.

California Non-Compete Agreements

Quick Summary

Non-compete agreements are illegal in California. Many companies are unaware of this fact, especially since non-compete agreements are legal in virtually all other states. However, there are two exceptions in California. Non-compete agreements are enforceable for partnerships and when someone is selling their ownership interest in a company. A related topic is the protection of trade secrets. A company can prevent the use of its trade secrets, but it cannot prevent fair competition.

Law Review

Non-Compete Agreements are Generally Illegal

Many companies seek to protect their business by requiring that employees sign agreements to not compete with the company should they leave employment. However, unlike in many other states, non-compete employment agreements are illegal in California. Business and Professions Code § 16600 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**." Section 16600 invalidates agreements to preclude employment in a certain line of work. The section has also been construed by California courts as invalidating agreements that seek to prevent former employees from accepting work from any of the former employer's clients. (*Morris v. Harris* (1954) 127 Cal.App.2d 476.) A former employee may also solicit employees from his or her former employer if unlawful means or acts of unfair competition are not used. (*Diodes, Inc. v. Franzen* (1968) 260 Cal.App.2d 244.)

Sample agreement held to be invalid: (*Kolani v. Gluska* (1998) 64 Cal.App.4th 402, 405)

> "[T]hat for one year after employment not compete with a radius of 40 miles for own account or on account of another."

Trade Secrets can be Protected

A company is however, permitted to protect their trade secrets. One type of trade secret is a customer list. Generally speaking, if a company could prevent a former employee from using a customer list

or trade secret to prevent unfair competition, the company can enforce an agreement that former employees will not use the confidential information. (*Metro Traffic Control, Inc. v. Shadow Traffic Network* (1994) 22 Cal.App.4th 853, 861.) For example, an employee could validly be required not to use a confidential list of preferred customers for one year after leaving employment. (*Gordon v. Landau* (1958) 49 Cal.2d 690.) By comparison, though, even if a former employee cannot solicit his or her former employer's clients, merely informing customers of one's former employer of a change of employment, without more, is not solicitation. Neither is discussing business after being first invited by the former employer's customer. (*Hilb, Rogal & Hamilton Ins. Services v. Robb* (1995) 33 Cal.App.4th 1812, 1821-1822.)

As indicated by the following language from one court, protection of trade secret provisions are treated differently from non-compete provisions and are valid and proper. "It clearly appears from the terms of the contract that it did not prevent defendant from carrying on a weekly credit business or any other business. He merely agreed not to use plaintiff's confidential lists to solicit customers for himself for a period of one year following termination of his employment. Such an agreement is valid and enforceable." (*Kolani v. Gluska* (1998) 64 Cal.App.4th 402, 406.)

Business Ownership Exception

Business & Professions Code § 16601 creates an exception permitting lawful non-compete agreements for company owners. It applies when a shareholder "sells" their stock to another for valuable consideration. (*Hilb, Royal & Hamilton Ins. Services v. Robb* (1995) 33 Cal.App.4th 1812, 1824-1825.) The typical scenario is when a shareholder sells or disposes of their stock. Assume the owner of ABC company is bought-out by DEF company. DEF can validly protect its investment by requiring the former owner of ABC to sign a reasonable non-compete agreement. A merger is also considered to be a transaction within the exception of section 16601. (*Id.*) In *Hilb*, the valid contract provision prohibited competition in several countries for a 3-year period of time.

In *Vacco Industries, Inc. v. Van Den Berg* (1992) 5 Cal.App.4th 34,the court upheld the enforceability of a non-compete agreement that lasted as long as the employer conducted business in the area. There, an officer held three percent of his employer's stock. When the employer was being acquired by another company, he agreed to sell the stock to the acquirer and as part of the agreement there was the non-compete provision. Because the non-compete provision was part of the stock sale, it was held enforceable.

However, sham agreements designed to circumvent section 16600's prohibitions by requiring stock purchases and sales upon termination of employment will not be upheld. (*Bosley Medical Group v. Abramson* (1984) 161 Cal.App.3d 284.) The *Bosley* court also noted

that a "substantial" sale of all shares must take place so that it can be said that goodwill of the company is being transferred. (*Id.*, at 290.) The purpose of this rule is to prevent a company from requiring that its employees purchase one share of stock and requiring them to enter into a non-compete agreement. In other words, Intel cannot require its employees to buy one share, and in the agreement include a non-compete provision intended to be enforceable under section 16601. Such an agreement is not enforceable.

