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Commercial Litigation and Employment Law Update

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The Wild West Lives On! California Supreme Court Strongly Rejects Attempt to Expand Non-Compete Agreements and Reaffirms an Employer's Obligation to Indemnify Its Employees

Analysis of *Edwards v. Arthur Andersen, LLP*, 2006 DJDAR 12286 (California Supreme Court, August 8, 2008)

Background

In 1872, the California legislature passed a law which voided almost all agreements which sought to limit the right of someone to work in their profession. Since 1941, this law has been codified in Business and Professions Code Section 16600. The only exceptions under this statute related to persons involved in the sale of a business.

California's "open competition" policy is at odds with the laws of most states which allow employers to set restrictions on the ability of employees to compete in the same industry and/or for the same clients immediately after the employment relationship is terminated. The rule in most states, which allows such restrictions to exist, is known as the "rule of reasonableness." In the past 25 years, the U.S. District Courts, interpreting California law, suggested that there was a "narrow restraint" exception to the rule of "open competition." Under the so-called "narrow restraint" exception, an employer could restrict an employee's ability to perform a small or limited amount of their trade and/or prevent an employee from working with certain clients, as long as these restrictions did not entirely preclude work in the employee's specific field. *See Campbell v. Trustees of Leland Stanford, Jr. Univ.*, 817 F.2d 499 (9th Cir. 1987); *General Commercial Packaging v. TPS Package*, 126 F.3d 1131 (9th Cir. 1999).

Brief Overview of *Edwards*

Raymond Edwards is a certified public accountant who was employed by Arthur Andersen, LLP ("Andersen") in Los Angeles between 1997 and 2002. When Mr. Edwards was hired, he signed an employment contract which imposed a one year moratorium on working with any Andersen client he had worked with during the prior 18 months and an 18 month restriction on soliciting any Andersen personnel.

After the Enron scandals of 2001-2002, Andersen announced that several of its divisions, including where Mr. Edwards worked, would be sold to HSBC USA ("HSBC") and that the new division would be operated through a subsidiary called Wealth and Tax Advisory Services ("WTAS"). HSBC offered Mr. Edwards a job, but required that he sign an agreement which waived Edwards' right to seek indemnity from Andersen. An employer's obligation to provide indemnity to its employees arising out of acts which are a direct consequence of employment is codified in California Labor Code Section 2802.

Labor Code Section 2804 voids any agreement which purports to waive an employer's indemnity obligations. The agreement with HSBC/WTAS also required Mr. Edwards to refrain from making disparaging comments about Andersen and/or its officers and contained an obligation for Mr. Edwards to cooperate with Andersen in any litigation and/or investigation. In addition to being hired by HSBC/WTAS, Mr. Edwards, if he signed the agreement, would be released from Andersen's non-compete clause.

Mr. Edwards refused to sign the HSBC/WTAS agreement, largely because he did not want to give up his right to indemnification, which was especially important given the numerous investigations arising out of the Enron scandal. As a result, Andersen terminated Edwards' employment and HSBC/WTAS withdrew their offer. Mr. Edwards sued Andersen, HSBC and WTAS on a variety of legal theories, including intentional interference with prospective economic advantage.

Prior to trial, Mr. Edwards settled with HSBC and WTAS. In a series of pre-trial motions, all claims against Andersen were dismissed. In dismissing the remaining claims against Andersen, the trial court ruled that the company's non-competition agreement was proper because it fit into the "narrow restraint" exception, which until that point had only been sustained by the federal appeals court. The trial court also found that it was not unlawful for HSBC and WTAS to require Mr. Edwards to waive his indemnity rights under Labor Code Section 2802.

Rulings Which Restored Mr. Edwards Claims Regarding the Non-Compete Agreement

The trial court's dismissal of Mr. Edwards' claim was reversed by the California Court of Appeals in August 2006. *See Edwards v. Arthur Andersen, LLP,* 142 Cal. App. 4th 603, 642 (2006). The Court of Appeal held that by carving out a "narrow restraint" exception to Business and Professions Code Section 16600, the Ninth Circuit misapplied California law. *Id.* Accordingly, the Court of Appeal voided the non-compete agreement and restored Mr. Edwards' related claims for economic damages. The Supreme Court, in affirming the decision, noted that since effectively Mr. Edwards could not practice as a CPA for any of Andersen's former clients in Los Angeles, the agreement violated Section 16600. *Edwards,* 2008 DJDAR at 12289. The Supreme Court explicitly refused to adopt the Ninth Circuit's "narrow restraint" analysis and noted that only the legislature could create such a rule in California. *Id at 12290.*

