Noncompetes Are D.O.A. In Calif.

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GUEST COLUMNS

New Final Rule Clarifies FDA's View On Preemption

The effect of the U.S. Food and Drug Administration's final rule on "Supplemental Applications Proposing Labeling Changes for Approved Drugs" is to limit the scenarios in which manufacturers of drugs, biologics and medical devices can change a previously approved label in advance of the FDA's review and approval mechanism, say Sharon L. Caffrey, Karen Shichman Crawford and Paul M. da Costa of Duane Morris LLP.

Noncompetes Are D.O.A. In Calif.

In a significant new opinion with far-reaching national implications, the California Supreme Court has expressly parted company with the U.S. Court of Appeals for the 9th Circuit and other courts by rejecting the so-called narrow restraint exception to the broad statutory prohibition against noncompetes that exists under California law, says Anthony J. Oncidi of Proskauer Rose LLP.

Smith V. Selma: Guidance For Peer Review Bodies

A California appeals court decision, holding that a hospital may not rely solely on the peer review findings of another hospital when considering whether to terminate a physician's medical staff privileges, provides important national guidance for peer review bodies, say Nathaniel M. Lacktman and Shirley P. Morrigan of Foley & Lardner LLP.

In a significant new opinion with far-reaching national implications, the California Supreme Court has expressly parted company with the U.S. Court of Appeals for the 9th Circuit and other courts by rejecting the so-called narrow restraint exception to the broad statutory prohibition against noncompetes that exists under California law (Cal. Bus. & Prof. Code § 16600).

Further, the Supreme Court determined that an employer's use of even an unenforceable noncompete may give rise to a tort claim resulting from interference with a former employee's prospective economic advantage. Edwards v. Arthur Andersen LLP, 189 P.3d 285, 81 Cal. Rptr. 3d 282 (Cal. S. Ct. Aug. 7, 2008). This new opinion affects all employers with employees located in or destined for California.

CPA Raymond Edwards II was hired in 1997 as a tax manager for the Los Angeles office of the now defunct accounting firm Arthur Andersen LLP ("Andersen").

As a condition of his employment, Edwards was required to execute a noncompetition agreement that prohibited his (1) "perform[ing] professional services" for 18 months post-termination on behalf of any client whose account he had handled during the final 18 months of his employment with Andersen; (2) soliciting for 12 months any of the clients he had serviced during his final 18 months at Andersen; and (3) soliciting other Arthur Andersen employees to work for another employer for 18 months post-termination.

Edwards signed the agreement and remained employed through May 2002 when, in the wake of its Enron indictment and pending dissolution, Andersen sold a portion of its Los Angeles tax practice to Wealth and Tax Advisory Services ("WTAS"), a newly formed subsidiary of HSBC Bank.

The HSBC transaction closing was conditioned in part on Andersen's requiring its employees to sign a "Termination of Noncompete Agreement" ("TONC") drafted by Andersen, which in relevant part required that they voluntarily resign from Andersen and release the firm from "any and all" claims in exchange for Andersen's agreement to forgo enforcement of the original noncompetition agreement.

In turn, HSBC conditioned its planned hiring of former Andersen employees, including Edwards, on their execution of the TONC. Edwards signed and returned HSBC's written employment offer, but he refused to sign the TONC (in large part because he was reluctant to sign a waiver that might affect his right to indemnification).

As a result, Andersen terminated Edwards's employment and withheld severance benefits, while HSBC withdrew its offer of employment to Edwards.

In his lawsuit against Andersen, HSBC and WTAS, Edwards alleged, among other things, intentional interference with prospective economic advantage.

On Andersen's motion, the lower court severed the trial on the issue of the enforceability of the noncompetition agreement and the TONC and ruled in favor of Andersen, finding the agreement to be enforceable under the so-called "narrow restraint" exception to Section 16600.

The trial court ruled that because Andersen only sought to prevent Edwards from working on or soliciting the same accounts he had serviced or been exposed to during his final 18 months at Andersen, the restraint did not significantly hamper his freedom of mobility or opportunities for reemployment.

Observed the trial court, "There were more than enough of these wealthy folks in L.A. for all C.P.A.'s to do the kind of work [Edwards] was doing."

Edwards appealed, arguing that even the partial restraint Andersen had imposed was incompatible with the plain language and spirit of Section 16600, which 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."

The court of appeal agreed, holding that the "narrow restraint" exception was irreconcilable with precedent and a distortion of the statute itself.

In affirming this part of the court of appeal's judgment, the Supreme Court noted that California courts have historically read Section 16600 as expressing a fundamental public policy favoring employee mobility and enterprise over a former employer's economic security.

Unlike many states, California has traditionally rejected any approach that purports to balance the competing interests of employer and employee.

Aside from three narrow statutory exceptions – Sections 16601 (the sale of the goodwill or assets of a business), 16602 (partnership dissolution) and 16602.5 (LLC sale or dissolution) – California courts have long held that restrictive covenants are enforceable only to the extent necessary to protect the former employer's trade secrets as defined in Cal. Civ. Code § 3426.1(d) (e.g., confidential compilations, customer lists, programs, devices, methods, techniques, processes and other forms of intellectual property). Thompson v. Impaxx, Inc., 113 Cal. App. 4th 1425 (2003).

In contrast to the state courts' interpretation of Section 16600, federal courts in California have until now been more inclined to apply a "rule of reason" analysis that many other states follow in their noncompete jurisprudence.

In 1987, in ostensible reliance on two mid-20th century California appellate decisions, the Ninth Circuit found a "narrow restraint" exception to Section 16600. Campbell v. Trustees of Leland Stanford Jr. Univ., 817 F.2d 499 (9th Cir. 1987).

In that case, the Ninth Circuit noted an exception to Section 16600 existed under California law "where one is barred from pursuing only a small or limited part of the business, trade or profession."

The Edwards Court, however, rejected in the starkest terms the narrow-restraint exception recognized in Campbell and its more recent progeny.

In the Supreme Court's view, "Section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints [on competition] that were unreasonable or overbroad, it could have included language to that effect."

This means that all forms of "narrow restraint," including, for example, so-called "employee choice" or "garden leave" provisions in which an employee who competes may forfeit stock options, salary continuation or other benefits are unlikely to be enforced under California law.

Edwards is very good news for California employers that find themselves hiring more key employees than they lose because noncompetes and customer non-solicitation provisions will presumably be treated as a nullity by any state or federal court applying California law.

Indeed, simply including such provisions in an employment agreement may give an employee leverage to assert that the employer has tortiously interfered with his or her prospective economic advantage.

Out-of-state employers should take heed of Edwards as well because California courts are reluctant to apply choice-of-law and forum-selection provisions that might adversely affect a California employee's rights under Section 16600. See, e.g., Application Group, Inc. v. Hunter Group, Inc., 61 Cal. App. 4th 881 (1998) (California court properly ignored Maryland choice-of-law provision in noncompete context).

When an out-of-state employer loses an employee with a noncompete/nonsolicitation agreement to a California employer, the chances are enhanced that the new employer will file a declaratory relief action in California seeking to invalidate the agreement.

In such cases, the former employer should lose no time in initiating litigation in its home state seeking to enforce the provision. See, e.g., Google, Inc. v. Microsoft Corp., 415 F. Supp. 2d 1018 (N.D. Cal. 2005) (federal court in California stays action pending outcome of earlier-filed Washington state case).

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