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The California Supreme Court's opinion in *Edwards v. Arthur Anderson L.L.P.*, reinforces California's public policy against enforcing covenants not to compete but at the same time found that broad releases of "any and all claims" in agreements are valid and do not include unwaivable claims.

## California Edition

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### The Mixed Bag of *Edwards v. Arthur Anderson*: Narrow Restraints in Non-Competition Agreements Are Not Allowed, Indemnity Rights Are Unwaivable But Broad Releases of "Any and All Claims" Are Valid

By Douglas A. Wickham and Lena K. Sims

The California Supreme Court's recent opinion in *Edwards v. Arthur Andersen L.L.P.*, S147190 (Aug. 7, 2008), is a turning point for two distinct bodies of law surrounding the validity of post-employment restrictions, such as covenants not to compete, and the validity of broad, employment-related releases in light of nonwaivable statutory rights.

At the outset, the court held that California's general prohibition against covenants not to compete, codified in Business and Professions Code section 16600, does not allow for an exception for so called "narrow restraints" on competition. In so holding, the *Edwards* court rejected a long line of authority developed in the federal courts, and in the U.S. Court of Appeals for the Ninth Circuit in particular, holding that "narrow restraints" on post-employment conduct are valid under California law.

The *Edwards* court then pivoted and examined the validity of a broad employment-related release of "any and all claims" and whether such a release can validly waive statutory indemnity rights under California Labor Code section 2802. Here, the court concluded that statutory indemnity rights under Labor Code section 2802 are made unwaivable by Labor Code section 2804. Therefore, the *Edwards* court found that any release purporting to waive such rights prospectively would be invalid. At the same time, however, the *Edwards* court upheld broad language releasing of "any and all claims," concluding that such language should be construed to effectuate a waiver of all such claims except as prohibited under California law, which, in

this instance, included Labor Code section 2804's limits on the release of such indemnity rights.

A mixed bag indeed.

### Factual & Procedural Background

*Edwards' Employment Agreement & the Termination of Noncompetition (TONC)*

*Edwards* was a Tax Manager and certified public accountant employed by Arthur Andersen L.L.P. He signed, as a condition of employment, an agreement covenanting not to solicit or perform services for Andersen's clients for whom he had performed work during the 18 months preceding termination. That contractual language provided:

If you leave the Firm, for eighteen months after release or recognition, you agree not to perform professional services of the type you provided for any client on which you worked during the eighteen months prior to release or resignation. This does not prohibit you from accepting employment with a client.

For twelve months after you leave the Firm, you agree not to solicit (to perform professional services of the type you provided) any client of the office(s) to which you were assigned during the eighteen months preceding release or resignation

You agree not to solicit away from the Firm any of its professional personnel for eighteen months after release or resignation.

Arthur Andersen ceased practicing public accounting in the United States and began selling off portions of its practice to its competitors following the well-publicized events involving Enron Corporation and the SEC's investigation. A competitor, HSBC USA, Inc., was to purchase that part of Andersen's practice that included Edwards' group through its subsidiary Wealth and Tax Advisory Services (WTAS). It was required that all managers, including Edwards, execute a "Termination of Non-Competition" (TONC). By the TONC, Andersen would agree to terminate its noncompete and customer nonsolicitation agreement with Edwards in exchange for Edwards' general release of claims. Edwards accepted HSBC's offer of employment but refused to execute the TONC, in part because he did not want to release his statutory indemnity rights under Labor Code section 2802 in light of the potential criminal and civil proceedings brought against Anderson. Andersen responded by terminating Edwards' employment and withholding severance benefits, and HSBC withdrew its offer of employment. Edwards filed his lawsuit against Andersen, HSBC and its subsidiary WTAS. He settled with all parties except Andersen and proceeded to trial on his claim for intentional interference with prospective economic advantage.

The tort of interference with prospective economic advantage requires that the defendant engage in an act that is independently wrongful, *i.e.*, "proscribed by some constitutional, statutory, regulatory, common law, or other determinable standard." Edwards alleged that Andersen had engaged in two "independently wrongful acts" that supported his claim, *i.e.*, that Andersen refused to permit Edwards' prospective employment with its competitor absent Edwards' agreement to: (1) release of Andersen's covenants not to compete or solicit customers, which Edwards contended was an illegal restraint of trade under Business and Professions Code section 16600; and (2) a general and broad release of claims that Edwards argued did not except Edwards' right to indemnity pursuant to section 2802 of the California Labor.