Section 16601 also applies when substantially all of the assets are sold. Unlike the provision for stock sales, in which all stock must be sold, only a substantial amount of the assets need to be transferred to make a non-compete agreement enforceable pursuant to this statute. (*Fleming v. Ray-Suzuki, Inc.* (1990) 225 Cal.App.3d 574.)

Section 16601 also applies to non-compete agreements outside of California. In *Fleming v. Ray-Suzuki, Inc.* (1990) 225 Cal.App.3d 574, the court upheld a non-compete agreement encompassing the entire United States, and ruled that California must be able to regulate beyond its borders for section 16601 to have meaning.

Partnership Exception

Another exception to section 16600's prohibitions exists for partnerships. (Business & Professions Code § 16602.) However, not every agreement restricting competition between partners is valid. A "rule of reason" applies. (*Howard v. Babcock* (1993) 6 Cal.4th 409.) For example, a partnership agreement may validly restrict competition by precluding withdrawing partners from practicing in a limited geographic area. (*Id.*) Unlike business sales and section 16601, there is no requirement pursuant to section 16602 that compensation for goodwill in the partnership be transferred. *South Bay Radiology Medical Associates v. Asher* (1990) 220 Cal.App.3d1074, 1083.)

Section 16602 has been held applicable to partnerships involving accountants (*Swenson v. File* (1970) 3 Cal.3d 389), attorneys (*Howard v. Babcock* (1993) 6 Cal.4th 409), and physicians (*South Bay Radiology Medical Associates v. W.M. Asher, M.D., Inc.* (1990) 220 Cal.App.3d 1073, *Farthing v. San Mateo Clinic* (1956) 143 Cal.App.2d 385).

Federal Court "Exception"

If the homes for the employer and employee are in two different states and certain jurisdictional rules are met (such as there being at least $75,000 in dispute), a lawsuit filed in California court may be "removed" to federal court. If that happens, the federal court interprets what it believes California law to be. The federal courts in California are located within the Ninth Circuit. The good news for employees is that the Ninth Circuit is generally considered to be pro-employee. The

very bad news for employees is that the Ninth Circuit has misinterpreted California's non-compete law and will usually uphold reasonable non-compete agreements as if this were another state. (*IBM v. Bajorek* (9th Cir. 1998) 191 F.3d 1033.) This is not California law and there is no exception for "reasonable" non-compete agreements. In the legal world the Ninth Circuit is known as a rogue circuit often at odds with other circuits and the United States Supreme Court. What is important to remember is that the employer will attempt to remove a lawsuit to federal court if they can to try to avoid California's limitations. Most lawsuits, however, cannot be removed. If the employer is a California business there generally will not be any basis for keeping a lawsuit in federal court.

What is Unlawful Competition

Even where there is a valid non-compete agreement, not all competitive activity is absolutely prohibited. Competition, or to carry on a similar business, generally means substantial competitive business activities, and not merely isolated or occasional transactions. (*Swenson v. File* (1970) 3 Cal.3d 389, 397.) Thus, engaging in isolated competitive activities should not subject someone to liability for violating a valid non-compete agreement.

Will a Court Reform an Illegal Non-Compete Agreement to Make it Legal?

If a contract provision violates section 16600, it is illegal and a court will not attempt to reform it to save it. In other words, if an employer steps over the line with a broad illegal non-compete provision, a court will not modify the provision to make it legal, or narrowly construe it so that it could be legal, even though the employer could have created a narrower provision. (*Kolani v. Gluska* (1998) 64 Cal.App.4th 402, 406.)

However, if a non-compete provision may be legal, such as pursuant to section 16601 relating to the goodwill of a company, then a court may attempt to save such a provision by narrowly construing it. (*Id.* at 407.)

Can an Employer and Employee Agree that a Non-Compete Provision is Valid?

No. The law and public policy declare such contracts to be void. A void agreement cannot be made valid by agreement.

