

EDWARDS AND COVENANTS NOT TO COMPETE IN CALIFORNIA: LEAVE WELL ENOUGH ALONE

By David R. Trossen

The California Supreme Court recently reannounced California's stance against covenants not to compete in *Edwards v. Arthur Andersen LLP*.¹ In ruling a noncompetition agreement invalid pursuant to section 16600 of the California Business and Professions Code, the Court rejected the Ninth Circuit's "narrow-restraint" exception as an improper interpretation of California law.² Under the "narrow-restraint" exception, section 16600 would not invalidate a noncompetition agreement unless it restrains the employee from practicing any part of his profession, trade, or business.³ After determining that the language of section 16600 was unambiguous, and that the legislature could have written the statute to apply only to unreasonable or overbroad restraints if it had desired to do so, the court left it to the legislature to relax section 16600's general prohibition against noncompetition clauses or to adopt additional exceptions.⁴

This decision epitomizes the California state courts' strong preference for employee mobility over employers' interest in protecting themselves from unfair competition. Part I details the statutes and case law relevant to the *Edwards* decision. Part II summarizes the facts and procedural history of *Edwards* and considers its practical impact on noncompete agreements in California. Part III considers the existing literature on the role of California's noncompetition law in the development of its economy. In particular, Part III analyzes whether the California State Legislature should modify section 16600's noncompete prohibition and concludes that, given the success of Silicon Valley and the lack of evidence showing that California's noncompetition law is a hindrance to innovation, leaving section 16600 intact is a wise decision.

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1. 189 P.3d 285 (Cal. 2008).
2. *Id.* at 290-91.
3. *Campbell v. Bd. of Trs. of Leland Stanford Junior Univ.*, 817 F.2d 499, 502-03 (9th Cir. 1987).
4. *Edwards*, 189 P.3d at 292.

I. BACKGROUND

This section summarizes the history and law leading up to *Edwards*. Section I.A describes section 16600 of the California Business and Professions Code and its history. Section I.B reviews the Ninth Circuit's narrow-restraints exception to section 16600. Finally, Section I.C analyzes the trade-secrets exception to section 16600.

A. Historical Development of Section 16600

1. Enactment

Covenants not to compete are employer-employee contracts that provide that the employee will not, after termination of his or her employment, compete with the employer in the employer's existing or contemplated businesses for a designated period of time and within a designated geographic area.⁵ The law governing covenants not to compete has traditionally been the province of the states.⁶

At common law, and under many state statutory regimes today, a restraint on the practice of a trade or occupation of a former employee is valid if reasonable.⁷ By adopting California Civil Code section 1673 in 1872 (now section 16600 of the California Business and Professions Code), the California State Legislature enacted a rule generally prohibiting noncompetition agreements rather than a reasonableness approach.⁸ California's noncompete law has remained virtually unchanged since.

The history of section 16600 began in 1847, when Senator David Field of New York was charged with codifying the law of the courts of record of his state.⁹ Although New York never adopted Field's civil code, states newly admitted to the Union, like California, sought to impose a consistent body of law throughout their territories.¹⁰

5. Chiara F. Orsini, Comment, *Protecting an Employer's Human Capital: Covenants Not To Compete and the Changing Business Environment*, 62 U. PITT. L. REV. 175, 176 (2000).

6. See Norman D. Bishara, *Covenants Not To Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment*, 27 BERKELEY J. EMP. & LAB. L. 287, 297 (2006).

7. *Bosley Med. Group v. Abramson*, 207 Cal. Rptr. 477, 480 (Ct. App. 1984).

8. *Id.*

9. Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 613-14 (1999).

10. *Id.* at 614.

Consequently, a series of California governors urged codification of the state's laws, and eventually the legislature appointed a commission to revise and compile the laws of California.¹¹ The commission moved promptly to adopt Field's proposed New York Civil Code in total, and ultimately the legislature adopted a version of it.¹² Section 833 of Field's proposed New York Civil Code, adopted verbatim by the California State Legislature, was the precursor of Business and Professions Code section 16600.¹³

Today section 16600 reads: "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."¹⁴ Section 16600 ensures that all citizens retain the right to pursue any lawful employment and enterprise of their choice.¹⁵

Subsequent sections exempt three kinds of noncompetition agreements: restraints on persons who sell the goodwill of a business from carrying on a similar business (section 16601); restraints on a partner from carrying on a similar business after the dissolution of the partnership or his disassociation from it (section 16602); and restraints on a member of a limited liability company from forming a similar business after the dissolution of, or the termination of his interest in, that limited liability corporation (section 16602.5).¹⁶ The statutory exceptions to section 16600 reflect legislative policy decisions. Section 16601, for example, reflects the policy judgment that when the goodwill of a business is sold, it is fair for the parties to contract to prohibit the seller from engaging in competition that would diminish the value of the asset he or she sells.¹⁷

2. *Early Judicial Interpretation*

In interpreting section 16600, the California Supreme Court has read the statutory prohibition broadly. For example, the California Supreme Court has used section 16600 to invalidate noncompetition agreements

11. *Id.* at 615-16.

12. *Id.* at 616.

13. *Id.* Section 833 of the proposed New York code became section 1673 of the California Civil Code in 1872, which in turn became section 16600 of Business and Professions Code in 1941. *Id.* at 619.

14. CAL. BUS. & PROF. CODE § 16600 (2008).

15. *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 27 Cal. Rptr. 2d 573, 577 (Ct. App. 1994).

