Calif. Noncompete Limits May Ease If Workers Have Counsel

By **Kurt Kappes and Mark Lurie** (March 26, 2020)

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Three years ago, in response to employer attempts to avoid California's public policy against noncompete restrictions, the California Legislature added a new Section 925 to the Labor Code. While Section 925 generally prohibited one-sided attempts by employers to have another state's choice of law and jurisdiction apply to such agreements, the statute also included a carveout for employees who are represented by counsel.

While there have been several cases during the past three years regarding Section 925 general prohibition, and these provisions have received considerable publicity, case law addressing the exception has been slow to evolve.

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Nonetheless, in 2020, some three years hence, we believe that we are now at a point where, although no California case has squarely addressed it, the law seems relatively certain to develop in only one direction — the California Legislature, in addressing the interplay between California's strong public policy of free competition and the parties' freedom of contract, has come out in favor of the latter, where an employee is represented by independent counsel.

This development has critical implications for counsel for both employers and employees. Counsel for employers, looking to protect their client, may be able to take comfort in the notion that a noncompete against a California employee may well be enforceable under the right circumstances. In light of the limited case law and noise surrounding this exception, counsel for both employees and employers may not be aware of the law, and could possibly be advising clients that such agreements are still not enforceable, only to find out that they are mistaken.

Until 2017, and for nearly a century and a half, California has steadfastly maintained a fundamental public policy favoring free competition and employment.[1] Accordingly, while most states recognize an employer's right to prevent — to a certain degree — former employees from engaging in competition and soliciting customers, California generally regards these restrictions as illegal restraints on trade and employment, with certain limited exceptions.

While this policy has been a blessing for individuals and some employers, it has been a bane for others, particularly those employers located outside California who seek uniform noncompete agreements throughout the organization, and who wish to enforce such restrictions against California residents who are former employees.

Recognizing the issues California's anomalous law presents, employers have tried various workarounds; most of which generally fail. For example, some employers used standard noncompete agreements that provided that the employer's home state law governed these restrictions.

However, in 1998, the California Court of Appeal significantly narrowed an employer's ability to rely on such choice-of-law provisions. In Application Group Inc. v. Hunter Group Inc.[2]

Hunter Group, a Maryland-based employer (with locations and customers in California) entered into noncompetition agreements with its non-California employees that provided that Maryland law would apply to these restrictions.

One of Hunter Group's Maryland employees resigned and accepted employment with a California competitor. The court affirmed a declaratory relief judgment in favor of the new employer, finding that the parties' choice-of-law provision was unenforceable, as California's interest in ensuring free competition was materially greater than Maryland's interest in enforcing noncompete agreements.

The court further noted that, as Hunter had employees and customers in California, it could reasonably anticipate that California companies may try to solicit such employees and customers, such that it was not unfair to apply California law. Accordingly, following Application Group, employers could not safely rely upon non-California choice-of-law provisions in their noncompetition agreements.

For a time, some employers successfully argued that, even assuming California law applies to their noncompete agreements, California law was not intended to be absolutist.

For example, relying on the U.S. Court of Appeals for the Ninth Circuit's 1987 holding in Campbell v. The Board Of Trustees Of The Leland Stanford Junior University,[3] employers argued that Business and Professions Code Section 16600 only makes illegal those restraints which preclude one from engaging in a lawful profession, trade or business in its entirety, such that one could lawfully prohibit something less than the occupation as a whole, such as psychiatric testing, but not psychiatry generally, without violating Section 16600.

In 2008 in Edwards v. Arthur Andersen LLP, the California Supreme Court explicitly rejected this narrow restraint doctrine, and strictly enforced noncompetes unless they fell within the few explicit exceptions enumerated in Section 16600.[4]

As noted, however, there have been some interesting statutory and case law developments addressing the interplay between California's strong public policy of free competition and the parties' freedom of contract.[5] Those developments strongly suggest that there has indeed been a change in the law.

More specifically, in 2016, California adopted Labor Code Section 925[6] to address agreements where the employer required as a condition of employment that the employee agree that non-California law would govern post-employment restrictions. Section 925 is not a long or particularly complicated statute.

In response to some of these developments, a few commentators have noted that, under Section 925(e)'s explicit terms, a California employee can voluntarily agree to another state's noncompete law and jurisdiction when counsel represents them.[7]

But, this view is certainly not unanimous. Others contend that, despite Section 925's plain language, it does not necessarily weaken California policy against noncompetes.[8] According to this line of reasoning, Section 925 does not explicitly state that it is an exception to Business and Professions Code Section 16600, and that section says that any such contract is void, whether or not it is negotiated by counsel.

Also, the language in the statute provides that employers cannot require employees to agree to non-California choice-of-law/forum selection provisions unless the employees are

represented by counsel in negotiating those terms. Further, while Section 925 states such provisions are automatically voidable at the employee's request when not negotiated by the employee's counsel, it does not in the inverse declare that such provisions are automatically enforceable simply because they were negotiated by counsel.