"When a contract creates an illegal restraint on trade, '[t]here is nothing which the parties to the action could do which would in any way add to its validity. If the contracts upon which the judgment is based are to that extent void, they cannot be ratified either by right, by conduct, or by stipulated judgment.' (*Hunter v. Superior Court* (1939) 36 Cal.App.2d 100, 113.)" (*South Bay Radiology Medical Associates v.*

Asher (1990) 220 Cal.App.3d1074, 1080.)

Can I be Terminated or Not Hired if I do Not Sign a Non-Compete?

An employee or prospective employee cannot legally be terminated or not hired if they refuse to sign a non-compete agreement. As explained in *D'Sa v. Playhut, Inc.* (2000) -- Cal.App.4th -- , an employee can sue for wrongful termination if they are fired because they refuse to sign an illegal non-compete agreement. Usually, though, the employee would prefer to be employed rather than be unemployed and embroiled in litigation that could take a long time to resolve. Since non-compete agreements are not valid, one strategy for the employee is to sign the agreement knowing that the paper is worthless and thereby be employed.

Out-of-State Agreements and Multi-State Employer Strategies

Who wins often depends upon a race to the courthouse. For multi-state employers it is often a rush to the courthouse to determine if a non-compete agreement is valid. The employer's strategy is to get an order outside of California in their favor. The employee or California prospective employer's strategy is to get an order within California in their favor. In the face of dueling, and opposing orders, the first to the courthouse may win because states often must give effect to orders from other courts.

For example, the legal newspaper Daily Recorder, reported the following situation on October 6, 2000. Net2Phone, Inc., based in New Jersey, went to court in New Jersey and obtained an order enjoining one of its employees from taking a job with Dialpad.com, a California competitor.

The seminal case discussing the conflict between California law and multi-state employers is *Application Group, Inc. v. Hunter Group, Inc.* (1998) 61 Cal.App.4th 881. In *Hunter*, a Maryland company with branch offices in California and other states required its non-California employees to sign a 1-year non-compete agreement. The agreement also stated that it was governed by and to be construed by Maryland law. In Maryland, non-compete agreements are valid. A Maryland employee [who had never set foot in California] then left and sought to go work for a competitor in California. When the prospective California employer sued to invalidate the agreement, the court agreed and ruled that the non-compete provision was invalid. Section 16600 reflects a "strong public policy of the State of California" and California has a strong interest in applying its law and protecting its businesses. (*Id.*, at 900.) California law may thus be applied to non-California employees seeking employment in California. (*Id.*, at 908.)

As a result of this case, the following individuals have the following

strategies to pursue:

California employees with a non-compete agreement signed in California - no problem, the agreement is invalid unless an exception applies.

Non-California individuals with an out-of-state non-compete seeking employment in California - file suit in California to invalidate the agreement.

California employers seeking to hire an employer with an out-of-state non-compete agreement - file suit in California to invalidate the agreement.

Out-of-state or multi-state employers with an out-of-state non-compete agreement - file suit anywhere but California to validate the agreement.

What if the Agreement States that Non-California Law Applies

The *Application Group* case discussed in the prior section holds that California law will apply, even if the contract states that the law of another state is to apply. Another prior case, *Frame v. Merrill Lynch, Pierce, Fenner & Smith* (1971) 20 Cal.App.3d 668, likewise held that a contract providing that New York law would apply cannot defeat California's public policy as set forth in section 16600.

Is a "Non-Interference" Agreement / No Solicitation of Employees Agreement an Invalid Non-Compete Agreement?

No. A non-interference agreement states that an employee agrees not to disrupt, damage, impair, or interfere with their former employer's business by raiding its employees. In *Loral Corp. v. Moyes* (1985) 174 Cal.App.3d 268, the court upheld the enforceability of this type of agreement.

Legal Snippets

"This statute presents an absolute bar to postemployment restraints and represents a strong public policy of this state." (*KGB, Inc. v. Giannoulas* (1980) 104 Cal.App.3d 844, 848.)

"In California under section 16600, even reasonableness may not save an injunction...." (*KGB, Inc. v. Giannoulas* (1980) 104 Cal.App.3d 844, 849.)