16. CAL. BUS. & PROF. CODE §§ 16601-16602.5 (2008).

17. *Hill Med. Corp. v. Wycoff*, 103 Cal. Rptr. 2d 779, 785 (Ct. App. 2001).

that only partially restrain trade. In *Chamberlain v. Augustine* the defendant became financially interested in, and assumed control of, a competing foundry, despite the defendant's agreement not to do so as part of a contract for the sale of foundry stock.¹⁸ In finding the agreement void pursuant to the precursor of section 16600, the court rejected the argument that the agreement was valid because it applied to only three states and allowed the defendant to act as a laborer at specifically named foundries.¹⁹ The court noted that the statute prohibited "every contract by which anyone is restrained from exercising a lawful business," and made no exception for partial restraints.²⁰

Some California courts have extended the reach of section 16600 by refusing to enforce choice-of-law provisions in an employment contract containing a covenant not to compete. For example, in *Application Group, Inc. v. Hunter Group, Inc.*, the court applied California law to a noncompete agreement between a Maryland employer and a Maryland resident despite a Maryland choice-of-law clause.²¹ The California court opined that California has a strong interest in protecting the freedom of movement of persons whom California-based employers wish to employ, regardless of the person's state of residence or precise degree of involvement in California projects.²²

B. The Ninth Circuit's "Narrow-Restraint" Exception to Section 16600

The Ninth Circuit created a judicial exception to section 16600 in *Campbell v. Board of Trustees of Leland Stanford Junior University*.²³

The California Supreme Court has called the Ninth Circuit's *Campbell* interpretation of section 16600 the "narrow-restraint" exception because the interpretation upholds so-called narrow restraints, or restraints that do not entirely preclude employees from engaging in a lawful profession, trade, or business.²⁴ In *Campbell*, plaintiff Campbell and Stanford Univer-

18. 156 P. 479, 479-80 (Cal. 1916).

19. *Id.* at 480.

20. *Id.* (emphasis added); see also *Morey v. Paladini*, 203 P. 760, 763-64 (Cal. 1922) (invalidating an exclusive contract for the sale of lobsters under California Civil Code section 1673, now section 16600 of the California Business and Professions Code, as being at least a partial restraint of trade).

21. 72 Cal. Rptr. 2d 73 (Ct. App. 1998).

22. *Id.* at 84-85.

23. 817 F.2d 499 (9th Cir. 1987).

24. *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 290 (Cal. 2008).

sity entered into a contract in which Campbell agreed to make certain revisions to the Strong-Campbell Interest Inventory (SCII) test for vocational guidance counseling.²⁵ Additionally, Campbell promised to refrain from preparing or causing to be published any similar work that might injure the sale of the SCII test.²⁶ In a breach of contract suit based on diversity jurisdiction, Campbell argued that the noncompete clause was void under section 16600.²⁷

The federal district court granted summary judgment in favor of Stanford University on the validity of the noncompete, and held that California courts imply a reasonableness standard into section 16600 and that the covenant not to compete was “inherently reasonable.”²⁸ The Ninth Circuit disagreed with the lower court’s interpretation of the statute.²⁹ Acknowledging that the California State Legislature had rejected the common-law rule that reasonable restraints of trade are generally enforceable, the panel reasoned that section 16600 “only makes illegal those restraints which preclude one from engaging in a lawful profession, trade, or business,” thus creating the “narrow-restraint” exception.³⁰ The court remanded the case for determination of Campbell’s profession and whether the noncompete clause precluded him from pursuing it.³¹

The Ninth Circuit in *Campbell* acknowledged that California law governs the substantive issues of state law in a diversity action.³² Accordingly, the Ninth Circuit supported its “narrow-restraint” exception to section 16600 with the California Court of Appeal case *Boughton v. Socony Mobil Oil Co.*,³³ while distinguishing the California Court of Appeal case *King v.*

25. *Campbell*, 817 F.2d at 501. Plaintiff-appellant Campbell revised and further developed the test for career guidance counseling called the Strong Vocational Interest Blank test. The current edition of the test is identified as the Strong-Campbell Interest Inventory test. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* at 502.

29. *Id.*

30. *Id.*; see also *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 290 (Cal. 2008) (labeling the *Campbell* rule a “narrow-restraint” exception).

31. *Campbell*, 817 F.2d at 503.

32. *Id.* at 501.

33. 41 Cal. Rptr. 714 (Ct. App. 1964). *Boughton* held that section 16600 did not prohibit a restriction on the use of a parcel of land as a gas station for a limited time. *Id.* at 715. The Ninth Circuit supported its interpretation of section 16600 with *Boughton*’s statement that “while the cases are uniform in refusing to enforce a contract wherein one is restrained from pursuing an *entire* business, trade, or profession, as falling within the

Gerold.³⁴ However, the Ninth Circuit in *Campbell* failed to mention, much less distinguish, *Chamberlain*, a California Supreme Court case that seems to reject such an exception in favor of a general rejection of *any* restraint, regardless of its purported narrowness.³⁵

The Ninth Circuit applied its “narrow-restraint” exception twice more, in *General Commercial Packaging, Inc. v. TPS Packaging Engineering* and in *International Business Machines Corp. v. Bajorek*.³⁶ In *General Commercial Packaging*, TPS Packaging Engineering (TPS) agreed not to work directly for, or solicit business from, any company that General Commercial Packaging introduced it to and contracted it to do business for.³⁷ The Ninth Circuit determined that section 16600 did not invalidate General Commercial’s contract with TPS unless the agreement entirely precluded TPS from pursuing its trade or business.³⁸ After determining that the contract did not bar TPS from soliciting work from any firm with which it had a prior relationship, the Ninth Circuit concluded that the contract only limited TPS’s access to a narrow segment of the packing and shipping market, and was therefore valid.³⁹

The Ninth Circuit’s application of the “narrow-restraint” exception in *International Business Machines Corp. v. Bajorek* held valid an agreement that required an employee to forfeit his stock options if he worked for a competitor within six months after termination.⁴⁰ The court noted that the

ambit of section 16600 . . . where one is barred from pursuing only a small or limited part of the business, trade or profession, the contract has been upheld as valid.” *Campbell*, 817 F.2d at 502 (quoting *Boughton*, 41 Cal. Rptr. at 716).

