ADVANCED BIONICS CORP. V. MEDTRONIC, INC.: PRELIMINARY INJUNCTIONS—ENFORCING CALIFORNIA'S FUNDAMENTAL POLICY IN SECTION 16600 AGAINST OUT-OF-STATE EMPLOYERS[1]

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Introduction

Private enforcement of California's antitrust and unfair competition laws plays a central role in enforcing California's fundamental policy in favor of free competition and employee mobility. Before a California resident and business are subject to the risks and costs of non-compete litigation—the specific ill that Business and Professions Code section 16600 ("Section 16600") was enacted to avoid—a California court should first resolve four issues: (a) whether California is an appropriate forum for the non-compete dispute; (b) whether California law and public policy should apply to the dispute; (c) whether parallel non-compete litigation would be contrary to California's public policy against restraints of trade and contribute to an impermissible *in terrorem* effect on competition; and (d) whether there is a compelling reason to nevertheless permit parallel non-compete litigation in another forum.

In *Advanced Bionics Corp. v. Medtronic, Inc.,*[2] after parallel non-compete litigation had commenced in Minnesota, the Second Appellate District affirmed an antisuit TRO issued by the trial court enjoining further prosecution of the Minnesota action, answering the first three questions in the affirmative. The majority of the Supreme Court did not review these holdings of the Second Appellate District, which relied largely on *Application Group, Inc. v. Hunter Group, Inc.*[3] The Court reversed the antisuit TRO on the fourth ground, finding a compelling reason to defer to the existing Minnesota action. The Supreme Court held that when another action is pending in another forum "significant principles of judicial restraint and comity" apply, and because judicial restraint takes on a more "fundamental importance" in this situation, as compared to when no action is pending in another forum, the antisuit TRO should not have issued.[4] In modifying its decision, the Supreme Court made clear

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1 This article continues the discussion began in Advanced Bionics Corp. v. Medtronic, Inc.: The ABC's of Antisuit Injunctions—Enforcing California's Fundamental Policy in Section 16600 Against Out-of-State Employers (*see* Competition, Vol. 12, No. 1, Summer 2003), authored by Todd M. Malynn and Michael J. Weber.

2 29 Cal. 4th 697 (2002), *modified en banc, reh'g denied*.

3. 61 Cal. App. 4th 881 (1998).

4 *Advanced Bionics*, 29 Cal. 4th at 705.

that its holding was limited to situations where another action is already pending in another forum.[5]

Part I of this Article discusses the importance of a temporary restraining order (TRO) at the outset of a case enjoining the enforcement of a post-employment non-competition agreement in California, including the commencement of non-compete litigation in another forum. If California courts do not immediately take control over non-compete litigation connected to California and preserve the *status quo*, then their ability to provide meaningful relief and declare a nationwide non-competition agreement "void in California" can be easily thwarted.[6] As shown by the facts of *Advanced Bionics,* once non-compete litigation commences in another state, California courts are essentially powerless to enforce California's public policy and unfair competition laws against out-of-state employers. Competition in California will be restrained contrary to California's public policy and unfair competition laws, whether due to a final judgment under the laws of another state, conflicting interim orders of the foreign court, the length, risk and expense of multi-state non-compete litigation, or the perceived risk and expense—the so-called "*in terrorem*" effect—of challenging a non-compete agreement. Absent a TRO, the enforcement of California's public policy against restraints of trade and unfair competition laws within California's own borders will essentially lie in the sole discretion of out-of-state courts—under standards far different than what would be applied in California—and therein lies the problem.

Part II of this Article assumes that a TRO consistent with the Supreme Court's decision in *Advanced Bionics* has issued at the outset of a case, before another lawsuit is filed, preserving the *status quo* and protecting the trial court's jurisdiction to provide meaningful relief under Business and Professions Code sections 16600 and 17200. It addresses whether the TRO should be converted into a preliminary injunction enjoining enforcement of a post-employment non-competition agreement in California, including the commencement of non-compete litigation in another forum.

Part II interprets Section 16600 and analyzes its application to post-employment covenants not to compete, dispelling common misconceptions about an employer's rights in California. Part II then shows why preliminary injunctions should routinely issue under Section 16600, why California is an appropriate forum for non-compete disputes, and why forum selection clauses should not be enforced against competitors or to restrain trade in California.

Responding to Justice Brown's concerns in *Advanced Bionics* about California becoming "a political safe zone" from "legal duties our sister states recognize,"[7] Part II then addresses the choice-of-law question—specifically, whether out-of-state employers can create by contract non-compete duties in California, and if so, whether California courts should enforce such duties or California's public policy against restraints of trade. It discusses

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5 *Id*. at 700.

6 Whether a post-employment non-competition agreement is "void in California" is ultimately not a question of substantive law. It presents almost a pure choice-of-law question. Because California follows a bright-line rule against post-employment covenants not to compete, which differs substantially from the laws of other jurisdictions, parties can easily anticipate in advance of litigation whether a restraint is "void in California" depending on whether California law applies to the dispute.

7 29 Cal. 4th at 710 (Brown, J., concurring).

whether a U.S. citizen's right to work in California in his chosen profession, trade or business depends, or should depend, on the following factors, and if so, to what extent: (a) where he resides; (b) where he executed the non-competition agreement; (c) where he used to work for his former employer; (d) where his former employer is headquartered; (e) whether his former employer does business in California; (f) whether the former employer included a choice-of-law or a forum selection clause in the non-competition agreement; (g) where the new employer is located; and (h) whether a court in another state would enforce the agreement in California.

Resolution of these issues will resolve whether California, other states, or corporate America controls whether restraints of trade are, in fact, "void in California." It will resolve whether California's public policy and unfair competition laws apply uniformly to the performance of contracts in California, or only to contracts between Californians. And it will resolve whether Business and Professions Code sections 16600 and 17200 will achieve their objective or be easily avoided. Part II concludes that California courts should consistently issue preliminary injunctions against the enforcement of post-employment restraints in California, including the commencement of non-compete litigation in another forum, regardless of whether (a) the former employer is based in California or another state, (b) the employee is a long-standing California resident or new arrival, (c) the former employer included a choice-of-law or choice-of-forum provision in the non-competition agreement, (d) a sister-state court would recognize a contractual duty in California not to compete against the former employer, and (e) the non-compete is narrow or broad or a partial or total restraint on competition.

Section 16600: Covenants Not To Compete & Common Misconceptions

California's Antitrust Laws

California's antitrust laws "rest 'on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic, political and social institutions.'"[8] They are not based on considerations of the interests of the parties, "but upon considerations of sound public policy."[9]

To preserve free competition in California, the Legislature enacted two statutory schemes—one regulating contracts in restraint of trade (Bus. & Prof. Code §§ 16600 *et. seq.*), and one regulating combinations in restraint of trade (Bus. & Prof. Code §§ 16700 *et. seq.*).[10] Both statutory schemes are cumulative of each other; both supersede common law

8 *Cianci v. Super. Ct. (Poppingo),* 40 Cal. 3d 903, 918 (1985) (internal citation omitted).

9 *Swenson v. File*, 3 Cal. 3d 389, 394 (1970) (internal citation omitted).