Finally, proponents of this view argue that Section 925's legislative history shows the authors were concerned that non-California employers may impose choice-of-venue and choice-of-law provisions on Californians to evade California law and obtain an advantage over in-state employees.

In our view, it is becoming increasingly clear that the Legislature did, in fact, permit a California employee to agree to an enforceable noncompete, when it can be demonstrated without question that the employee was represented by independent legal counsel. Indeed, any contrary interpretation makes Section 925(e) meaningless, which the Legislature could not have intended when it enacted this provision.

As German philosopher Arthur Schopenhauer commented, truth passes through three stages: ridicule, violent opposition and acceptance as self-evident. We believe that case law will continue to develop in this direction, unless the California Legislature decides to amend Section 925.

First, while it is true that Business and Professions Code Section 16600 provides that noncompete contracts are void without distinction between unilaterally enforced and freely negotiated agreements, that is the result under California law. If the parties can lawfully contract for the application of another jurisdiction's law without running afoul of California public policy, that result simply does not apply.

Here, Section 925 appears to recognize that California public policy will permit another jurisdiction's law to apply, when there is some equal bargaining power such that the employee retains her own counsel to negotiate such provisions, receives advice as to their effect, and determines whether to accept or reject them. Indeed, some employees may request some sort of premium in return for so agreeing.

Further, even applying California law, California's policy in Business and Professions Code Section 16600 is not absolute. Instead, and even as the court in Edwards recognized, it is subject to certain statutory exceptions, including the sale of a business.[9] Another de facto statutory exception, although it does not explicitly reference Section 16600 or noncompetes, is the California Uniform Trade Secrets Act.[10]

While the court in Edwards referenced a so-called trade secret exception to Section 16600, the court was merely pondering whether the statutory scheme relating to noncompetes includes an express carveout for trade secrets. As the employee in Edwards conceded that he was bound by the noncompete agreement's confidentiality restrictions, the court did not reach, much less rule, that Section 16600 and the California Uniform Trade Secrets Act conflicted or are somehow irreconcilable.

Notably, case law is replete with similar exceptions to the absolute bar.[11]

Moreover, the California Legislature, with full knowledge of the policy underlying Business and Professions Code Section 16600, decided that, in instances where a party is represented by counsel and has an employment contract, the intent is to give full effect to the parties' choice-of-law and choice-of-venue provisions, rather than deprive the parties of their freedom of contract.

While it is true that Labor Code Section 925 does not declare that such provisions are automatically enforceable where they are negotiated by counsel, statutory construction does not require such language, and that is the statute's clear implication. Indeed, were this interpretation incorrect, there would be no need to include Section 925(e) declaring that it

> shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice-of-law to be applied.

Simply, if the Legislature had intended that such freely and knowingly negotiated agreements were unenforceable, it would not have included this exception or it would have stated that, notwithstanding attorney advice and review, such agreements are void as a matter of law.

The legislative history further confirms that it carefully considered this issue, and intended to carve out agreements that are fairly and freely negotiated with the assistance of independent counsel. In advocating for the passage of Section 925, the law's author observed that

> California has a history of protecting against potentially one-side contractual arrangements. ... [G]iven employees may not have the freedom to select their employer with particularity, let alone negotiate the terms of their employment contracts, employers largely have the upper hand when requiring an employee to agree to choice-of-law, choice-of-venue and choice of forum provisions.[12]

The legislature recognized, however, that this concern was not present where the employee had some negotiating ability. Accordingly, the original bill was amended to include subsection (e). As the Assembly's June 21, 2016, floor analysis explains:

> The opposition raises the concern that this bill would relieve a highly paid employee — who has more than sufficient bargaining power in negotiating her employment agreement — of honoring the terms of her contract. The author's recent amendments appear to be aimed at addressing this concern. This bill now exempts employment contracts where an employee is individually represented by legal counsel in negotiating the terms of an agreement that designate venue or the choice-of-law. …Californians should only be bound by these potentially one-sided terms if the Californian knowingly and voluntarily wants to leave the state to adjudicate a claim.[13]

Put simply, the Legislature agreed that employees who freely negotiate their agreements should be bound by their terms.

Nor is there reason to believe, as some have suggested, that the Legislature needed to cross-reference the noncompete provisions in Labor Code Section 925, any more than it needed to do so in the California Uniform Trade Secrets Act. They are all unique, and have different positions in the legislative scheme, as the court in Edwards tacitly recognized.

Indeed, were that argument correct, one must also assume that the Legislature could have just as easily amended Business and Professions Code Section 16600 to indicate that Labor Code Section 925 was not applicable to any contract encompassed within Section 16600. It did not; nor did it need to.

Moreover, in 2019 in Lyon v. Neustar Inc., the U.S. District Court for the Eastern District of California applied Section 925 and appeared ready to enforce it.[14] In Neustar, among other issues, the court considered whether Section 925 permitted the employer to apply a Virginia choice-of-law provision in an employment agreement to enforce a noncompete against an employee working in California.