34. 240 P.2d 710 (Cal. Ct. App. 1952). *King* upheld an agreement restricting a manufacturer from making a particular model of housing trailers. *Id* at 712. The Ninth Circuit in *Campbell* read *King* as upholding a noncompete agreement to stop making housing trailers as long as the manufacture of housing trailers in general was not prohibited by the agreement. *Campbell*, 817 F.2d at 503. The Ninth Circuit distinguished *King* as only barring the production of one particular model, rather than from prohibiting competing tests in general. *Id*.

35. *Campbell*, 817 F.2d 499. See *infra* Section II.B. for the Supreme Court of California’s determination in *Edwards* that *Campbell*’s reliance on *Boughton* and *King* was misguided.

36. *Gen. Commercial Packaging, Inc. v. TPS Package Eng’g, Inc.*, 126 F.3d 1131, 1133 (9th Cir. 1997); *IBM v. Bajorek*, 191 F.3d 1033, 1041 (9th Cir. 1999).

37. *Gen. Commercial Packaging, Inc.*, 126 F.3d at 1132.

38. *Id*. at 1133.

39. *Id*. at 1134.

40. *Bajorek*, 191 F.3d at 1041.

employee could have kept the value of the stock options and gone to work for a competitor immediately upon quitting, had he exercised his stock options six months before he quit.⁴¹ Because the restraint was thereby limited, the court found the restriction to be distinguishable from a California Supreme Court case holding that section 16600 invalidated an agreement that required a worker to forfeit his pension if he ever worked for a competitor.⁴²

C. The Trade-Secrets Exception to Section 16600

In addition to the statutory exemptions to section 16600, and the Ninth Circuit's "narrow-restraint" exception which was rebuked by the California Supreme Court in *Edwards*, a trade-secrets exception to section 16600 might exist. Of particular importance to the practical effects of *Edwards* on noncompete practice in California, discussed infra in Section II.C, is whether there is a trade-secrets exception to section 16600.

The Court in *Edwards* specifically declined to decide the issue, and stated in a footnote, "[w]e do not here address the applicability of the so-called trade-secrets exception to section 16600."⁴³

Gordon v. Landau is the critical case on the issue of whether there is a trade-secrets exception.⁴⁴ In *Gordon*, a collector-salesman was given a set of cards on each working day containing confidential customer information such as the customer's name, address and a list of previously purchased merchandise.⁴⁵ Despite having signed an agreement to the contrary, shortly after his termination, the salesman began selling the same kind of merchandise along his old route to the customers he knew through his former employer.⁴⁶ In holding that section 16600 did not void the contract, the Supreme Court of California determined that the terms of the contract did not prevent the defendant from carrying on a business, but rather prevented him from using his employer's confidential lists for a period of one year following his termination.⁴⁷ The court determined that the contract was valid and enforceable because the list of customers was a

41. *Id.*

42. *Id.*; see also *Muggill v. Reuben H. Donnelley Corp.*, 42 Cal. Rptr. 107, 109 (Cal. 1965).

43. *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 291 n.4 (Cal. 2008).

44. 321 P.2d 456 (Cal. 1958).

45. *Id.* at 457-58.

46. *Id.* at 458.

47. *Id.* at 459.

valuable trade secret and that the employer was damaged by the defendant's unlawful use of that trade secret.⁴⁸

The later Supreme Court of California case *Muggill v. Reuben H. Donnelley Corp.* created the language typically cited for the trade-secrets exception.⁴⁹ In *Muggill*, the court cited *Gordon* in dictum for the proposition that section 16600 invalidates noncompetition agreements "unless they are necessary to protect the employer's trade secrets."⁵⁰ Although many recent appellate court cases recognize the exception,⁵¹ it may be unwise for employers to count on it as a mechanism for enforcement of noncompete clauses for two key reasons. First, the appellate courts have repeated the dictum from *Muggill* without much analysis, and the dictum may stand for nothing more than the proposition that section 16600 doesn't void or preempt California trade secrets law.⁵² Secondly, even if the trade-secrets exception exists, the California courts hesitated in viewing such provisions as necessary to protect an employer's trade secrets, and have never upheld a noncompetition agreement because of the trade-secrets exception.⁵³ *D'sa v. Playhut* illustrates the courts' preference in interpreting a provision as restricting competition, rather than as necessary to protect trade secrets.⁵⁴

In *D'sa*, an employee alleged that his employer hired him pursuant to an oral contract for an indefinite term.⁵⁵ Thereafter, the employer presented the employee with a confidentiality agreement, which the employee refused to sign.⁵⁶ After the employee was fired, he brought a wrongful termination claim alleging that the employment agreement contained a covenant not to compete in violation of section 16600, and that the fact that the agreement contained a severability provision making the remainder of the contract lawful did not make his termination lawful.⁵⁷

48. *Id.*

49. *Muggill v. Reuben H. Donnelley Corp.*, 42 Cal. Rptr. 107 (Cal. 1965).