"Thus, an agreement by an employee or independent contractor not to compete with his employer after leaving that employment is void." (*Bosley Medical Group v. Abramson* (1984) 161 Cal.App.3d 284, 288.)

"When a contract creates an illegal restraint on trade, '[t]here is nothing which the

parties to the action could do which would in any way add to its validity. If the contracts upon which the judgment is based are to that extent void, they cannot be ratified either by right, by conduct, or by stipulated judgment.' (*Hunter v. Superior Court* (1939) 36 Cal.App.2d 100, 113.)." (*South Bay Radiology Medical Association v. Asher* (1990) 220 Cal.App.3d 1074, 1080.)

"In declaring a contract void to the extent it exceeds such statutory limitations as those imposed by section 16600, the Legislature thereby adopted a rule of public policy." (*South Bay Radiology Medical Association v. Asher* (1990) 220 Cal.App.3d 1074, 1080.)

"California courts have consistently declared this provision an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice." (*Metro Traffic Control, Inc. v. Shadow Traffic Network*(1994) 22 Cal.App.4th 853, 859.)

"Section 16600 has specifically been held to invalid employment contracts which prohibit an employee from working for a competitor when the employment has been terminated, unless necessary to protect the employer's trade secrets." (*Metro Traffic Control, Inc. v. Shadow Traffic Network*(1994) 22 Cal.App.4th 853, 859.)

"It is quite clear that a covenant prohibiting a California employee from working for a competitor after termination of his or her employment violates section 16600." (Application Group, Inc. v. Hunter Group, Inc. (1998) 61 Cal.App.4th 881, 895.)

"The basic rule in this state is that contracts precluding a former employee from obtaining new employment with a competitor are invalid under section 16600." (*Loral Corp. v. Moyes* (1985) 174 Cal.App.3d 268, 275-276.)

"Section 16600 does not invalidate an employee's agreement not to disclose his former employer's confidential customer lists or other trade secrets or not to solicit those customers." (*Loral Corp. v. Moyes* (1985) 174 Cal.App.3d 268, 276.)

"Antisolicitation covenants are void as unlawful business restraints except where their enforcement is necessary to protect trade secrets." (*Moss, Adams & Co. v. Shilling* (1986) 179 Cal.App.3d 124, 130.)

"[C]ovenants not to compete in contracts other than for sale of goodwill or dissolution of partnerships are void...." (*Kolani v. Gluska* (1998) 64 Cal.App.4th 402, 406.)

"Narrower contractual restraints on a departing employee, which prohibit him/her from using confidential information taken from the former employer, have been held to be lawful." (*Kolani v. Gluska* (1998) 64 Cal.App.4th 402, 406.)

Frequently Asked Questions

Is the following non-compete agreement valid _____?

No. They are not valid unless an exception applies, such as a partnership or company ownership being involved.

Can I be sued if a violate my non-compete agreement?

Anyone can be sued. The real question is whether you face liability. Assuming the agreement in invalid, providing the employer with a copy of section 16600 is usually enough to prevent a lawsuit from being filed.

California Business & Professions Code Statutes

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."

16601

"Any person who sells the goodwill of a business, or any shareholder of a corporation selling or otherwise disposing of all his shares in said corporation, or any shareholder of a corporation which sells (a) all or substantially all of its operating assets together with the goodwill of the corporation, (b) all or substantially all of the operating assets of a division or a subsidiary of the corporation together with the goodwill of such division or subsidiary, or (c) all of the shares of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of said corporation, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein. For the purposes of this section, "subsidiary" shall mean any corporation, a majority of whose voting shares are owned by the selling corporation."

16602

"(a) Any partner may, upon or in anticipation of any of the circumstances described in subdivision (b), agree that he or she will not carry on a similar business within a specified county or counties, city or cities, or a part thereof, where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any such other member of the

partnership, carries on a like business therein.

(b) Subdivision (a) applies to any of the following circumstances:

(1) A dissolution of the partnership.

(2) Dissociation of the partner from the partnership.

(3) A sale or other disposition of the partner's interest in a partnership."

