ALERT

November 30, 2023

CALIFORNIA'S NEW NONCOMPETE LAW HAS NATIONWIDE IMPLICATIONS

California generally prohibits an employer from restricting an employee's right to engage in competition subsequent to termination of employment. California recently enacted legislation providing that its noncompetition provisions apply "regardless of where and when the contract was signed."

In light of this broad language and the potential penalties for noncompliance, companies outside of California that include noncompete provisions in employment contracts have begun to focus on understanding the reach of this new California legislation, which may apply to existing contracts.

This Alert reviews the new legislation and some of the issues it raises. Some of its conclusions are:

- The legislative history suggests that the statute only applies if services are performed in California but also indicates that services can be treated as performed in California, at least in some cases, even if the employee resides outside California,
- There is potential failsafe language that could be added to employment contracts that might prevent potential lawsuits alleging a violation of the statute, and
- There are strategies that a company might consider investigating with legal counsel that could limit the scope of the statute.

Overview

Many companies consider it important to enter into employment arrangements that limit to some degree an executive's ability to compete against them subsequent to termination of employment.[1] New California legislation, as described below, is applicable to companies with such provisions, irrespective of a company's location and where the original employment arrangements were made.

As explained in more detail below, there are several steps companies may want to consider undertaking if they have such arrangements:

- An initial step is developing an inventory of such arrangements;

[1] While this Alert focuses on executives, the same considerations apply in the case of non-executives.

- A related step is determining the likelihood of harm through competitive actions in California;
- Based on these investigations, companies may want to consider adding language to employment arrangements (including existing arrangements) providing that the noncompete provisions do not apply to the extent inconsistent with California law; and
- Companies may want to consider whether there are steps that they might want to undertake in particular cases to limit the impact of the new law.

The Current Law

California generally provides that employment contracts cannot restrict an employee's right to compete after termination of employment.[2] Section 16600 of the Business and Professions Code provides: "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." The law is clear that "[n]oncompetition agreements are invalid under section 16600 in California, even if narrowly drawn." *Edwards v. Arthur Andersen, LLP,* 44 Cal. 4th 937, 955 (2008). There is little question that a noncompete clause executed in California between a California employer and an employee working in California would be generally unenforceable.[3]

What was less clear prior to the recent enactment of California legislation was how this broad prohibition applied if some or all of the relevant contacts occurred outside of California. For example, suppose an executive went to work in Texas for a Texas employer, signed a contract in Texas containing a noncompete provision, and then moved to California to start work with a California employer. Assuming that the noncompete provision applied to California employment and was valid under Texas law (which does not categorically ban noncompete agreements), could the noncompete agreement be enforced against the employee?[4]

New Section 16600.5

Senate Bill 699 (link) recently added section 16600.5 to the Business and Professions Code. The law will go into effect on January 1, 2024. The first three subsections of 16600.5 provide:

> "(a) Any contract that is void under this chapter [section 16600 is part of the chapter] is unenforceable regardless of where and when the contract was signed.
> (b) An employer or former employer shall not attempt to enforce a contract that is void under this chapter regardless of whether the contract was signed and the employment was maintained outside of California.

[2] There are limited exceptions that basically relate to certain sales of the business or its assets. The following discussion assumes that none of these exceptions apply.
[3] The possible application of California Labor Code section 925 will be discussed below.
[4] The following discussion assumes that, absent the application of California law, the noncompete clause would have been enforceable. Texas, like many jurisdictions that allow some noncompete provisions, also provides that the provision must be reasonable in terms of geographic scope. This discussion assumes that the noncompete provision at issue would not be struck because of its geographic breadth.

(c) An employer shall not enter into a contract with an employee or prospective employee that includes a provision that is void under this chapter."

Sections (d) and (e) state it is a civil violation for an employer to enter into a contract void under this provision. In addition, they specify that an employee, former employee or prospective employee can bring an action for injunctive relief or damages in case of violation and reasonable attorney's fees and costs can be awarded in the case of a successful action.

Finally, the new statute does not contain any language limiting its scope to contracts entered into after its effective date. This certainly raises the possibility that the statute is intended to apply to contracts previously in existence.

Literally, 16600.5 appears unlimited in scope. It would appear to apply if the Texas employee in our example left her first employer and began employment with another employer ***in Texas***. Of course, one would expect that the lawsuit would need to be brought in California (since we can't think of a reason why a Texas court would apply California law), but that might be possible if the employer had adequate contacts in California so that personal service was permissible. Moreover, even if brought in a California court, there would still be the questions of (1) whether the court would apply California law or Texas law[5] and (2) whether the court might hold that the lawsuit had to be brought in Texas rather than California, even if it were jurisdictionally permissible to file in California.[6]

So, we think there is a threshold question of whether the legislative history of 16600.5 indicates it has a more limited application than its literal language might suggest.