Rulings as to the Employer's Indemnity Statute

The Court of Appeal decision contained strong language that Andersen's attempts to persuade Mr. Edwards to waive his right to seek indemnity under Labor Code Sections 2802 and 2804 violated public policy and was an action so egregious, that it was enough to form the basis of an independent cause of action. *Edwards,* 142 Cal. App. 4th at 630. Although the Supreme Court believed the waiver void under public policy, California's highest court did not believe these actions formed the basis of an independent cause of action. The Supreme Court's reasoning is based on Labor Code Section 2804, which clearly states that such an agreement is void because it violates public policy. *Edwards,* 2008 DJDAR at 12291 to 12292. Accordingly, since the Supreme Court views the waiver language as null and void, Mr. Edwards cannot seek recovery of economic damages based on an unenforceable clause that could not be upheld in the first place.

Warnings for Employers on the Indemnity Statute

In his concurring and dissenting opinion, Supreme Court Justice Kennard, along with Justice Werdegar, criticized the majority for lightly dismissing Mr. Edwards' claims regarding Labor Code Section 2802. *Edwards*, 2008 DJDAR at 12293. Justice Kennard reasoned that employees tend to have less experience with the law. As such, employers should not be permitted to make a practice of including clauses that by definition violate California law, because most employees are too unsophisticated to know otherwise. To prevent employers from taking advantage of employees by including these types of clauses, Justice Kennard supported the Court of Appeal's view that the mere act of proposing the waiver itself, could form the basis of an independent wrong against Andersen.

Given California's consistent pattern of supporting employee's rights, employers need to determine whether their agreements include clauses that are known to violate California law and/or public policy. Our experience defending employers and litigating complicated contracts in California suggests to us that under the right fact pattern, future decisions may permit these types of claims to proceed. Mr. Edwards was a CPA who handled complex and high value matters involving tax planning, estate, gift and real estate tax. It is possible that an unsophisticated plaintiff, who signed an agreement known to violate public policy, may trigger a series of decisions which are more in line with justice Kennard's dissent.

The Anti-Disparagement Clause: Not Addressed by the Supreme Court

The Court of Appeals affirmed the dismissal of this aspect of Mr. Edwards claim against Andersen. *Edwards*, 142 Cal. App. 4th 632-633. Mr. Edwards alleged that the requirement that he refrain from making disparaging comments about Andersen violated the California whistleblower statute. The Court of Appeals rejected Mr. Edwards' assertion and noted that all employees receive protection when making statements to the authorities that would be protected under the whistleblower statute. *Id.* The Court of Appeals also noted that Mr. Edwards' complaint contained no claim that he made any disparaging statements or that he was retaliated against, in any way, by Andersen for making statements. *Id.*

We note that the Supreme Court explicitly declined to comment on the dismissal of the anti-disparagement claim. *Edwards*, 2008 DJDAR at 12286. As such, neither the majority nor Justice Kennard addressed the merits of this claim. However, it stands to reason that in future cases, an unsophisticated employee who is required to sign such an agreement may trigger a series of decisions that allow such claims to proceed. Accordingly, it is important that employers review their personnel documents to be certain that the language complies with the current state of California law. Further, companies must ensure that management knows not to attempt to enforce any illegal agreements to which an employee previously agreed.

Can California Employers Protect Their Customer Lists?

The California Supreme Court's decision in *Edwards* does not affect the ability of employers to protect trade secrets, which can include customer lists. However, it is important for employers to be mindful that California courts are reluctant to protect customer lists to the extent they embody information which is "readily ascertainable" through public sources, such as business directories. *Morlife, Inc. v. Perry*, 56 Cal. App. 4th 1514 (1997) (citing *American Paper & Packaging Products, Inc. v. Kirgan* 183 Cal. App. 3d 1318, 1326 (1986)). On the other hand, where the employer has expended time and effort identifying customers with particular needs or characteristics, courts will prohibit former employees from using this information to capture a share of the market. Such lists are to be distinguished from mere identities and locations of customers where anyone could easily identify the entities as potential customers. *Klamath-Orleans Lumber, Inc. v. Miller*, 87 Cal. App. 3d at p. 461; *ABBA Rubber Co. v. Seaquist*, 235 Cal. App. 3d 1, 19-20 (1991). As a general principle, the more difficult information is to obtain, and the more time and resources expended by an employer in gathering it, the more likely a court will find such information constitutes a trade secret. *Courtesy Temporary Service, Inc. v. Camacho*, 222 Cal. App. 3d 1278, 1287 (1990).

Thus, a California employer is more likely to succeed in preventing employees from stealing and using customer lists when the information itself is considered to be more of a confidential trade secret, rather than a mere recitation of the known customers of the business. As such, we recommend that employers be proactive and to document all the ways in which their customer lists should be considered to be trade secrets.

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