Legal Research

The following resources discuss California law relating to non-competition agreements:

Section 16600 cases:

Hill Medical v. Wycoff (2001) -- Cal.App.4th --
D'Sa v. Playhut, Inc. (2000) -- Cal.App.4th --
Kolani v. Gluska (1998) 64 Cal.App.4th 402
Application Group, Inc. v. Hunter Group, Inc. (1998) 61 Cal.App.4th 881
IBM v. Bajorek (9th Cir. 1998) 191 F.3d 1033
Metro Traffic Control, Inc. v. Shadow Traffic Network (1994) 22 Cal.App.4th 853
John F. Matull & Associates, Inc. v. Cloutier (1987) 194 Cal.App.3d 1049
Blank v. Kirwan (1985) 39 Cal.3d 311
Loral Corp. v. Moyes (1985) 174 Cal.App.3d 268
Bosley Medical Group v. Abramson (1984) 161 Cal.App.3d 284
KGB, Inc. v. Giannoulas (1980) 104 Cal.App.3d 844
Center v. Roseville Community Hospital (1979) 107 Cal.App.3d 62
Monogram Industries, Inc. v. Sar Industries, Inc. (1976) 64 Cal.App.3d 692
Dayton Time Lock Service, Inc. v. Silent Watchman Corp. (1975) 52 Cal.App.3d 1
Radiant Industries, Inc. v. Skirvin (1973) 33 Cal.App.3d 401
Frame v. Merrill Lynch, Pierce, Fenner & Smith (1971) 20 Cal.App.3d 668
Moss, Adams & Co. v. Shilling (1986) 179 Cal.App.3d 124 *Swenson v. File* (1970) 3 Cal.3d 389
Diodes, Inc. v. Franzen (1968) 260 Cal.App.2d 244
Muggill v. Reuben H. Donnelley Corp. (1965) 62 Cal.2d 239
Gordon v. Landau (1958) 49 Cal.2d 690
Morris v. Harris (1954) 127 Cal.App.2d 476
Continental Car-Na-Var Corp. v. Moseley (1944) 24 Cal.2d 104

Section 16601 cases:

Hill Medical v. Wycoff (2001) -- Cal.App.4th --
Weber, Lipshie & Co. v. Christian (1997) 52 Cal.App.4th 645
Hilb, Royal & Hamilton Ins. Services v. Robb (1995) 33 Cal.App.4th 1812
Vacco Industries, Inc. v. Van Den Berg (1992) 5 Cal.App.4th 34
Fleming v. Ray-Suzuki, Inc. (1990) 225 Cal.App.3d 574
John F. Matull & Associates, Inc. v. Cloutier (1987) 194 Cal.App.3d 1049
Bosley Medical Group v. Abramson (1984) 161 Cal.App.3d 284
Kaplan v. Nalpak Corp. (1958) 158 Cal.App.2d 197
Martinez v. Martinez (1953) 41 Cal.2d 704

Section 16602 cases:

Howard v. Babcock (1993) 6 Cal.4th 409
South Bay Radiology Medical Associates v. W.M. Asher, M.D., Inc. (1990) 220 Cal.App.3d 1073
Swenson v. File (1970) 3 Cal.3d 389
Farthing v. San Mateo Clinic (1956) 143 Cal.App.2d 385

Trade Secret Cases regarding Customer Lists:

American Credit Indemnity Corp. v. Sacks (1989) 213 Cal.App.3d 622
Gordon v. Landau (1958) 49 Cal.2d 690
Fortna v. Martin (1958) 158 Cal.App.2d 634
Morris v. Harris (1954) 127 Cal.App.2d 476
Aetna Bldg. Maintenance Co. v. West (1952) 39 Cal.2d 198

If You Need a California Employment Law Attorney Regarding This Issue:

Brian Kindsvater, Esq.
Law Office of Brian Kindsvater
10510 Superfortress Avenue, Suite C
Mather, California 95655 [Sacramento]
brian@kindsvater.com email
916.231.0101 - Sacramento office
916.313.3443 - facsimile
877.600.8500 - toll free

Mr. Kindsvater has assisted numerous individuals and businesses throughout California, the United States, and in Canada regarding California employment, consumer, and other legal issues.