10 *See* Chapter 1 of Part 2, Division 7 of the Business and Professions Code (Contracts in Restraint of Trade), and Chapter 2 of Part 2, Division 7 of the Business and Professions Code (Combinations in Restraint of Trade).

as to matters covered by those statutes; and both codify common law as to matters not covered by those statutes.[11]

Business & Professions Code Section 16600

In *Advanced Bionics,* the Second Appellate District provided a succinct interpretation of Business and Professions Code section 16600: "The statute means what it says. . . ." The Legislature plainly provided: "Except as provided by 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 Legislature did two things when it enacted Section 16600's predecessor statute. First, it codified the common law distinction between contracts that promote a trade or business and contracts in restraint of trade—the former being valid and the later being void in California.[12] The Supreme Court stated the general rule under Section 16600 as follows: "'[I]t may be said as a general rule that courts will not hold to be in restraint of trade a contract between individuals, the main purpose of which and effect of which are to promote and increase business in the line affected, merely because its operations might possibly in some theoretical way incidentally and indirectly restrict trade in such line.'"[13]

Next, the Legislature addressed a reoccurring problem in California—the use of covenants not to compete, which has its "genesis in either an employer-employee relationship, or in the sale of the 'goodwill' of a business."[14] "'The number of texts, treatises and judicial opinions that have been written in the field constitute a 'sea—vast and vacillating, overlapping and bewildering' and the sheer volume [could] 'drown the researcher.'"[15] The Legislature's solution was to declare all covenants not to compete void in California, "[e]xcept as provided in this chapter . . . ."

California's Bright-Line Rule—Eliminating The "In Terrorem" Effect

The Legislature has specified by statute the types of covenants not to compete that are valid in California. There are three types—covenants arising out of the sale of goodwill of a business or ownership interest in or operating assets of an entity (Bus. & Prof. Code § 16601), covenants arising out of the dissolution or disassociation of a partnership (*id.* §

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11 *See* Cal. Bus. & Prof. Code § 16700; *Rolley v. Merle Norman Cosmetics*, 129 Cal. App. 2d 844, 846 (1954) (under California common law "combinations and contracts in restraint of trade are illegal and void as against public policy. California courts had long recognized this public policy before the advent of the Cartwright Act" which is "merely a statutory enactment of the common law of the state")(internal punctuation omitted); *Centeno v. Roseville Cmty. Hosp.*, 107 Cal. App. 3d 62, 68-69 (1979) (as to exclusive dealing contracts, which are not expressly covered by statute, "Section 16600 is basically a codification of the common law relating to contracts in restraint of trade. . . . Where, as here, there is no express intent to depart from, alter, or abrogate the common law rules, a statute purporting to embody such doctrine or rules will be construed in light of common law decisions on the same subject").

12 *See Great W. Prods. v. J.A. Wathen Distillery Co.*, 10 Cal. 2d 442, 448-49 (1937); *Loral Corp. v. Moyes*, 174 Cal. App. 3d 268, 276 (1985); *Keating v. Preston*, 42 Cal. App. 2d 110, 123 (1940).

13 *Great W.,* 10 Cal. 2d at 448-49. Applying this general rule to contracts relating to employment, the Supreme Court has held that "contracts prohibiting an employee from working for a competitor after completion of his employment or imposing a penalty if he does so [are invalid] . . . unless they are necessary to protect the employer's trade secrets . . . ." *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239, 242 (1965) (internal citations omitted).

14 *Monogram Indus., Inc. v. Star Indus., Inc.,* 64 Cal. App. 3d 692, 697 (1976).

15 *Id.* (internal citation omitted).

16602), and covenants arising out of the dissolution or sale of a limited liability company (*id*. § 16602.5).

California courts have consistently held that Section 16600 is a "bright-line rule"[16] and "absolute bar"[17] against post-employment covenants not to compete. Customer relations, market share, goodwill, financial investment in an employee, and other competitive interests of the employer cannot be protected by a post-employment covenant not to compete.[18] Similarly, employers cannot use the expediency of a covenant not to compete to protect trade secrets or confidential information.[19]

The Legislature resolved the tension between free competition and employee mobility, on the one hand, and the protection of proprietary and property rights and the competitive interests of the employer, on the other hand, when it enacted Section 16600's predecessor statute. The Legislature flatly barred employers from using the expediency of a covenant not to compete. It required them to prove unfair competition and an entitlement to equitable relief in the form of an order barring the former employee from pursuing a profession, trade or business of his choosing. The Supreme Court affirmed this careful balance and policy decision in *Continental Car-Na-Var Corp. v. Moseley*:

> Equity will to the fullest extent protect the property rights of employers in their trade secrets and otherwise, but public policy and natural justice require that equity should also be solicitous for the right inherent in all people, not fettered by negative covenants upon their part to the contrary, to follow any of the common occupations of life. . . . A former employee has the right to engage in a competitive business for himself and to enter into competition with his former employer, even for business of those who had formerly been the customers of his former employer, provided such competition is fairly and legally conducted.[20]

"The code introduces no new principle; it simply eliminates from the controversy arising upon such restriction the question as to what is a reasonable [covenant not to compete], by specifically defining it, *and thus preventing litigation*; and in this the statute is wise and salu-

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16 In California, there is no "rule of reason"—"the so-called rule of reasonableness was rejected by this state in 1872." *Bosley Med. Group v. Abramson*, 161 Cal. App. 3d 284, 288 (1984); *Hill Med. Corp. v. Wycoff*, 86 Cal. App. 4th 895, 901 (2001).

17 *KGB, Inc. v. Giannoulas*, 104 Cal. App. 3d 844, 848 (1980) ("*Giannoulas*"); *Diodes, Inc. v. Franzen*, 260 Cal. App. 2d 244, 255 (1968) ("[t]he interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of the employers, where neither the employee nor his new employer has committed any illegal act accompanying the employment change").

18 *E.g., Giannoulas*, 104 Cal. App. 3d at 848 (despite investment in developing character, radio station could not restrain competition by former employee known as the San Diego Chicken); *Golden State Linen Serv., Inc. v. Vidalin*, 69 Cal. App. 3d 1, 12-13 (1977) (market share, customer relations and "goodwill" invested in departing employee cannot be protected with covenant not to compete).

19 *E.g., D'Sa v. Playhut, Inc.,* 85 Cal. App. 4th 927, 935 (2000) (post-employment covenant not to compete was not intended to protect, and was unnecessary to protect, trade secrets); *Kolani v. Gluska*, 64 Cal. App. 4th 402, 406 (1999) (post-employment covenant not to compete is overbroad and void on its face to protect trade secrets); *Latona v. Aetna U.S. Healthcare, Inc.*, 82 F. Supp. 2d 1089, 1096 (C.D. Cal. 1999) (post-employment covenant not to compete cannot be justified on trade secret grounds, because employer's non-disclosure and confidentiality agreement provides "all of the protection of its trade secrets and other confidential information that the law allows").