While the employee referenced "my lawyers" in an email discussing the noncompete agreement, the employee testified, without contradiction, that he did not, in fact, have an attorney, and that he used this phrase for negotiation posturing. Based on this unrebutted testimony, and the lack of anything in the contract to reflect that the employee was, in fact, represented by counsel, the court held that Section 925(e)'s legal counsel exception is inapplicable.

As the court noted:

> Neustar is of course correct that the plain meaning of a statute's text controls, if the meaning is plain, and every statute should be read to avoid rendering any provisions superfluous. However, in so arguing, Neustar fails to provide any meaningful discussion or construction [of the statute].

Put simply, the court did not reject the legal counsel exception; it found only that it was inapplicable in this particular case.

Finally, while it is certainly true that the Legislature passed Section 925 to protect employees, there is no reason to assume that, by defining what agreements were not enforceable, it thought that employees who are represented by counsel needed special assistance or protection. The reality is that, in most cases where an employee is represented by counsel, it is because the employee is sophisticated, highly compensated and may have valuable knowledge, and is perfectly capable of negotiating a different deal if they do not wish to agree to a foreign jurisdiction or forego Business and Professions Code Section 16600.

Assuming this analysis is correct and that courts will recognize freedom of contract where the noncompete has been negotiated with the assistance of counsel, the question becomes how best to ensure the enforceability of this exception, particularly in light of Neustar.

Counsel must tread carefully. Following Neustar, companies would be prudent to confirm that the employee was, in fact, represented by independent counsel.

The approach involving the least risk is to expressly identify the attorney in the documents, indicate that counsel is independent, has reviewed the agreement and, if possible, to secure the independent counsel's written acknowledgement as to enforceability of the agreement. The agreement, as well as the confirmation, should also expressly reference the choice-of-law and jurisdiction provisions, rather than stating that the attorney generally reviewed the agreement.

And, finally, the independent counsel should truly be independent, and not someone who can be later challenged because they were referred, hired or paid by the employer. The best defense of supporting such an agreement is to build a record that the provision was the result of a freely bargained for exchange with counsel's advice.

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[1] See Business & Professions Code 16600.

[2] (1998) 61 Cal.App.4th 881.

[3] 817. F.2d 499, 502 (9th Cir. 1987).

[4] Edwards v. Arthur Andersen (2008) 44 Cal. 4th 937.

[5] See Labor Code Section 925; see also NuVasive, Inc. v. Patrick Miles 2018 WL 4677607 (Del. Ch. Sept. 28, 2018)(enforcing a Delaware choice-of-law provision and covenant not to compete in an employment agreement between a California resident and his former Delaware-based employer); Lyon v Neustar, Inc. 2019 Us Dist Lexis 75307 (E.D. Cal. 2019)(discussing Labor Code 925, and declining to apply it for failing to satisfy the statutory requirement that the employee be represented by counsel).

[6] The statute states in full:

(a) An employer shall not require an employee who primarily resides and works in California, as a condition of employment, to agree to a provision that would do either of the following:

(1) Require the employee to adjudicate outside of California a claim arising in California.

(2) Deprive the employee of the substantive protection of California law with respect to a controversy arising in California.

(b) Any provision of a contract that violates subdivision (a) is voidable by the employee, and if a provision is rendered void at the request of the employee, the matter shall be adjudicated in California and California law shall govern the dispute.

(c) In addition to injunctive relief and any other remedies available, a court may award an employee who is enforcing his or her rights under this section reasonable attorney’s fees.

(d) For purposes of this section, adjudication includes litigation and arbitration.

(e) This section shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice-of-law to be applied.

(f) This section shall apply to a contract entered into, modified, or extended on or after

January 1, 2017.

[7] See Jeffrey S. Klein and Nicholas J. Pappas, "Can Employers Enforce Non-Competes Against California Employees?," February 5, 2019.; Kurt A. Kappes, Mark D. Lurie, "California Employee Can Agree to Non-Compete Clause When Represented by Counsel, Nat.L.Rev. December 17, 2018.

[8] See, e.g., Debra Fischer, Adam Wagmeister, "Does Section 925 Reinforce or Weaken Policy Against Noncompetes," Daily Journal, Monday, January 7, 2019, Fisher and Wagmeister.

[9] B&PC 16601.

[10] See Civil Code Section 3294 et seq.

[11] See, e.g., Jones v Humanscale (2005) 130 Cal. App. 4th 401 (reversing trial court vacating New Jersey arbitration award, because arbitrator's findings and decision on enforceability of covenant not to compete was not palpably erroneous under California law, as "a former employee's right to pursue his or her lawful occupation is not without limitation."); see also Gordon v. Laundau (1958) 49 Cal.2d 690 (finding a defendant's agreement not to use plaintiff's confidential lists to solicit customers for himself for a period of one year following termination of employment valid and enforceable).

[12] (CA SB 1241 April 25, 2016 Judiciary Report, pp. 6 and 7.).

[13] (Id. at 7).

[14] Lyon v. Neustar, Inc. 2019 US Dist Lexis 75307 (E.D. Cal. 2019).