50. *Id.* at 109.

51. *See, e.g.*, *Thompson v. Impaxx, Inc.*, 7 Cal. Rptr. 3d 427, 429-30 (Ct. App. 2003); *Whyte v. Schlage Lock Co.*, 125 Cal. Rptr. 2d 277, 292-93 (Ct. App. 2002) (in dicta); *ReadyLink Healthcare v. Cotton*, 24 Cal. Rptr. 3d 720, 731 (Ct. App. 2005); *D'sa v. Playhut, Inc.*, 102 Cal. Rptr. 2d 495, 500 (Ct. App. 2000).

52. *See infra* Section II.C.

53. *See infra* Section II.C.

54. *See D'sa*, 102 Cal. Rptr. 2d at 500.

55. *Id.* at 497.

56. *Id.*

57. *Id.*

The California Court of Appeals first determined that the intended purpose of the provision at hand was to create a covenant not to compete, not one to protect trade secrets.⁵⁸ As a result, the agreement was void under section 16600.⁵⁹ The court noted that other provisions of the agreement were meant to provide trade secret protection, and the covenant not to compete placed a one year restriction on the plaintiff's activities while the other provisions were not so limited.⁶⁰ After the court determined the clause invalid, it ruled in favor of the defendant, and held that it did constitute wrongful termination to fire an employee for refusing to sign an employment agreement containing an invalid covenant not to compete, even if the contract contained a severability provision that would make the lawful provisions survive.⁶¹ The court rejected the concept that a worker, compelled by the economic necessity to secure employment, could be coerced into signing such a sweeping agreement in the uninformed hope that the agreement would not be enforced by the courts.⁶²

II. CASE SUMMARY

The California Supreme Court finally rebuked the Ninth Circuit's "narrow-restraint" exception to section 16600 in *Edwards*.⁶³ Section II.A discusses the facts and procedural history of *Edwards*. Section II.B details the California Supreme Court's analysis. Finally, Section II.C discusses the practical impacts of *Edwards* on noncompete practice in California.

A. Facts and Procedural History

Raymond Edwards II (Edwards), a certified public accountant, was offered a position as a tax manager at the accounting firm Arthur Andersen LLP (Andersen) contingent upon his signing a noncompetition agreement.⁶⁴ The agreement prohibited Edwards: (1) for eighteen months after his termination, from performing professional services of the type he provided for any client for whom he had worked during the eighteen months prior to his termination; (2) for twelve months after his termination, from soliciting any client for whom he had worked during the eighteen months

58. *Id.* at 501.

59. *Id.*

60. *Id.*

61. *Id.* at 497.

62. *Id.* at 501.

63. *Edwards v. Arthur Andersen LLP*, 189 P.3d 285 (Cal. 2008).

64. *Id.* at 285.

prior to his termination; and (3) for eighteen months after his termination, from soliciting away from Andersen any of its personnel.⁶⁵

After signing the agreement, Edwards worked for Andersen for several years, during which he moved into the firm's private client services practice group, where he handled income, gift, and estate tax planning for wealthy individuals and entities.⁶⁶ In April 2002, in response to Andersen's indictment in connection with the federal investigation of Enron, Andersen announced it would cease its United States accounting practices and began selling off its practice groups.⁶⁷ HSBC USA, Inc. (HSBC) contracted to purchase a portion of Andersen's tax practice, including Edwards's group.⁶⁸ As part of the deal, HSBC required that Andersen provide it with a completed "Termination of Non-compete Agreement" (TONC) signed by every employee on the "Restricted Employees" list, of which Edwards's name was listed on at least one draft.⁶⁹ In July 2002, HSBC offered Edwards employment, contingent on Edwards executing the TONC, which required Edwards to: (1) voluntarily resign from Andersen, (2) release Andersen from any and all claims, (3) continue indefinitely to preserve Andersen's confidential information and trade secrets except as otherwise provided by a court or government agency, (4) refrain from disparaging Andersen or its related entities or partners, and (5) cooperate with Andersen in connection with any investigation or litigation against Andersen.⁷⁰ In exchange, Andersen would agree to accept Edwards's resignation, agree to Edwards's employment by HSBC, and release Edwards from the 1997 noncompetition agreement.⁷¹ After Edwards refused to sign the TONC Andersen terminated him and HSBC withdrew Edwards's employment offer.⁷²

In April 2003, Edwards filed a complaint in California state court against Andersen for intentional interference with prospective economic advantage.⁷³ Edwards alleged that Andersen's noncompetition agreement

65. *Id.*

66. *Id.* at 285-86.

67. *Id.* at 286.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* Edwards refused to sign the TONC, in part, because he was afraid of losing his right to indemnification from his employer. *See id.* at 286-87.