20 24 Cal. 2d 104, 110 (1944).

tary, even though, in certain cases, . . . it gives [one party] less than he [bargained for], and less than he might enjoy without violating the interests of the public."[21]

Absent California's bright-line rule, the risk and expense of non-compete litigation would result in an impermissible restriction on future employment and employment opportunities in California.[22] One court aptly described this prescribed ill as the "*in terrorem*" effect on competition:

> [E]ven if [employees] strongly suspect that a non-compete clause is unenforceable, such employees will be reluctant to challenge the legality of the contractual terms and risk the deployment of [the former employer]'s considerable legal resources against them. Thus, the *in terrorem* effect of the Agreement will tend to secure employee compliance with its illegal terms in the vast majority of cases. Prospective future employers, too, may be reluctant to hire [the former employer]'s workers; even if secure in the knowledge of the unenforceability of [the] non-compete clause, these employers may well wish to avoid the expense and energy of defending a lawsuit in which they are likely to be joined.[23]

Section 16600 protects and ensures free competition and employee mobility by preventing the *in terrorem* effect non-compete litigation would otherwise have on the free exercise of the important legal right of every Californian to pursue any lawful profession, trade or business of their choice.

The Anticompetitive Effects Test—Overly Broad and Unnecessary Restraints

Section 1660's prohibition against restraints of trade applies to all restraints, including "partial restraint[s] of trade."[24] Some are void *abinitio*. From the moment the contracts are made, they are in restraint of trade and convey no rights. They are a nullity. California courts refer to them as "illegal."[25]

Often times, it is easy to determine that a contract is void *abinitio*. By simply looking at the terms of the contract, the court can determine that it is in restraint of trade.[26] Challenges to the facial validity of a contract are, in fact, common under Section 16600.[27]

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21 *City Carpet Beating etc., Works, v. Jones*, 102 Cal. 506, 511 (1894) (emphasis added).

22 *See People v. McKale,* 25 Cal. 3d 626, 635 (1979) (harm caused by unlawful terms inserted into mobile home park agreements is that "[t]enants are likely to believe a park has authority to enforce rules it requires its tenants to acknowledge," even if park owner never attempted to enforce unlawful term); *Kolani,* 64 Cal. App. 4th at 407 (harm caused by post-employment covenants not to compete is that "[m]any, perhaps most, employees would honor these clauses without consulting counsel or challenging the[m] in court, thus directly undermining the statutory policy favoring competition").

23 *Latona,* 82 F. Supp. 2d at 1096-97.

24 *Chamberlain v. Augustine*, 172 Cal. 285, 289 (1916) (Section 16600 "makes no exception in favor of contracts in only partial restraint of trade"); *Great W.,* 10 Cal. 2d at 448-49 (contracts falling outside of statute are ones "tending solely to promote" trade or business).

25 *E.g., Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal.4th 83, 123 n.12 (2000) (post-employment non-competes are "illegal"); *Kolani*, 64 Cal. App. 4th at 407 (same).

26 *E.g., Latona*, 82 F. Supp. 2d at 1096-97 (even under "narrow restraint" exception created by Ninth Circuit, contract that would require employee to move to new geographic market or change field within which she worked to compete against former employer is overly broad and void on its face).

27 *E.g., Chamberlain*, 172 Cal. at 287-89 (affirming facial "construction of the contract" as restraint on competition); *Kolani,* 64 Cal. App. 4th at 407 (non-compete void on its face); *Anderson Crop Duster, Inc. v. Matley*, 159 Cal. App. 2d 811, 812-14 (1958) (contract void on its face).

But even if a court is uncertain at the outset whether a contract was in restraint of trade when made, but finds that it was so when evidence is presented and the case is fully adjudicated, the contract remains void *abinitio*.[28]

Other contracts are void only to the extent that they restrain trade in California ("to that extent void"). For example, non-solicitation agreements are not *per se* illegal in California; however, they are enforceable only to the extent necessary to protect trade secrets.[29] Similarly, California courts have consistently held that choice-of-law provisions are void to the extent that they are being invoked to restrain trade in California contrary to California's fundamental policy.[30]

The principal example of a contract that falls outside the scope of Section 16600 is one that controls the use of property—whether real or intellectual. "The rule invalidating contracts in restraint of trade does not include every contract of an individual by which his right to dispose of his property is limited or restrained. Section 1673 of the Civil Code makes void every contract by which one is restrained from 'exercising a lawful profession, trade, or business,' except in certain instances. But this is far different from a contract limiting [one's] right to dispose of a particular piece of property, except upon certain conditions. As the owner of property has the right to withhold it from sale, he can also, at the time of its sale, impose conditions upon its use without violating any rule of public policy."[31]

Section 16600 is concerned with the anticompetitive effects of contracts ("every contract by which anyone is restrained"). In determining whether a contract is void *abinitio* as a partial or total restraint; whether a contract is void only to the extent that it restrains trade in California; or whether a contract is valid in California as one that promotes a trade or business, the Supreme Court has followed a three-step approach: "'Public welfare is first considered [*e.g.,* California's bright-line rule], and if it be not involved, and the restraint upon one party is not greater than protection to the other (party) requires, the contract may be sustained. The question is whether, under the circumstances of the case, and the nature of the particular contract involved in it, the contract is, or is not, unreasonable.'"[32]

Applying these principles, California courts have consistently held that to fall outside the scope of Section 16600 and not unduly burden the exercise of the important right of every citizen to engage in a lawful profession, trade or business of their choice, a contract must

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28 *E.g., Morey v. Paladini*, 187 Cal. 727, 736 (1922) (exclusive dealing contract void *abinitio* under Section 16600, because it was "conclusively established [by the evidence] that in the inception of the transaction it was contemplated by the parties that the contract was one which would result in at least a partial restraint of trade." The facts concerning the real intent of the parties were thus brought to light upon the framing of the issues of fact and a trial on the merits).

29 *Thompson v. Impaxx, Inc.,* 113 Cal. App. 4th 1425, 1429 (2003) ("antisolicitation covenants are void as unlawful business restraints except where their enforcement is necessary to protect trade secrets.") citing *Moss, Adams & Co. v. Shilling*, 179 Cal. App. 3d 124, 130 (1986) (same); *John F. Matull & Ass., Inc. v. Cloutier*, 194 Cal. App. 3d 1049, 1055 (1987) (same).

30 *See, e.g., Nedloyd Lines B.V. v. Super. Ct. (Seawinds Ltd.),* 3 Cal. 4th 459, 466 (1992) ("*Nedloyd*"); *Application Group,* 61 Cal. App. 4th at 902; *Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 20 Cal. App. 3d 668, 673 (1971); *Hollingsworth Solderless Terminal Co. v. Turley*, 622 F.2d 1324, 1338 (1969) ("*Hollingsworth*"); *Davis v. Jointless Fire Brick Co.*, 300 F. 1, 3 (9th Cir. 1924); *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034, 1041 (N.D. Cal. 1990).

31 *Grogan v. Chaffee,* 156 Cal. 611, 615 (1909) (internal citation omitted); *Smith v. San Francisco & N. P. Ry. Co.*, 115 Cal. 587, 604-05 (1897); *Keating*, 42 Cal. App. 2d at 123.

32 *Grogan,* 156 Cal. at 615 (internal citation omitted); *Great W.,* 10 Cal. 2d at 446.

