunction prohibiting employment under the theory that employees will necessarily rely upon knowledge of the former employer’s trade secrets in performing their new job duties, a clause prohibiting solicitation of employees with the purpose of obtaining a former employer’s trade secrets would not be valid in California. But the act of solicitation may constitute a misappropriation of a trade secret if the identity of employees or their skills or salaries are a trade secret.\textsuperscript{51} Courts recognized that where the employer incurred expense in compiling lists of employees and other data pertaining to them and took reasonable steps to ensure the secrecy of information, the lists were a protectable trade secret.\textsuperscript{52}

Thus, in cases (most probably limited to temporary employment agencies and similar entities) where the employer can make a defensible claim that the identities of employees constitute a trade secret, a carefully drafted employee nonsolicitation clause might be upheld. But the issue is far from settled.
VI. Conclusion

The evolution of the law of restrictive covenants in the past decade and the Supreme Court’s Edwards decision strongly suggest that the employee nonsolicitation clauses, like the customer nonsolicitation clauses, are no longer valid. Edward’s holding also raises serious issues about the existence of a trade secret exception to generally invalid nonsolicitation agreements. Employers are advised to exercise caution in including employee nonsolicitation clauses in employment agreements, especially since the context in which employee lists and other information about employees may be defensible as a trade secret is extremely limited.

3 Bus. & Prof. Code § 16601.
4 Bus. & Prof. Code § 16602.
5 Bus. & Prof. Code § 16602.5.
7 See Loral, 174 Cal. App. 3d at 279 (reasonably limited restrictions do not violate Section 16600); Cap Gemeni Am. v. Judd, 597 N.E.2d 1272, 1287 (Ind. Ct. App. 1992) (interpreting California law and applying the reasonableness analysis to employee nonsolicitation clause).
10 See IBM Corp. v. Bajorek, 191 F.3d 103, 1040 (9th Cir. 1999); Gen. Comm. Pkg. v. TPS Pkg., 126 F.3d 1131, 1132 (9th Cir. 1997).
12 Id. at 274.
13 Id. at 276.
14 Hollingsworth Solderless Terminal Co. v. Turley, 622 F.2d 1324, 1338 (9th Cir. 1980).
15 Loral, 174 Cal. App. 3d at 277-278.
16 Hollingsworth, 622 F.2d at 1338.
20 Id. at 278-280.
21 Id. at 279.
22 Notably, the agreement at issue in Loral precluded the former employee from “interfering with or raiding its employees,” which could reasonably be interpreted to comprise a prohibition on hiring as well as solicitation.
23 See, e.g., Cap Gemeni, 597 N.E. 2d at 1287 (applying Loral’s reasonableness analysis to an employee nonsolicitation clause and holding it overbroad and therefore invalid).
24 Thompson, 113 Cal. App. 4th 1425.
28 Id. at 797, 803.
29 Id. at 800.
30 Id. at 797- 798 (citing Thompson, 113 Cal. App. 4th 1425).
31 Id. at 797 n.4
32 Id. at 805.
33 See Edwards, 44 Cal. 4th 937.
34 Id. at 948.
35 Id. at 942.
36 Edwards, 44 Cal. 4th at 948.
39 See Brian M. Malsberger, Employee Noncompetition Law § 3-12 at 3-37 to 3-38 (citing cases).
41 See Edwards, 44 Cal. 4th at 946 n.4.
44 Id. at 1241.
46 Id. at 577.
47 See Nielsen v. Platinum Equity, No. B205605, 2009 WL 2385874, at *4-6(Cal. Ct. App. Aug. 5, 2009) (unpublished) (holding that unlike traditional noncompetition agreements that are invalid per se, customer and employee nonsolicitation clauses are valid if necessary to protect trade secrets; employee’s wrongful termination claim dismissed for failure to plead that customer and employee info was not a trade secret); compare to Majestic Mktg. Inc., No. E047085, 2010 WL 338966 (covenants not to compete may be enforced to the extent that enforcement is necessary to protect a company’s trade secrets; upholding preliminary injunction based on noncompetition agreement protecting trade secrets).
50 See Morlife, Inc. v. Perry, 56 Cal. App. 4th 1514, 1522 (1997) (“While labeling information ‘trade secret’ or ‘confidential information’ does not conclusively establish that the information fits this description . . . , it is nonetheless an important factor in establishing the value which was placed on the information and that it could not be readily derived from publicly-available sources.”)