73. *Id.* at 286. In order to prove a claim for intentional interference with prospective economic advantage, a plaintiff has the burden of proving five elements: (1) an economic

violated section 16600, and therefore Andersen's demand that he give consideration to be released from it was a wrongful interference.⁷⁴ The Superior Court of Los Angeles County determined that the noncompetition agreement did not violate section 16600 because it was narrowly tailored and did not deprive Edwards of his right to pursue his profession.⁷⁵ The Court of Appeal reversed, holding that the noncompetition agreement was invalid under section 16600.⁷⁶ The Court of Appeal further held that requiring Edwards to sign the TONC as consideration to be released from it was in violation of public policy and an independently wrongful act for purposes of a claim of intentional interference with prospective economic advantage.⁷⁷

B. The Supreme Court of California's Analysis

The Supreme Court of California affirmed the Court of Appeal's ruling that the noncompetition agreement was invalid pursuant to section 16600 because it restrained Edwards's ability to practice his profession.⁷⁸

In reaching this conclusion, the court rejected Andersen's request that the court adopt the "narrow-restraint" exception to section 16600 that the Ninth Circuit discussed in *Campbell*.⁷⁹ The court was similarly not persuaded by the analysis of either *Boughton* or *King*.⁸⁰ Distinguishing *Boughton* because it involved a covenant not to use a parcel of land as a gasoline station, the court held that section 16600 was not implicated in that case because it involved the use of land.⁸¹ With regards to *King*, the court emphasized that the plaintiff was allegedly selling a trailer design substantially similar to that of his former employer, the inventor of the de-

relationship between plaintiff and a third party, with the probability of future economic benefit to the plaintiff; (2) defendant's knowledge of the relationship; (3) an intentional act by the defendant, designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) economic harm to the plaintiff proximately caused by the defendant's wrongful act, including an intentional act by the defendant that is designed to disrupt the relationship between the plaintiff and a third party. *Id.* at 287.

74. *Id.*

75. *Id.*

76. *Edwards v. Arthur Andersen LLP*, 47 Cal. Rptr. 3d 788, 803 (Ct. App. 2006).

77. *Id.* at 804.

78. *Edwards*, 189 P.3d at 290.

79. *Id.* at 290-92.

80. *Id.* at 291-92; *see also supra* Section I.B.

81. *Edwards*, 189 P.3d at 291 (distinguishing *Boughton v. Socony Mobil Oil Co.*, 41 Cal. Rptr. 714 (Ct. App. 1965)).

sign.⁸² The court emphasized that the case involved more than the plaintiff simply manufacturing and selling competing goods.⁸³ Furthermore, after stating that neither *Boughton* nor *King* provides any guidance on the issue of noncompetition agreements, the court went on to say that “to the extent they are inconsistent with our analysis, we disapprove.”⁸⁴

Although the court agreed with Andersen that *Campbell* has been followed in some Ninth Circuit cases, the court stated that no reported California state court decision has endorsed the Ninth Circuit’s reasoning.⁸⁵ The court emphasized that section 16600 was unambiguous, and stated that if the legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect.⁸⁶

C. The Practical Effect of *Edwards* on Noncompete Practice in California

The *Edwards* decision rebuked the Ninth Circuit’s “narrow-restraint” exception to section 16600 and reaffirmed California’s robust right to employee mobility. The decision recognized the statutory exceptions to section 16600’s prohibition on noncompetes in connection with the sale or dissolution of a business, partnership, or limited liability corporation.⁸⁷ However, *Edwards* did not decide whether there is a trade-secrets exception to section 16600.⁸⁸

In light of *Edwards*, employers should review their existing noncompetition agreements to make sure that they do not contain unenforceable clauses that rely on the Ninth Circuit’s “narrow-restraint” exception. Employers should also redraft their employment agreements for incoming employees to remove any unlawful noncompetition clauses.

Additionally, employers should not count on the trade-secrets exception to section 16600. *Gordon*, which held a contract prohibiting a salesman from selling to customers on his former employer’s secret list enforceable because the list of customers was a valuable trade secret, might be construed to only apply to activities, such as misuse of trade secrets or

82. *Id.*

83. *Id.* at 291 (distinguishing *King v. Gerold*, 240 P.2d 710 (Cal. Ct. App. 1952)).

84. *Id.* at 293 n.5.

85. *Id.* at 291.

86. *Id.* at 292.

87. *Id.* at 288; CAL. BUS. & PROF. CODE §§ 16601-16602.5 (2008).

88. *See supra* Section I.C.

breach of fiduciary duty, that are illegal in the absence of contract.⁸⁹ Accordingly, contracts that restrict these activities are not a restraint of a “lawful profession, trade or business.”⁹⁰ Under this interpretation, the trade-secrets exception stands for nothing more than the proposition that section 16600 doesn’t void or preempt the operation of California trade secrets law.⁹¹

Assuming arguendo that the proof of an interest in trade secrets might make a noncompetition agreement valid under the trade-secrets exception, an employer should not rely on the exception for enforcement of their noncompetition agreements. In particular, no California case has ever upheld a noncompetition agreement under the trade-secrets exception.⁹² Hence, even if the trade-secrets exception exists, cases like *D’sa* illustrate that California courts may view skeptically noncompetition agreements alleged to be provisions legitimately protecting trade secrets.⁹³ Accordingly, it is unwise for employers to count on this exception in drafting noncompetition agreements.

Furthermore, an employer should be careful about firing an employee who refuses to sign an agreement containing an invalid noncompetition clause, as this may be grounds for a wrongful termination action.⁹⁴

Additionally, employers should not count on choice-of-law provisions to ensure the enforcement of noncompetition clauses.⁹⁵ However, even though a California court might refuse to enforce a choice-of-law provision as in *Application Group*, companies with employees in other jurisdictions may still wish to include choice-of-law and choice-of-forum provisions.⁹⁶

III. DISCUSSION

The California Supreme Court in *Edwards* declined to legitimize the Ninth Circuit’s “narrow-restraint” exception to section 16600.⁹⁷ This deci-

89. Brief for Law Professors & Writers of Learned Treatises as Amici Curiae at 12-13, *Edwards*, 189 P.3d 285.

90. *Id.*

91. *Id.*

92. *Id.* at 14.

