California's Prohibition on Non-Compete Contract Provisions

Summary: Although most employers might prefer non-compete provisions in their employment contracts to protect their business when key employees leave, the State of California's public policy on workplace mobility prohibits such provisions except in very limited circumstances. This article discusses this prohibition, its exceptions, and what employers can do to protect their business.

California Business and Professions Code section 16600

Although some states, permit non-compete clauses that are reasonable in scope, reasonable in duration, and necessary to protect a legitimate business interest,[1] California has long rejected this reasonableness test. Under California Business and Professions Code section 16600,

> 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.

That is, under California law, absent a statutory exception, a non-compete clause in an employment contract that prohibits a former employee from competing against his or her former employer after the termination of his employment is void.

Even limited restraints, such as customer non-solicitation clauses, are void unless the customer lists fall under the definition of a trade secret.[2] Even then, customer lists are generally not trade secrets unless an employer has expended time and effort identifying customers with particular needs or characteristics.[3]

Choice of Law and Forum Selection Clauses

An employer seeking to avoid this reality by inserting favorable choice of law and choice of forum clauses in its employment contracts will most likely be unsuccessful as to its California employees.

Under a conflict of law analysis, California courts will apply the substantive law specified in a contract unless the transaction falls into either of two exceptions: (1) the chosen state has no substantial relationship to the parties or the transaction, or (2) the application of the

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[1] *See e.g., Bdo Seidman v. Hirshberg* (1999) 93 N.Y.2d 382, 389.
[2] *See Edwards v. Arthur Andersen LLP* (2008) 44 Cal.4th 937, 945-950, 946 fn. 4; *Wanke, Industrial, Commercial, Residential, Inc. v. Keck* (2012) 209 Cal.App.4th 1151, 1177.
[3] *See Morlife, Inc. v. Perry* (1997) 56 Cal.App.4th 1514, 1521.

law of the chosen state would be contrary to a fundamental policy of the state.[4] Under the second exception, where California employers and/or employees are involved, California courts will apply California law and invalidate an employment contract's non-compete provisions regardless of the choice of law provisions in the contract.[5]

California courts, however, will not enjoin proceedings in another state where an employer seeks to enforce in that forum the non-compete provisions in an employment contract.[6] That forum would apply its own conflict of law analysis to determine whether California's prohibition against non-compete clauses in employment contract would apply. Thus, the application California Business and Professions Code section 16600 could depend on a race to the courthouse.[7]

In 2016, the California legislature attempted to address this issue by enacting California Labor Code section 925, which applies to contracts entered into after January 1, 2017 by California residents working in California. Under California Labor Code section 925, it is a violation of the Labor Code for an employer to require an employee to agree, as a condition of employment, to any provision that would (a) require the employee to adjudicate claims arising in California outside of California; or (b) deprive the employee of the substantive protections of California law for claims arising out of California.[8] There is an exception for contracts where the employee was represented by independent counsel who negotiated the choice of law and forum selection clauses.[9] Absent this exception, such provisions are voidable by the employee.[10] It remains to be seen what impact this statute will have on the conflict of law analysis in other jurisdictions.

At least one Delaware court concluded that Labor Code section 925 altered California's public policy with respect to non-compete provisions, favoring a public policy of freedom of contract over for employment contracts that this exception.[11] It remains to be seen whether a California court would interpret a statute enacted to strengthen California's prohibition against non-compete provisions in employment contracts to weaken such prohibitions where an employment contract is negotiated by independent counsel.

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[4] *See Application Group v. Hunter Group* (1998) 61 Cal.App.4th 881, 896.
[5] *See id.* at p. 901.
[6] *See Advanced Bionics Corp. v. Medtronic, Inc.* (2002) 29 Cal.4th 697, 708.
[7] *See ibid*.
[8] *See* California Labor Code section 925, subdivision (a).
[9] *See* California Labor Code section 925, subdivision (e).
[10] *See* California Labor Code section 925, subdivision (b)
[11] *See NuVasive, Inc. v. Miles* 2018 Del. Ch. LEXIS 329 at *2-4; *compare Ascension Ins. Holdings, LLC v. Underwood* 2015 Del. Ch. LEXIS 19, at *18.