(a) fall outside of California's statutory scheme against covenants not to complete, and (b) be both "narrowly tailored"[33] and "necessary"[34] to protect a "proprietary or property right"[35] or to prevent "unfair competition."[36]

Section 16600: Eliminating Common Misconceptions

Section 16600 should not be "diluted by judicial fiat."[37] California's fundamental policy in favor of free competition and employee mobility has stood the test of time, and has proven extremely successful, both in terms of promoting California's economy and protecting the welfare of its citizens. Section 16600 in no way undermines the intellectual property—or any other property right—of companies doing business in California, which have thrived since its enactment. California fully protects patents, copyrights, trademarks and trade secrets. Proprietary knowledge developed at great expense, with substantial economic value and treated as confidential, is protectible as trade secret.[38]

Nevertheless, "[i]n recent years, large companies have drafted non-compete agreements using clever means by which to circumvent [Section 16600]. The two most prevalent have been based on the use of the 'inevitable disclosure' doctrine, and the 'narrow restraint' exception."[39] Out-of-state employers rely upon these espoused legal theories to persuade courts to restrain trade in California in ways that are antithetical to California's public policy against restraints of trade.

There Is No Exception For "Trade Secret" Protection

California's statutory scheme regulating contractual restraints of trade makes no exception for trade secret protection—which is in stark contrast to the statutory schemes in other states.[40] Nor has the Legislature provided an exception for any other proprietary or

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33 *Kolani*, 64 Cal. App. 4th at 406 (only "narrowly tailored" restrictions are lawful); *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 861 (1994) (contracts must be "carefully limited" to be valid); *Loral Corp.*, 174 Cal. App. 3d at 276 (only "reasonably limited" restrictions have been upheld); *Latona*, 82 F. Supp. 2d at 1095 (contracts must be "carefully limited").

34 *Muggill*, 62 Cal. 2d at 242 (post-employment restraints are void "unless they are necessary to protect the employer's trade secrets"); *Great W.*, 10 Cal. 2d at 446 (to be valid restraint cannot be greater than protection to the other requires); *Grogan,* 156 Cal. at 615 (same); *Thompson,* 113 Cal. App. 4th at 1429 (same); *Moss, Adams & Co.,* 179 Cal. App. 3d at 130 (same).

35 *E.g., Gordon v. Landau*, 49 Cal. 2d 690, 694 (1958) (trade secrets); *Thompson,* 113 Cal. App. 4th at 1429 (same); *Moss Adams & Co.,* 179 Cal. App. 3d at 130 (same); *Boughton v. Socony Mobil Oil Co.,* 231 Cal. App. 2d 188, 192 (1964) (restriction on use of real property); *King v. Gerold*, 109 Cal. App. 2d 316, 317 (1952) (intellectual property license).

36 *See Metro Traffic Control*, 22 Cal. App. 4th at 861 (restraints are invalid under Section 16600, unless they merely protect a right "recognized as entitled to protection under the general principles of unfair competition"); *Hollingsworth,* 622 F.2d at 1338 (same); *Latona,* 82 F. Supp. 2d at 1096 (same); *Loral Corp.*, 174 Cal. App. 3d at 276 (reasonably drawn non-interference provision was not *per se* illegal; it could be necessary to prevent unfair competition under circumstances; "[w]e note that the law of unfair competition has struggled with the recurrent problem of when solicitation of another's employees gives rise to tort liability").

37 *Scott,* 732 F. Supp. at 1042.

38 *See* Cal. Civ. Code § 3426 *et seq*. (California's Uniform Trade Secret Act) ("UTSA").

39 Brief of Amicus Curiae, California Employment Lawyers Association at 7-8, *Advanced Bionics*, 29 Cal. 4th 697 ("CELA Brief").

40 *E.g.,* Colo. Rev. Stat. § 8-2-113(2) ("*Any covenant not to compete* which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void, but this subsection (2) shall not apply to: . . . (b) *Any contract for the protection of trade secrets* . . . .") (emphasis added).

property right—even though the Legislature has often amended and added to its statutory scheme.[41]

There is no need for any judicially created exceptions. Section 16600 renders void only those contracts that restrain a "*lawful* profession, trade, or business" (emphasis added). By its terms, it excludes actual or threatened misappropriation of trade secrets and any other type of *unlawful* conduct from its scope. Accordingly, California courts have enforced narrowly drawn agreements, such as non-disclosure, non-solicitation and non-interference agreements, if necessary to prevent unfair competition, including but not limited to the misappropriation of trade secrets.

Misinterpreting the "unless . . . necessary to protect the employer's trade secrets" *dicta* from Justice Traynor's decision in *Muggill v. Reuben H. Donnelley Corp.,*[42] however, some courts have hypothesized that a prohibition on competition might be necessary to protect trade secrets, and that a narrowly drawn covenant not to compete might be enforceable for this purpose. Though no reported California decision has ever upheld a non-compete for this reason, former employers routinely argue that Section 16600—a statute that *voids* contracts and recognizes only *three* exceptions for covenants not to compete—should not be interpreted as a "bright-line rule," but should be interpreted instead as a statute that "authorizes" or "permits" narrowly drawn non-competes as a form of "supplemental" protection. They argue that employers should be entitled to "bargain for" protection beyond that which is provided by unfair competition law and employees should be entitled to waive their fundamental right to work in their chosen profession, even when competition by the former employee would not violate the law or the terms of any other agreement. Such additional protection they claim is "reasonably necessary" to protect against the "inevitable disclosure" of trade secrets.

The inevitable disclosure doctrine is premised on the notion that, unless enjoined from competing against their former employers, employees who possess trade secrets will inevitably compete unlawfully against their former employers. The doctrine does not require any evidence of misappropriation or unfair competition. Rather, "[i]t permits an employer to enjoin the former employee without proof of the employee's actual or threatened use of trade secrets based upon an inference (based in turn upon circumstantial evidence) that the employee inevitably will use his or her knowledge of those trade secrets in the new employment."[43]

California courts have rejected the "inevitable disclosure" doctrine as contrary to California's fundamental policy in favor of free competition and employee mobility.[44] There is no room for this doctrine, either under UTSA, which protect trade secrets, or Section

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41 *Bosley Medical Group*, 161 Cal. App. 3d at 289.

42 62 Cal. 2d at 242.

43 *Whyte v. Schlage Lock Co.*, 101 Cal. App. 4th 1443, 1461-62 (2002) ("*Schlage*").

44 *See e.g., Schlage,* 101 Cal. App. 4th at 1463; *GlobeSpan, Inc. v. O'Neill*, 151 F. Supp. 2d 1229, 1235 (C.D. Cal. 2001) ("'[doctrine] creates a *de facto* covenant not to compete [and] run[s] counter to the strong public policy in California favoring employee mobility'") (internal citation omitted)(emphasis added); *Bayer Corp. v. Roche Molecular Sys.*, 72 F. Supp. 2d 1111, 1120 (N.D. Cal. 1999) ("California trade-secrets law does not recognize the theory of inevitable disclosure; indeed, such a rule would run counter to the strong public policy in California favoring employee mobility"); *Danjaq LLC v. Sony Corp.,* 50 U.S.P.Q. 2d (BNA) 1638, 1640 (C.D. Cal. 1999) (inevitable disclosure is not the law of the State of California).

16600, which prohibits contractual restraints of trade in general, and post-employment covenants not to compete in specific.