93. *See supra* Section I.C.

94. *See supra* Section I.C.

95. *See Orsini, supra* note 5, at 192-93.

96. *See supra* Section I.A.

97. *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 291-92 (Cal. 2008).

sion raises the question of whether or not the California State Legislature should revise existing noncompetition law. This Note analyzes empirical and theoretical sources, with an emphasis on Silicon Valley, and concludes that the legislature should leave California's noncompetition law alone.

A. Regional Studies about the Effect of Noncompetition Law on the Success of Technology-Focused Economies

Many commentators have suggested that California noncompete law has played a key role in the development of California's technology sector.⁹⁸

In particular, AnnaLee Saxenian traced the importance of high employee mobility in the development of the Silicon Valley. After noting, *inter alia*, that the Silicon Valley was distinguished by unusually high levels of job hopping, and that the job tenures of the region's computer professionals averaged two years during the 1970s, Saxenian concluded that this fluid environment accelerated the diffusion of technological capabilities and know-how in the region.⁹⁹ Saxenian posited that when engineers moved between companies, they took with them knowledge, skills, and experience from their previous jobs that created a localized accumulation of knowledge that enhanced the viability of Silicon Valley startups.¹⁰⁰

Likewise, Professor Ronald Gilson posits that California's lack of enforcement of covenants not to compete played a pivotal role in the Silicon Valley's triumph over the similarly technology-focused region in Massachusetts called Route 128.¹⁰¹ Gilson suggested that California's general prohibition against noncompetes, as contrasted to Massachusetts' general enforcement of them under a reasonableness approach, explains how Silicon Valley has continued its economic success, while Route 128's economic prosperity waned.¹⁰² According to Gilson, much of a company's intellectual property is embedded within the tacit knowledge¹⁰³ of its employees.¹⁰⁴ Section 16600 creates an easy path for employees to move be-

98. *See, e.g.*, ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994); Gilson, *supra* note 9, at 627.

99. SAXENIAN, *supra* note 98, at 34-37.

100. *Id.* at 37.

101. *See* Gilson, *supra* note 9, at 608-09.

102. *Id.* at 594, 608-09.

103. "'Tacit knowledge' is the skill or expertise, as opposed to easily codifiable information, that employees acquire through experience." *Id.* at 577 n.10.

104. *Id.* at 594.

tween employers, and take with them and apply in their new position their former employer's tacit knowledge.¹⁰⁵ California's legal infrastructure of noncompetition has caused employers to adopt a strategy of simultaneous cooperation and competition, which in turn generated a dynamic process leading to Silicon Valley's characteristic career pattern, lack of vertical integration, knowledge spillovers, and business culture.¹⁰⁶ Thus, the legal infrastructure generated the initial conditions which ultimately caused Silicon Valley to thrive.¹⁰⁷ In contrast, the widespread use and enforcement of covenants not to compete in Massachusetts slowed employee mobility below the threshold necessary to support continued regional economic success.¹⁰⁸

Gilson and Saxenian agree that knowledge spillover is of primary importance in sustaining a technology-based economy. Gilson also claims that noncompetition law is a casual underpinning to the creation of the culture of the region and ultimately led to the Valley's success. Based on these studies, it would appear at first glance that the California State Legislature should not modify section 16600.

However, despite the success of the Silicon Valley under California's existing noncompetition law, a later analysis including Austin, Texas, and the Research Triangle in North Carolina, indicates that Gilson's emphasis on noncompete law as a driving force of sustainable economic success in a technology-based economy is either overemphasized or obscured by other factors in the complex industrial development equation.¹⁰⁹ Despite a wide diversity in noncompetition law, with California and Texas being reluctant to enforce such covenants and North Carolina and Massachusetts favoring enforcement,¹¹⁰ Jason Wood found that in the years following Gilson's

105. *Id.* at 593, 608.

106. *Id.* at 608-09.

107. *See id.* at 609.

108. *See id.* at 602-03.

109. *See generally* Jason S. Wood, *A Comparison of the Enforceability of Covenants Not To Compete and Recent Economic Histories of Four High Technology Regions*, 5 VA. J.L. & TECH. 14 (2000).

110. As discussed *supra* in Section I.A., postemployment covenants not to compete are generally unenforceable in California. In Massachusetts, which is generally representative of the approach taken by the great majority of states, postemployment covenants are enforced, under a rule of reason, if the covenant's duration and geographic coverage are no greater than necessary to protect an employer's legitimate business interest and not otherwise contrary to the public interest. Gilson, *supra* note 9, at 603-04. In Texas, noncompetes are evaluated under a four factor rule of reason, although in practice the Texas Supreme Court has generally refused to enforce covenants not to compete by virtually

study, all four of these regions have enjoyed high levels of economic success.¹¹¹ In particular, since Gilson's article, the technology section in the Route 128 area rebounded economically, and the Research Triangle in North Carolina exhibited the largest rate of entrepreneurial growth.¹¹² Despite California's continued lead in venture capital investment in absolute dollars, Wood questioned how important a region's noncompetition law is in the development and growth of a complex technology-based economy.

From these studies, it is difficult to determine if California's choice of noncompetition law hindered or helped Silicon Valley's economy. For example, proximity to elite universities, the awarding of government contracts, the interaction of universities with local businesses, attractive weather and geography, cultural perceptions of risk, industry associations, nonhierarchical management, and lack of vertical integration—rather than noncompetition law—might be the real factors leading to the success of Silicon Valley.¹¹³ Accordingly, comparing the noncompetition law in various regions to the economic success of those regions does not convincingly demonstrate the optimum form of noncompetition law. Therefore, in considering whether the legislature should modify California's noncompetition law, a more tractable approach is to determine if major negative effects have materialized from California's choice of noncompetition law.