Legislative History of Section 16600.5

The text of 16600.5 suggests a more limited reading. Two legislative findings are of particular relevance[7]:

"(e) The California courts have been clear that California's public policy against restraint of trade laws trumps other state laws when an employee seeks employment in California, even if the employee had signed the contractual restraint while living outside of California and working for a non-California employer."
"(f) California has a strong interest in protecting the freedom of movement of persons whom California-based employers wish to employ to provide services in California, regardless of the person's state of residence. This freedom of employment is paramount to competitive business interests."

If a court determined these two findings controlled the interpretation of 16600.5, this would suggest that the statute would not be a constraint unless the employee were hired to "provide services in California." One

[5] Under choice of law rules, a court does not automatically apply the substantive law of the state in which the lawsuit is filed. The choice of law rules, which are complex, require the court to see whether the parties in the case have such extensive contacts with another state that it is appropriate for that other state's law to apply.
[6] This second issue involves the legal doctrine of forum non conveniens, which provides that, under certain limited circumstances, a court may dismiss a lawsuit because it is brought in an inappropriate jurisdiction.
[7] See section 1(e) and (f) of Senate Bill 699.

would expect courts to be predisposed to reach the conclusion that services were provided in California if the employee moved to California. It also appears, however, that residence may not be the sole test since (f) refers to providing services in California, "regardless of the person's state of residence." It is hard to guess where a court will draw the line if it determines the statute can apply when the employee lives outside California but provides some services inside California. Imagine a company headquartered in New York with significant California operations. Are services in California measured by how many visits are made to California by an executive headquartered in New York? Does one also consider phone calls, electronic meetings, or other communications with persons residing in California? Does the reference to "California-based employers" in (f) imply that the employee must be a California resident to qualify for protection unless the employer is "California-based," whatever that term means?

While the legislative history certainly supports the argument that 16600.5 will not apply absent some employment nexus with California, we do not see a clear answer to the question of how little nexus might trigger the statute.

Potential Avenues to Avoid 16600.5 Liability

Suppose a former executive, who previously worked out of state under a contract with a noncompete clause, begins work in California. One might think the easiest path for an out-of-state employer to avoid liability when this occurs is to simply not enforce the noncompete provision. But the statute authorizes the former employee to bring a private action for injunctive relief and collect attorney's fees if successful. Doing nothing may not be enough if the employee decides to sue first. An employer worried about litigation might attempt to avoid a lawsuit by notifying the employee it did not intend to enforce the noncompete insofar as it related to services in California.

A related solution would be to amend the contract to explicitly provide it does not apply to the extent inconsistent with 16600.5.[8] Another approach might be to wait until the lawsuit is filed and then persuade the court that the noncompete clause never applied to California employment because the geographic scope of the contract never extended to California. While this argument might avoid injunctive relief (no relief is necessary), the employee's attorney might still claim attorney's fees for her help in resolving the matter.

Suppose, however, the out-of-state employer wants to enforce the noncompete clause. Are there any avenues that might allow enforcement? Two avenues might warrant exploration.

The first avenue is for the employer to sue first. The lawsuit would be brought in the state court in which the employment was actually performed. This approach could be worth exploring if the facts clearly indicated that the employee was quitting to take employment in California and that employment would violate the noncompete.[9] The hoped-for relief would be an injunction against engaging in the prohibited employment with

[8] Legal advice should be sought as to the best language for such an amendment, for example, whether explicit reference to 16600.5 is desirable, whether the noncompete provision should have a carve-out for services performed in California, or whether some other phrasing is desirable.

[9] Courts generally attempt to avoid deciding theoretical matters, so an important aspect of deciding whether to bring suit will be to ascertain whether a court can be persuaded that, absent injunctive relief, the executive will begin competing in California.

the hoped-for result that California courts would need to honor this injunction under the Full Faith and Credit Clause of the United States Constitution. As even this abbreviated discussion indicates, this complex strategy will require thorough analysis by legal counsel before being undertaken.

Section 925 of the California Labor Code opens the possibility of a second approach to enforcing the noncompete in the case of new contracts. Section 925's intent included preventing an employer from depriving an employee of the protection of California law by inserting in the employment contract a provision that would require the employee to adjudicate a claim outside of California even if the claim arose in California. Section 925(e) provides, however, that section 925's protections do 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." Assuming the executive were represented by legal counsel, this might suggest that the executive could be forced to litigate in the out-of-state court, which may be inclined to apply its own law, not 16600.5. The interrelation of 16600.5 and 925 is far from clear, so again detailed legal analysis will be critical.[10]

About the only thing that appears certain at this early stage of analyzing 16600.5 is that it may be some time before out-of-state employers settle on the best approach for dealing with this new and potentially far-reaching statute.

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[10] It is worth noting that 925(a) literally says the statute only applies if the employee primarily resides and works in California when employment begins. It would appear that an employer would thus not be relying on section 925 directly but using it to indicate that California must have no policy against enforcing a forum selection clause when employment commences out-of-state, and the executive is represented by an attorney since California specifically allows such a clause when employment is commenced in state. Alternatively, an employer might argue that out-of-state employment does not even require representation of the executive by counsel.