A "bargained for" rationale for any judicially created exception would run directly contrary to the Legislature's statutory scheme and California's fundamental policy codified in that statute. To begin with, post-employment restraints are invariably contracts of adhesion; no bargaining really occurs. While some employees may have some ability to negotiate salary and other benefits, post-employment restraints are offered on a "take-it or leave-it" basis.[45] Secondly, a "bargained for" rationale ignores that employees cannot waive fundamental public policies. Section 16600 was not enacted to protect the individual interests of any particular employee. It was enacted to protect California's interests in free competition and employee mobility. Those interests cannot be waived or restrained by contract.[46]

An "inevitable disclosure" justification for a non-compete would also be more offensive to California's fundamental policy interests than if that doctrine were simply adopted in some form under UTSA. Under the guise of a bargained for exchange, employers would file non-compete litigation, restrain trade, and state a *prima facie* case simply by pleading that they provided the departing employee with a trade secret. Even in jurisdictions that have adopted the inevitable disclosure doctrine under UTSA, however, courts require *more* than just a showing that the former employee *possesses* trade secrets; they require proof, such as "out and out lies" and "lack of forthrightness," by a preponderance of evidence that unfair competition by the former employee would be "inevitable."[47]

Finally, a trade-secret exception would swallow the rule. Covenants not to compete would still be overly broad and unnecessary to protect trade secrets. UTSA, as supplemented by confidentiality and non-disclosure agreements, already provide all the protection afforded by California law, including a statutory and contractual basis to continue to press inevitable disclosure arguments in California.

Not surprisingly, California courts have repeatedly refused to narrowly construe, sever or reform a post-employment covenant not to compete as one necessary to protect trade secrets, let alone save an employer from liability for inserting the illegal term in an agreement.[48] Even if narrowly drawn post-employment restraints are deemed "reasonable" in other states, California courts have consistently recognized that Section 16600 was enacted to promote and ensure free competition and employee mobility, and thus to prevent non-compete litigation and its *in terrorem* effect on competition.

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45 This practical reality has led to numerous lawsuits after employees are terminated for refusing to sign a post-employment restraint. *See e.g., Thompson,* 113 Cal. App. 4th at 1432 (employee fired for refusing to sign non-solicitation agreement); *D'Sa,* 85 Cal. App. 4th at 935 (employee fired for refusing to sign non-compete agreement); *Latona*, 82 F. Supp. 2d at 1096 (same).

46 *See* Cal. Bus. & Prof. Code § 16600; Civ. Code §§ 1668, 3513; *Armendariz*, 24 Cal. 4th at 101 (parties cannot waive right enacted for public reason); *Weber, Lipshie & Co. v. Christian*, 52 Cal. App. 4th 645, 659 (1997) ("section 16600 was adopted for a public reason. It follows that Christian could not by agreement waive the benefit afforded by California law").

47 *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262, 1267 (7th Cir. 1995).

48 *E.g., Thompson,* 113 Cal. App. 4th at 1432; *D'Sa,* 85 Cal. App. 4th at 935; *Kolani,* 64 Cal. App. 4th at 406; *Latona*, 82 F. Supp. 2d at 1096.

There Is No "Narrow Restraint" Exception

In a series of opinions that no published California decision is yet to follow, but which started some time ago, the Ninth Circuit Court of Appeals has interpreted Section 16600 differently than the California Supreme Court. Instead of following the common law distinction between contracts that restrain trade, in whole or in part, and contracts that promote trade, the Ninth Circuit interpreted "restrain" to mean contracts that "prohibit" or "preclude" competition in an "entire" profession, trade or business (defining "profession, trade or business" to include subspecialties and fields of expertise).[49]

Relying on *dicta* in *Boughton* and *King* but ignoring a plethora of precedent from California and its own circuit, the Ninth Circuit dispensed altogether with the requirement recognized in *Grogan* and *Great Western*, and reiterated in *Continental Car-Na-Var and Muggill,* that to be valid, a post-employment restraint must be necessary to protect the employer's trade secrets (or some other *bone fide* property right), or no greater than required to prevent unfair competition. In its place, the Ninth Circuit adopted an analysis of the employee's "profession, trade or business" to determine whether the restraint prohibits the employee from competing in a "substantial segment" of the market.[50]

The Ninth Circuit's proffered interpretation of Section 16600 is contrary to the plain language of the statute. The Legislature did not use the words "prohibit" or "preclude"; it used the word "restrained," which obviously includes restrictions falling short of a complete or total restraint on a chosen profession. Moreover, there is and was no ambiguity that warranted the Ninth's Circuit's proffered interpretation. The word "restrained" had an accepted definition; it meant a contract that did not promote a trade or business, such as a prohibition or a penalty on competition. The Ninth Circuit's proffered interpretation also is not supported by the cases cited (*Boughton* and *King*). Those cases involved contracts concerning the use of land and intellectual property. The California Supreme Court had long since recognized that parties could control and condition the use of their own property.

By judicial fiat, the Ninth Circuit simply struck a new political balance. Instead of following California precedent that the interests of California in employee "mobility and betterment are deemed paramount to the competitive business interests of the employers, *where neither the employee nor his new employer has committed any illegal act accompanying the employment change*"; in the Ninth Circuit, California's interests in employee "mobility and betterment are [no longer] paramount to the competitive business interests of the employers" *if the restraint only precludes competition "in a small or limited part of the business,"* such as competing for the business of one client of the former employer.[51]

The Ninth Circuit's interpretation of Section 16600, which courts have referred to as the judicially created "narrow restraint exception," is contrary to the weight of California precedent. Among other things, by dispensing with the requirement that the restraint must be necessary to protect a proprietary or property right of the employer, or no greater than required to prevent unfair competition, the Ninth Circuit has endorsed partial restraints of trade—contrary to the rule of law established by the Supreme Court in *Chamberline* that Section 16600 proscribes "partial restraint[s] of trade."

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49 *See e.g., Campbell v. Board of Trustees of Leland Stanford Junior Univ.*, 817 F.2d 499, 502 (9th Cir. 1987).

50 *Latona,* 82 F. Supp. 2d at 1096.

51 *See e.g., Gen. Commercial Packing, Inc. v. TPS Package Eng'g, Inc.*, 126 F.3d 1131, 1132-34 (9th Cir. 1997)(emphasis added).

Moreover, the Ninth Circuit's interpretation is contrary to numerous decisions, including *Metro Traffic Control, Golden State Linen Service, Giannoulas, Diodes* and *Application Group,* which recognize that customer relations, market share, goodwill and other competitive interests of the employer are subordinate to California's interest in employee mobility and betterment. The Ninth Circuit's interpretation is particularly unsettling because an inquiry into one's "profession, trade or business" might breathe new life into non-compete litigation where none should exist. The corresponding threat, risk and expense of non-compete litigation can be used by employers to stifle and prevent the precise competition Section 16600 was enacted to protect—without even an allegation of trade-secret protection. As stated by CELA, "[t]he 'minor part of the market' addressed will usually be the precise market in which the employee has knowledge and experience. Enjoining competition on 'competitive products' or in the same industry in which one was formerly employed is the only kind of competition that is meaningful and which produces the economic benefits of competition."[52]

California courts should continue to reject this doctrine and the Ninth Circuit should overrule it. Although covenants not to compete—whether broad or narrow—might be an effective way to protect trade secrets, customer relations, employee investment, goodwill and market share, they "are effective in the same sense that burning down [all or some parts of] a house to eliminate termites is effective: the problem is eliminated but the collateral damage from the solution is worse than the problem itself. In other words, enforcing covenants not to compete comes at a cost. Not only are employees prevented from earning a living at [what] they know best, but the [competition and] employee mobility, and the concomitant spillover of non-trade secret information that supports California's [economy], cannot develop."[53] At a minimum, the Ninth Circuit should construe its own case law consistent with California Supreme Court precedent and require employers to show that the challenged contract is intended to promote trade, is narrowly tailored and is necessary to prevent unfair competition.