B. Institutional Developments Have Mitigated the Drawbacks of California's Noncompete Law

Silicon Valley has developed unique solutions to overcome each major drawback accompanying California's noncompetition law.¹¹⁴ Accordingly, even assuming *arguendo* that laws more permissive to noncompete contracting were optimal *ex ante*, reliance and the Valley's success in mitigating or overcoming these drawbacks make retention of the law optimal.

always invalidating the agreements under the rule of reason factors. Wood, *supra* note 109, at 29. North Carolina also follows a rule of reason approach, although unlike Massachusetts, North Carolina requires a few additional factors, such as valuable consideration, which makes it somewhat tougher for employers to enforce such agreements. *Id.* at 25-26.

111. Wood, *supra* note 109, at 44.

112. *Id.* at 39, 48-49.

113. SAXENIAN, *supra* note 98, at 29-57.

114. *See supra* Section II.B.

This Note will now address the two most important critiques of California's noncompetition law: (1) disincentive to employers to provide employee training, and (2) employer reduction in investment in research and development due to deteriorated trade secret and misappropriation protection.

1. *Disincentive to Provide Employee Training*

Commentators have suggested that high employee mobility and concern over employee poaching may undermine an employer's incentive to invest in training.¹¹⁵ Under this theory, firms operating in a regime with limited recourse to noncompete agreements perceive they cannot count on returns on investment in human capital and therefore inefficiently underinvest in their employees.¹¹⁶

Assuming *arguendo* that these commentators are correct in their hypothesis, Silicon Valley appears to have addressed this limitation of weak noncompete law with a unique solution: a labor market that facilitates the rapid hiring and shedding of labor. By making it easy for employers to obtain employees with specific skills and experience, the importance of encouraging employer investment in training homegrown employees lacking the requisite skills may decrease. Hence, a mobile work force of specialized employees that can be matched to specific jobs at a low transaction cost might shift the optimal point of employer investment in employee training downward.

In Silicon Valley, employers hire for specific skill sets and experience, and accordingly, they are able to eliminate some job training, job ladders, and mentoring because of specific labor market institutions that match specific skills with specific needs.¹¹⁷ Accordingly, Silicon Valley uses temporary employees—employees of temporary help agencies—at twice the national rate.¹¹⁸ In high tech, temporary employees do not just work in such traditional temporary positions as secretaries and receptionists, they also work in technical jobs such as programming and manufacturing.¹¹⁹

115. See Gillian Lester, *Restrictive Covenants, Employee Training, and the Limits of Transaction-Cost Analysis*, 76 IND. L.J. 49, 75 (2001); Bishara, *supra* note 6, at 303.

116. See Lester, *supra* note 115, at 75-76.

117. ALAN HYDE, *WORKING IN SILICON VALLEY* 96 (2003).

118. *Id.* at 98.

119. *Id.*

The nature of the job market led one executive of AT&T to say, “[j]obs’ are being replaced by ‘projects’ and ‘fields of work.’”¹²⁰

Saxenian also determined that the while Silicon Valley’s social and professional networks disseminate technical and market information, they also function as efficient job search networks.¹²¹ Accordingly, the Valley’s social and professional networks may have evolved to help address the need for easy acquisition of highly specialized labor as an alternative to employer training of existing labor.

Silicon Valley also extensively uses electronic job sites to match workers to jobs.¹²² Electronic recruiting, on websites such as hotjobs.com and careerbuilder.com, supports the short-term hiring of individuals with particular skills, as opposed to long-term commitment to individuals who would be trained and retrained for changing roles.¹²³ These electronic recruiting sites facilitate information flow in the labor market and reduce employee search costs, thereby making it possible for an employer to rely on a mobile labor market rather than a homegrown work force.¹²⁴

Silicon Valley’s infrastructure supporting the matching of qualified employees to specialized jobs has decreased the importance and need to encourage employer investment in training. In order to secure investment in employee training where employer training is necessary, such as for skilled employees whose demand exceeds the supply, alternative methods to noncompetes can be used to prevent employee loss. For example, Professor Bishara has suggested that employers may be able to secure costly investment in valuable employees by potentially lucrative yet-to-vest stock options, other forms of delayed compensation, or simply by encouraging employee ownership.¹²⁵

As an alternative to employer-provided training, employers may also emphasize skill development by using competency-based organization, whereby employees are paid for the skills they have, rather than under traditional job evaluation formulas.¹²⁶ According to this management style, skill-based pay gives employees an incentive to acquire new skills on their

120. Katherine V.W. Stone, *Knowledge at Work: Disputes over the Ownership of Human Capital in the Changing Workplace*, 34 CONN. L. REV. 721, 728-29 (2002).

121. SAXENIAN, *supra* note 98, at 32-34.

122. HYDE, *supra* note 117, at 143-45.

123. *Id.* at 145-46.

124. *Id.* at 143-44.

125. Bishara, *supra* note 6, at 296.

126. *See* Stone, *supra* note 120, at 733-34.

own, and they will pressure employers to provide training development opportunities.¹²⁷

The alternative methods to employer-provided training coupled with Silicon Valley's hiring practices and unique labor market make up for any employer disincentive to provide training that might exist under *Edwards* or section 16600 in general.