#### *The Trial Court Determines that the Employment Agreement & the TONC Are Both Enforceable*

The trial court found that the agreement

between Edwards and Arthur Andersen was lawful. It held first that the customer nonsolicitation agreement was enforceable because it effected only a "narrow restraint" on trade, relying on a line of *federal* authority recognizing that "narrow restraints" on trade are permissible. It reached this conclusion despite Business and Professions Code section 16600's dictate that "[e]xcept 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."

The trial court further held that the TONC's general release of claims did not impliedly include a release of Edwards' indemnity rights, and it therefore did not run afoul of Labor Code section 2804.

#### *The Court of Appeal Reverses the Trial Court in Full, Finding Both Agreements Are Unenforceable*

The California Court of Appeal reversed the trial court on both counts. It held that the Ninth Circuit's "narrow restraint" exception to section 16600 is contrary to California law. The more readily recognized cases in that line of Ninth Circuit case law include *General Commercial Packaging v. TPS Package Engineering, Inc.*, *Campbell v. Trustees of Leland Stanford Jr. Univ. and International Business Machines Corp. v. Bajorek*. Those cases are often cited for the general proposition that agreements restraining trade are enforceable if they only narrowly restrain trade. The Court of Appeal referred to the Ninth Circuit's holdings in these cases as "a misapplication of California law when applied to an employee's noncompetition agreement." In so holding, the appellate court limited the enforceability of customer nonsolicitation agreements to the statutorily defined exceptions to section 16600 and to the protection of an employer's proprietary information satisfying the definition of "trade secret" under California's Uniform Trade Secret Protection Act, Civil Code section 3426.1 *et seq.*

Regarding the lawfulness of the general release, the Court of Appeal held that failure to expressly exempt claims for indemnification under Labor Code section 2802 from any general release is an independently wrongful act that may be the basis for tort liability.

## The Edwards Court Rejects the Ninth Circuit's "Narrow-Restraint" Doctrine

At the outset of the decision, the *Edwards* court provided a summary of California law governing restraints of trade and covenants not to compete and concluded that California law, as shown in Business and Professions Code section 16600 and numerous California Supreme Court and intermediate state appellate court decisions, unequivocally invalidates all contracts that purport to restrain "anyone ... from engaging in a lawful profession, trade, or business of any kind[.]"<sup>1</sup> This broad prohibition on covenants not to compete is intended to foster the dual interests in protecting employee mobility and open competition. The court, therefore, found that there was no valid exception to section 16600 except for those statutory exceptions contained in Business and Professions Code section 16601 (relating to the sale or transfer of interests in businesses and corporations), 16602 (pertaining to partnerships) and 16602.5 (relating to limited liability companies).<sup>2</sup> In so holding, the court observed that, by enacting section 16600 (and its predecessor statutes), the California State Legislature expressly rejected the common law that allowed "reasonable" post-employment restrictions (as are widely accepted in other states).

The *Edwards* court then turned to Andersen's argument concerning the language of section 16600, which used the term "restrain," and Anderson's assertion that the term should be deemed synonymous with "prohibit," thus allowing for contractual limitations on an employee's post-employment conduct so long as that restraint did not "prohibit" employee from engaging in his or her chosen business, trade or profession. The court rejected this argument and rejected the line of Ninth Circuit cases upon which it was based, noting "California courts have not embraced the Ninth Circuit's narrow-restraint exception. Indeed, no California state court decision has endorsed the Ninth Circuit's reasoning, and we are of the view that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat."

To the contrary, the *Edwards* court found that section 16600 "unambiguously" dictates that

even partial restraints on individuals' ability to practice their profession are prohibited. Thus, having rejected the so called narrow restraint doctrine, the Edwards court applied the "unambiguous" mandate of section 16600 and held that Edwards' employment agreement, which prohibited him from performing professional services for other companies that were of the type he provided while at Andersen was unlawful and unenforceable because it restricted Edwards' ability to engage in his chosen profession.