Preliminary Injunctions Under Section 16600 Are Expressly Authorized By Statute

Section 16600's bright-line rule against post-employment covenants not to compete has several implementing statutes, including California's Unfair Competition Law (Bus. & Prof. Code §§ 17200 *et seq*.), California's Declaratory Relief Act (Civ. Proc. Code §§ 1060 *et. seq*.) and statutes regulating the issuance of injunctions (Civ. Proc. Code §§ 560 *et seq*.). These statutes expressly authorize a preliminary injunction enjoining enforcement of a post-employment restraint in California, including the commencement of non-compete litigation in another forum.

California's Unfair Competition Law (Bus. & Prof. Code § 17203)

California courts are directed to enjoin violations of the UCL "in whatever context such activity might occur," including litigation based on a covenant not to compete in another

52 CELA Brief at 8-9.

53 Brief of Amicus Curiae, Professor Ronald J. Gilson at 10-11, *Advanced Bionics*, 29 Cal. 4th 697.

forum.[54] It violates the UCL to insert an unlawful or unconscionable term into a form contract, to assert a contractual right that one does not have, and to assert a contractual right in disregard of express public policy.[55] Therefore, (a) the inclusion of a covenant not to compete in an employee agreement, (b) a threat to enforce an employee agreement in disregard of California's public policy, and (c) the use of a contract to restrain trade in California in violation of California law constitute enjoinable acts of unfair competition.[56]

Code of Civil Procedure § 526(a)(1)

California courts are directed to grant an injunction "[w]hen it appears by the complaint that the plaintiff is entitled to the relief demanded, and the relief, or any part thereof, consists in restraining the commission or continuance of the act complained of, either for a limited period or perpetually."[57] Here the "act complained of" is a former employer's attempt to restrain trade in California through the use of a void agreement. California courts are specifically empowered to enjoin such conduct, including the threat and commencement of non-compete litigation in another forum, which are two of the ways in which post-employment non-competition agreements are used to restrain trade in California.

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54 Cal. Bus. & Prof. Code § 17203; *Cal-Tech Communications, Inc. v. Los Angeles Cellular Tel., Co.*, 20 Cal. 4th 163, 180 (1999); *Application Group,* 61 Cal. App. 4th at 901 (California has strong "interest in protecting its employers and their employees from anticompetitive conduct by out-of-state employers such as Hunter—*including litigation based on a covenant not to compete to which the California employer is not a party*—who would interfere with or restrict these freedoms [protected by Section 16600]") (emphasis added).

55 *See McKale,* 25 Cal.3d at 635 (including unlawful provisions in mobile home park agreements "constitutes an unfair and deceptive business practice," even if park owners "have not attempted to enforce them"); *Loving & Evans v. Blick*, 33 Cal. 2d 603, 607 (1949) ("a contract made contrary to the terms of a law designed for the protection of the public and prescribing a penalty for the violation thereof is illegal and void, and no action may be brought to enforce such contract") (internal quotations and citations omitted); *State Farm Fire and Cas. Co. v. Super. Ct. (Allegro)*, 45 Cal. App. 4th 1093, 1104 (1996) ("[e]xamples of unfair business practices include: . . . placing unlawful or unenforceable terms in form contracts . . . ; asserting a contractual right one does not have . . . ; and imposing contract terms that make the debtor pay the collection costs . . . .") (internal citations omitted) abrogated by *Cal-Tech Communications, Inc. v. Los Angeles Cellular Tel. Co.*, 20 Cal 4th 163 (1999); *Samura v. Kaiser Found. Health Plan, Inc.*, 17 Cal. App. 4th 1284, 1297, 1299 n.6 (1993) ("it is an unfair or fraudulent business practice 'to assert a contractual right that one does not have'"; and "a practice of enforcing [a contract] with disregard for considerations of unconscionability might constitute an unfair business practice") (internal citation omitted); *Baker Pac. Corp. v. Suttles*, 220 Cal. App. 3d 1148, 1154 (1990) (since the release "is violative of Civil Code section 1668, it follows that requiring prospective employees to sign an illegal agreement as a condition of employment is contrary to law"); *Shadoan v. World Sav. and Loan Ass'n,* L19 Cal. App. 3d 97, 101-02 (1990) ("that a contractual provision is unconscrionable may be relevant to the question of whether a party who drafted—and seeks to enforce—the provision, has commented an unfair business practice"); *People v. Custom Craft Carpets, Inc.*, 159 Cal. App. 3d 676, 683-84 (1984) (attorney's practice of requesting clients to sign contractual provisions that misstate their rights as provided by statute may be enjoined as unfair and deceptive business practice).

56 *See D'Sa,* 85 Cal. App. 4th at 933 (because non-compete "violated public policy, it necessary followed that requiring prospective workers to sign [it] as a condition of employment was contrary to law"); *Herzog v. "A" Co.,* 138 Cal. App. 3d 656, 660 (1982) (letter threatening to enforce non-disclosure agreement in violation of Business and Professions Code section 16600 to restrain former employee and new employer for engaging in lawful competition stated claim for unfair competition); *Application Group,* 61 Cal. App. 4th at 901, 908 & n.21 ("trial court did not err in finding [employer's] use of covenant not to compete in violation of Section 16600 to be a violation of section 17200 as well").

57 Cal. Civ. Proc. Code § 526(a)(1).

Code of Civil Procedure § 526(a)(2)

California courts are directed to grant an injunction "[w]hen it appears by the complaint or affidavits that the commission or continuance of some act during the litigation would produce waste, or great or irreparable injury, to a party to the action."[58] Here the "act during the litigation" would be the commencement of parallel non-compete litigation in another forum. California courts are expressly authorized to enjoin that act, because the Legislature has declared as a matter of public policy that "waste, great or irreparable injury" to California, its residents and businesses would occur if post-employment covenants not to compete were enforced in California.

Code of Civil Procedure § 526(a)(3) & (6)

The mere threat a duplicative litigation, by itself, is not enough to warrant an injunction against it. An injunction is normally not needed. California courts will abate a second action between the same parties involving the same dispute, and they expect foreign courts, under principles of comity, to do the same.[59] Even if that expectation is erroneous and a foreign court would not dismiss or stay a second action for reasons that a California court would not find justifiable, parallel litigation in another forum is normally tolerated. It is viewed as a natural outgrowth of our federal system of government.[60]

However, California courts are expressly authorized to enjoin the mere threat of duplicative litigation in two instances: (1) "Where the restraint is necessary to prevent a multiplicity of judicial proceedings,"[61] and (2) "[w]hen it appears, during the litigation, that a party is doing, or threatens, or is about to do, or is procuring or suffering to be done, some act in violation of the rights of another party to the action respecting the subject of the action, and tending to render the judgment ineffectual."[62]

Stated simply, when multiple actions are threatened in other states, or when a parallel action would threaten the California court's ability to provide meaningful relief, then an injunction enjoining the commencement of litigation in another forum is expressly authorized by statute. In these instances, the subsequent litigation is viewed as "interdictory," not parallel. The mere existence of the proceeding—not the outcome—offends California's interests in adjudicating the first dispute.[63]

Here the "act in violation of the rights of another" and "tending to render the judgment ineffectual" would be the commencement of non-compete litigation in another forum. Such an action would be interdictory, not parallel, because Section 16600 was enacted to prevent non-compete litigation. If Section 16600 controls the dispute, the former employer would be asserting rights that it did not have or that would be contrary to California's public policy. The mere existence of the second lawsuit would render California's public policy against restraints of trade ineffectual.