2. *Effect of Research and Development Investment*

Commentators have suggested that protecting trade secrets in high technology is important in order to encourage investment in research and development (R&D).¹²⁸ Most of the results of R&D are not patentable.¹²⁹ Without protection for trade secrets, firms would have reduced incentives to invest in R&D and instead may invest financial resources in raising salaries so as to draw creative employees from firms that have made investments in R&D.¹³⁰ Thus, in theory, rival firms could free ride on firms rather than invest in R&D.

To assess the validity of this contention, it is first necessary to evaluate whether or not weak noncompete law leads to the underenforcement of trade secret law. Although this statement has not been definitively or otherwise proved, many commentators have suggested that high employee mobility weakens trade secret protection.¹³¹ But assuming California's noncompetition law has weakened its trade secret protection, has this caused underinvestment in R&D?

There are several explanations why firms might continue to produce technological information even if it cannot be excluded from competitors in a highly mobile labor market. For example, firms might make so much money from technological change that R&D is still their best investment, despite the cyclical turnover of their labor force.¹³² Under this theory, a

127. *Id.* at 734.

128. Yuval Feldman, *Experimental Approach to the Study of Normative Failures: Divulging of Trade Secrets by Silicon Valley Employees*, 2003 U. ILL. J.L. TECH. & POL'Y 105, 120 (2003).

129. *Id.*

130. *Id.*

131. See Gilson, *supra* note 9, at 594-96 (Silicon Valley firms have been unable to prevent knowledge spillover because of the legal infrastructures failure to provide complete protection for an important category of intellectual property); Feldman, *supra* note 128, at 117 (trade secret disclosure correlates with non-compete contracts).

132. See HYDE, *supra* note 117, at 50-54.

firm may still invest in R&D *and* accept its loss resulting from high turnover as a cost of doing business.¹³³

Increased information spillover also reduces the level of R&D necessary to achieve a given cost reduction.¹³⁴ For example, in Silicon Valley, informal information exchange about technical matters facilitates rapid technological advancement at reduced costs.¹³⁵ Analogously, the reduction in the cost of R&D resulting from receiving competitors' trade secrets might *exceed* the investment loss resulting from spillover, making it profitable for the firm to nevertheless invest in research and development.

Additionally, some of a firm's trade secrets might be embedded in firm-specific form, and therefore would not be as valuable to competitors.¹³⁶ Professor Kenneth Arrow posits that each firm has a way of *coding* information which need not be uniquely optimal, like the multiplicity of human languages.¹³⁷ This firm-specific aspect of information makes it less valuable to rivals.¹³⁸

One study showed that research and development experience from previous employers has a positive and significant impact on an employee's wages.¹³⁹ Accordingly, because employees may be on the market soon, they have maximum financial incentives to produce valuable information for their current employer.

Retention of employees by means other than noncompete agreements can also make investment in R&D profitable. Stock options may be useful in retaining employees with valuable information. Technology firms grant options three times as aggressively as non-technology firms, and stock options are used particularly generously in Silicon Valley firms.¹⁴⁰ Although studies question the relation between stock option grants and employee retention, stock options might be effective in binding employees for a few additional years who would otherwise leave sooner.¹⁴¹ In high technology

133. See SAXENIAN, *supra* note 98, at 35.

134. HYDE, *supra* note 117, at 50-54.

135. SAXENIAN, *supra* note 98, at 33.

136. Kenneth J. Arrow, *The Economics of Information: An Exposition*, 23 *EMPIRICA* 119, 126-27 (1996).

137. *Id.* at 127.

138. *Id.* at 126-27.

139. Jarle Møen, *Is Mobility of Technical Personnel a Source of R&D Spillovers?* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 7834, 2000), available at <http://www.nber.org/papers/w7834>.

140. HYDE, *supra* note 117, at 187-88.

141. *Id.* at 190.

industries where trade secrets are of a time-sensitive nature due to obsolescence from technological progress, stock option compensation may prove to be an effective tool in retaining critical employees and preventing the spillover of critical information.

In conclusion, employer alternatives to noncompete agreements, the positive effects of information spillover, and the firm-specific nature of some trade secrets counterbalances any employer disincentive to invest in R&D that might exist under *Edwards* or section 16600 in general.

IV. CONCLUSION

The Supreme Court in *Edwards* rejected the Ninth Circuit's "narrow-restraint" exception as an improper interpretation of California law. In many ways this case can be seen simply as the California Supreme Court rebuking the Ninth Circuit for interfering with the province of the state by trailblazing a judicial exception to section 16600. However, *Edwards* also stands for the court's prudent approach to California noncompete law: leave well enough alone.

In particular, despite the theoretical debate on optimal noncompetition law, employer backlash from a jurisdiction without covenants not to compete as labor investment protection has not materialized within Silicon Valley.¹⁴² Rather, the Valley continues to thrive as evidenced by California's continued lead in venture capital investment in absolute dollars.¹⁴³ Whether firms continue to invest in the Valley *despite* California's non-compete law or whether a highly mobile labor market aids in the Valley's success is uncertain. The problem of promoting technological growth is very complex, but until the evidence clearly shows that California's non-competition law is a hindrance to innovation, leaving section 16600 intact is a wise decision.

142. Bishara, *supra* note 6, at 309.

143. Wood, *supra* note 107, at 39, 48-49. However, the landscape of venture capital investment might be in for a radical change due to the 2008 banking meltdown. It would be prudent to compare the venture capital investment in technological innovation across the United States as the economic crisis progresses.