### While Holding that Section 2802 Indemnity Rights Are Unwaivable, the Court Upheld a Broad Release of "Any and All Claims"

In further support of his attempt to bring an interference claim, Edwards argued, and the Court of Appeal agreed, that the TONC's release language was unlawful and unenforceable because it purportedly waived Edwards' indemnity rights under California Labor Code section 2802. Edwards argued that this was yet another "wrongful" act to support the interference claim.

In this regard, Edwards was not hired by HSBC because he refused to execute the TONC, which contained the typical broad release language releasing "any and all claims," including "claims that in any way arise from or out of, are based upon or relate to [Edwards'] employment by, association with or compensation from" Andersen. Edwards refused to sign the TONC because he did not want to release any of his right under Labor Code section 2802 to have Andersen indemnify him for "all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties." Edwards was concerned that he could be personally named as a defendant in a lawsuit arising out of the events surrounding the demise of Enron, and he wanted to ensure the he preserved any right

he had to have Andersen pay his litigation-related expenses. As noted above, the Court of Appeal concluded that this broad release language was unlawful and unenforceable under section 2804. The California Supreme Court disagreed and reversed.

Initially, the court analyzed Labor Code sections 2802 and 2804 and concluded that, given the express language of section 2804, an employee's indemnity rights under section 2802 are unwaivable.<sup>3</sup> Then, the court turned to the release language of the TONC and observed that it did not expressly waive indemnity rights under section 2802. The court next applied general rules governing the interpretation of contractual language and concluded that the release language, which purported to release "any and all claims," should not be given an interpretation that would render the agreement null and void. To the contrary, the court determined that Edwards and Andersen were presumed to have known that the law prohibited waiver of such claims, and they therefore intended that claims for indemnity would be not be waived by the TONC. Accordingly, the court upheld the broad release language of the TONC, including the language releasing "any and all claims," while at the same time the court concluded that such language did not release the unwaivable indemnity rights under section 2802.<sup>4</sup>

### What This Means for Employers

Many practitioners were eagerly anticipating the court's decision in *Edwards*. Indeed, had the court adopted the Ninth Circuit's "narrow-restraint" doctrine, this would have been a watershed event for California law governing post-employment covenants not to compete. However, the court's rejection of that doctrine means that there is no change in the law except that the Ninth Circuit and federal cases, which established and applied the narrow restraint

doctrine no longer are valid and should not be relied upon in California in the future. Furthermore, employers should promptly engage in a top-to-bottom review of all existing employment agreements, confidentiality agreements and employment policies and forms to ensure that all such documents do not contain language that might constitute even a "narrow restraint" on lawful post-employment competition, which would now be invalid under *Edwards*.

With regard to the section 2802 issue, the *Edwards* court averted a major disaster for employers who typically use broad release language in severance agreements. Under the rationale of the Court of Appeal, all such severance agreements might be invalid and unenforceable by virtue of their purported waiver of unwaivable rights under section 2802. Accordingly, by interpreting agreements as being valid despite the broad language, the court avoided the potential wave of suits claiming that waivers in employment-related severance agreements should be struck down based on a technical reading of such agreements.

Nevertheless, in light of *Edwards*, employers and practitioners are well advised to review all forms of severance agreements currently in use and ensure that such agreements do not contain express waivers of indemnity rights under section 2802 (and that they do not contain express waivers of any other "unwaivable" statutory rights).

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<sup>1</sup> Cal. Bus. & Prof. Code § 16600.

<sup>2</sup> Interestingly, the *Edwards* court expressly chose not to address the widely recognized exception arising in connection with the protection of trade secrets, commenting only that that exception was not relevant to Edwards' claim.

<sup>3</sup> California Labor Code section 2804(a) provides that "[a]ny contract or agreement, express or implied, made by any employee to waive the benefits of, among other things, Labor Code section 2802] is null and void, and this article shall not deprive any employee or his personal representative of any right or remedy to which he is entitled under the laws of this State."

<sup>4</sup> Nevertheless, the court indicated that, on remand, Edwards was entitled to present evidence to rebut this presumption if, for example, Anderson expressly and intentionally sought his waiver and release of section 2802 indemnity rights.