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58 *Id.* § 526(a)(2).

59 *Simmons v. Super. Ct.*, 96 Cal. App. 2d 119, 124-25 (1950).

60 *Advanced Bionics*, 29 Cal.4th at 705-06.

61 Cal. Civ. Proc. Code § 526(a)(6).

62 *Id.* § 526(a)(3).

63 *See e.g., Laker Airways Ltd. v. Sabena, Belgian World Airlines*, 731 F.2d 909, 915 (D.C. Cir. 1984) (affirming antisuit injunction against foreign lawsuit, because it was "interdictory and not parallel").

Code of Civil Procedure § 526(a)(4) & (5)

California courts are directed to grant an injunction "[w]hen pecuniary compensation would not afford adequate relief"[64] or "[w]here it would be extremely difficult to ascertain the amount of compensation which would afford adequate relief."[65] Both statutes authorize injunctive relief to protect one's right to work in California. Damages would not afford adequate relief. The deprivation of the right to work in one's chosen profession for a substantial period of time could cause atrophy in the industry and a loss of time, experience, and business connections that could never be recaptured. It would also be difficult to ascertain the correct amount of compensation to the employee. Similarly, it would be very difficult to ascertain the new employer's damages for the loss of the planned business relationship.

California Is The Appropriate Forum For Section 16600 Disputes

To avoid a preliminary injunction, businesses aggressively try to avoid litigating non-compete disputes in California. The risk of sanctions is far less a cost than litigating on the merits and risk losing the opportunity to restrain trade in California. Even if the employers lose in California, the cost of litigation might cause the next competitor to think twice about recruiting one of their employees.

Out-of-state employers will often file a motion to dismiss the California action, and argue that California is an inconvenient forum and/or that the California plaintiffs have engaged in "forum shopping." If there is a forum selection clause, they will also seek to enforce that agreement. In any *bona fide* Section 16600 dispute, each one of these arguments should be rejected.

California is a Convenient Forum

California courts normally will not dismiss or stay an action brought by a California employer and an employee invoking California law to protect their existing or planned business relationship in California on the ground that California is not a convenient forum. Such a motion is particularly without merit when the employee resides in California and when the former employer does business in California. California courts will honor the plaintiffs' choice of forum, even if California law does not apply to the dispute, unless there is a compelling reason to deny the plaintiffs their choice of forum.

Former employers will typically claim "unfairness" as such a reason. They might characterize themselves as the "natural plaintiff," arguing that the rights of their competitor are "derivative" of the rights, if any, of the employee, and disparage their competitor and former employee for engaging in "clandestine" tactics (conducting an interview while the employee still had a job and preparing to compete after an offer was extended) and launching a "preemptive strike" on the non-compete.

The "natural plaintiff" argument had some early traction in California federal courts, where declaratory relief actions are not a matter of right and federal courts generally decline

64 Cal. Civ. Proc. Code § 526 (a)(4).

65 *Id.* § 526 (a)(5).

to exercise their discretionary jurisdiction "where another suit is pending in state court presenting the same issues, not governed by federal law, between the same parties."[66] Subsequent decisions in both state and federal courts have rejected the "natural plaintiff" argument as inconsistent with California's public policy against restraints of trade and the rights of employers under California's unfair competition laws.[67]

California Employers and Employees are "Natural Plaintiffs"

The "natural plaintiffs" in a Section 16600 action, whether brought under the Declaratory Relief Act (Civ. Proc. Code §§ 1060 *et seq*.), the Unfair Competition Law (Bus. & Prof. Code §§ 17200 *et seq*.), or a common law theory of unfair competition, are the parties subject to the restraint of trade, not the former employer.[68] Private enforcement of California's antitrust and unfair competition laws is well recognized and critical to the objectives of those laws.[69] Both the new employer and the subject employee may seek relief for their own separate injuries and bring a claim on behalf of the general public to enforce California's public policy against restraints of trade and unfair competition laws.

For example, in *Application Group*, the First Appellate District affirmed the trial court's refusal to dismiss an action for declaratory relief brought by an employer under Business and Professions Code section 16600 and 17200 as moot and/or not justiciable. The employer (AGI) and the employee (Pike), a Maryland resident, sought a judgment against her former employer (Hunter), a Maryland company doing business in California, declaring all of Hunter's covenants not to compete, including Pike's, "void in California." During the litigation, Hunter "never really disputed and, indeed, conceded it cannot lawfully require a covenant not to compete in the employment agreement of any employee who is a California resident."[70] The trial court entered a judgment in favor of AGI and Pike, declaring all of Hunter's covenants not to compete void in California, including but not limited to those signed by California resident employees. Hunter appealed and while the action was pending on appeal, the term of Pike's non-competition agreement expired, which rendered her individual claims moot.

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66 *DeFeo v. Proctor & Gamble Co.*, 831 F. Supp. 776, 778 (N.D. Cal. 1993) (internal quotation marks and citations omitted). In *DeFeo*, the California plaintiffs did not bring a coercive action under California's Unfair Competition Law, and because a parallel action was pending in another state, the court had to consider the significant principles of comity and judicial restraint underlying the federal Anti-Injunction Act and the *Advanced Bionics* decision in determining whether to exercise its discretionary jurisdiction. In dismissing the action, the district court did not refer to or discuss California's public policy interests or the rights of California employers protected by Section 16600 and the UCL, nor did the court have the benefit of subsequent decisions under Section 16600 and the UCL.

67 *E.g., Bennett v. Medtronic, Inc.*, 2001 WL 34076416 at *3-4 (S.D. Cal. April 18, 2001) (denying motion by a former employer to dismiss or stay, or to transfer California action to Tennessee, where non-compete litigation was already pending). The Ninth Circuit overruled *Bennett* in 2002; *see* 285 F. 3d 801 (9th Cir. 2002).

68 *See Application Group,* 61 Cal. App. 4th at 887-88 (both new employer and former employee have standing to challenge non-compete as restraint of trade); *Herzog,* 138 Cal. App. 3d at 660 (unfair competition claim by new employer and former employee); *Centeno*, 107 Cal. App. 3d at 69 (claim for interference with profession, trade or business brought by professional restrained by Hospital's exclusive dealing agreements with other professionals).

69 Cal. Bus. & Prof. Code § 17204; *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.,* 473 U.S. 614, 635 (1985) ("*Mitsubishi*") ("[w]ithout doubt, the private cause of action plays a central role in enforcing [antitrust laws] . . . .").