Exceptions to California Business and Professions Code section 16600

The Sale of Good Will

The most common exception to California Business and Professions Code section 16600 is where an owner of a business entity (or division thereof) disposes all of his or her ownership interest in a business entity (or division thereof), including it's the business entity's goodwill. As a condition of the sale, the seller may agree to refrain from carrying on a similar business within the specified geographic area where the business had operated so long as the buyer who acquired the goodwill conducts a similar business in that geographic area.[12]

This exception applies equally to the sale of capital stock by a shareholder of a corporation, the sale of a partnership interest in a general or limited partnership, or the sale of a membership interest in a limited liability company.[13]

This exception also applies to situations where a partnership or limited liability company is being dissolved and certain partners or members will conduct a similar business thereafter.[14]

The transfer of goodwill necessarily requires the interest in the company be substantial and that goodwill must be component of the purchase price – nominal ownership or buy back provisions limited to the book value of the company (i.e., no purchase of goodwill) fall outside of this exception.[15]

Restrictions during Employment

California Business and Professions Code section 16600 applies to post-employment restraints. An employer can prohibit an employee from competing with another company during the term of his employment.[16]

Misappropriation of Trade Secrets

Distinct from a non-compete provision, California Uniform Trade Secrets Act, California Civil Code section 3426 et seq., provides for injunctive relief for the actual or threatened misappropriation of trade secrets and for damages caused by the misappropriation of trade

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[12] *See* California Business and Professions Code section 16601; *see also Alliant Ins. Services, Inc. v. Gaddy* (2008) 159 Cal.App.4th 1292, 1302-1303.
[13] *See* California Business and Professions Code sections 16601-16603.
[14] *See* California Business and Professions Code sections 16602-16603.
[15] *See Hill Medical Corp. v. Wycoff* (2001) 86 Cal.App.4th 895, 903-904; *Bosley Medical Group v. Abramson* (1984) 161 Cal.App.3d 284, 291-292.
[16] *See Stokes v. Dole Nut Co.* (1995) 41 Cal.App.4th 285, 295-296.

secrets.[17] This generally does not prevent a former employee from competing against his or her former employer but does prevent him or her from using his former employer's trade secrets in the process.

However, the California Uniform Trade Secrets Act cannot be used as a proxy for a non-compete provision. California has rejected the inevitable disclosure doctrine which is an argument to enjoin a former employer from competing because he or she would inevitably have to rely, consciously or subconsciously, on his former employer's trade secrets.[18]

A trade secret of a company is information, "including a formula, pattern, compilation, program, device, method, technique, or process" that: (a) derives independent economic value from not being generally known to the public or persons who could obtain economic value from its disclosure or use that is (b) the subject of reasonable efforts by the company to maintain its secrecy.[19]

Trade secrets can include computer software and source code,[20] customer lists and customer information,[21] inventions and ideas,[22] and pricing information and rates.[23]

Misappropriation however requires that the information was acquired or disclosed by improper means, such as the breach of a non-disclosure agreement. If a former employee was not subject to a non-disclosure agreement, no misappropriation can occur as the former employee did not breached any duty owed to his or her former employer in using or disclosing the information.

Thus, California Uniform Trade Secrets Act provides some protection on what information a former employee can use in his or her new employment and creates a risk of liability to the former employee if he or she misappropriated those trade secrets and to his or her new employer if the employer has knowledge of the misappropriation.[24]

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[17] See California Civil Code sections 3426.2 and 3426.3.
[18] *See Whyte v. Schlage Lock Co.* (2002) 101 Cal.App.4th 1443, 1464.
[19] See California Civil Code sections 3426.1.
[20] *See Vermont Microsystems, Inc. v. Autodesk, Inc.* (2d Cir. 1996) 88 F.3d 142, 149;
[21] *See Reeves v. Hanlon* (2004) 33 Cal.4th 1140, 1155; *DocMagic, Inc. v. Ellie Mae, Inc.* (N.D.Cal. 2010) 745 F.Supp.2d 1119, 1144.
[22] *See Altavion, Inc. v. Konica Minolta Systems Laboratory, Inc.* (2014) 226 Cal.App.4th 26, 56.
[23] See *Hilderman v. Enea TekSci, Inc.* (S.D.Cal. 2008) 551 F.Supp.2d 1183, 1201-1202.
[24] *See PMC, Inc. v. Kadisha* (2000) 78 Cal.App.4th 1368, 1383.

Conclusion

An employer in California cannot use non-compete provisions in employment contracts to protect itself from former employers competing against their former employer. However, the employer should protect its valuable information to the extent possible to limit the negative impact when a former employee decides to do so. This requires some diligence on the part of the employer in identifying its trade secrets and undertaking reasonable efforts, including employee non-disclosure agreements, to protect this information.

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