70 *Application Group*, 61 Cal. App. 4th at 893.

The First Appellate District held that the trial court "did not abuse its discretion either by finding AGI's claims to be justiciable, or by granting declaratory relief in AGI's favor." The court found that AGI had "standing as a 'person interested under' the noncompetition agreement." Hunter had used its non-competition agreement for the "purpose of deterring and preventing the solicitation, recruitment and hiring of [its] employee by its competitors, especially those in California. [It served] as a complete barrier between its competitors and all of its employees. [It allowed Hunter] to avoid a 'bidding war' that would increase the salary of its [employees]. . . . Indeed, Hunter's president testified that the covenant not to compete was designed to 'scare [AGI] away' from soliciting its employees and that, until [this dispute], Hunter's strategy had 'worked quite well for three years.'"[71]

The First Appellate District also found that AGI's cause of action for declaratory relief, both as it related to AGI's right to hire Hunter's California resident and other nonresident employees was justiciable, even though Pike's non-competition agreement had expired. The court held:

> The trial court had before it evidence of the very real and concrete controversy over Pike's recruitment by AGI. The court reasonably could find that the dispute over Pike's employment is typical of controversies that will almost certainly continue to arise between AGI and Hunter over nonresident employees. Furthermore, it is essentially a pure question of law whether Hunter's covenant not to compete is enforceable when invoked to prevent a California-based competitor from soliciting or recruiting a current or former Hunter consultant for employment in California. Plainly, AGI is such a competitor and it has been and will continue to be subject to litigation in this precise factual context.[72]

Forum Selection Clauses Should Not Be Enforced Against Competitors

To direct non-compete litigation to another forum, out-of-state employers have begun to insert forum selection clauses into their form non-competition agreements, and have tried to enforce these provisions against their former employees and competitors. While "California favors contractual forum selection clauses so long as they are entered into freely and voluntarily, and their enforcement would not be unreasonable,"[73] the enforcement of a forum selection clause in a dispute arising under Business and Professions Code sections 16600 and 17200 would be unreasonable.

To begin with, it would be unreasonable to enforce a forum selection clause against a competitor who did not agree to it. As a general rule, non-signatories are not bound by a forum selection clause. An exception is sometimes made for "transaction participants,"[74] such as when "the non-signatory's interests are derivative of a signatory's interests or there is a unity of interest such that it is reasonably foreseeable and just for a non-signatory to waive his or her rights to select a forum for resolving conflicts."[75] Thus, spouses, joint venturers, affiliated companies, corporate executives, and parties suing in a representative capacity on behalf of a contracting party have been bound by forum selection clauses signed by

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71 *Id.* at 893, 887-88.

72 *Id.* at 893 n.6.

73 *America Online, Inc. v. Super. Ct. (Mendoza)*, 90 Cal. App. 4th 1, 11-12 (2001).

74 *Manetti-Farrow, Inc. v. Gucci America, Inc.*, 858 F.2d 509, 514 n.5 (9th Cir. 1988).

75 *Bennett*, 2001 WL 34076416 at *2 (citing *Manetti-Farrow*).

others.[76] This exception should not be extended to cover employers in California in disputes arising under Business and Professions Code sections 16600 and 17200.

As the First Appellate District made clear in *Application Group*, the rights of an employer under Section 16600 and the UCL do not flow from the challenged restraint of trade (which expired in that case) and are not derivative of the rights of the employee (Pike's claims were dismissed as moot). An employer in California has its own rights and standing to sue under Business and Professions Code 16600 and 17200, including in its individual capacity, as a representative of the contracting parties, and as a private attorney general to enforce California's antitrust and unfair competition laws.

While it might be foreseeable that a dispute between a California employer and an out-of-state competitor involving the enforceability of a nationwide covenant not to compete will arise, the former employer cannot force its competitor into an out-of-state forum to adjudicate the dispute. There is not a "unity of interests" between the California employer, the employee and the State of California, such that acts of the employee or the employer should compromise the rights of the other—let alone the interests of California—which was the conclusion reached in *Bennett v. Medtronic, Inc.*,[77] where a California employer had agreed to a forum selection clause in a settlement agreement with its competitor, and the district court refused to enforce the clause against non-signatory California resident employees.

Forum Selection Clauses Should Not Be Enforced To Restrain Trade In California

Forum selection clauses should not be enforced to redirect non-compete litigation over an employee's right to work in California even if a California employer is not a party to the lawsuit. While the former employer will argue that "freedom of contract" in forum selection is different than restraining trade in California, because the chosen forum could still conceivably apply California law after a choice-of-law analysis, this transparent argument should be rejected. It confuses the rule that California courts will enforce a forum selection clause even though it might diminish the individual rights of the plaintiffs,[78] with the rule that "California courts will refuse to defer to the selected forum if [it] would substantially diminish the rights of California residents in a way that violates our state's public policy."[79]

Choice-of-law considerations inform the forum selection analysis. For example, if the laws of the competing forums are substantially the same, then that will weigh in favor of enforcing a forum selection clause. Similarly, if the court would apply the law of the other forum under the circumstances of the case, which may include the consideration of a choice-of-law provision, then that will weigh in favor of enforcing a forum selection clause.

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76 *E.g., Lipcon v. Underwriters at Lloyd's, London*, 148 F.3d 1285 (11th Cir. 1998) (spouses); *Manetti-Farrow,* 858 F.2d at 514 n.5 (Gucci executives and affiliated companies); *Smith v. Prof'l Claims, Inc.* 19 F. Supp. 2d 1276 (M.D. Ala. 1998) (joint venturers); *Lu v. Dryclean-U.S.A. of Cal. Inc*, 11 Cal. App. 4th 1490 (1992) (parent corporations sued as "alter egos"); *Net2Phone, Inc. v. Super. Ct. (Consumer Cause, Inc.),* 109 Cal. App. 4th 583, 588-89 (2003) (consumer protection organization that brought a representative action under section 17200).

77 *See* 2001 WL 34076416 at *2-3.

78 *E.g., Furda v. Super. Ct. (Seriological Biopsy Labs)*, 161 Cal. App. 3d 418, 427 n. 5 (1984); *CQL Original Prods., Inc. v. Nat'l Hockey League Players' Ass'n,* 39 Cal. App. 4th 1347, 1357 (1995) (enforcing clause even though plaintiff's rights in another forum were likely less than under California law).

79 *America Online*, 90 Cal. App. 4th at 13.

Litigating in the other forum in both instances would be within the reasonable expectations of the parties, so long as the forum selection clause was adequately disclosed and entered into knowingly and voluntarily. The potential differences in the individual rights of the parties, by itself, "does not amount to a conflict involving fundamental policy in California."[80]

California courts will not enforce a forum section clause, though, if it would either (a) violate a public policy of California or (b) result in an evasion of a statute protecting the rights of a California resident.[81] For example, in *Hall v. Superior Court*, the Fourth Appellate District refused to enforce a Nevada forum selection clause that was coupled with a Nevada choice-of-law provision, because of California's strong public policy to protect investors from securities fraud in California.[82] After determining that the securities transaction involved "an offer *in this State*," and that if the case were brought in Nevada, Nevada law would likely be applied to the dispute, the Fourth Appellate District held that California's public policy, "without more, would probably justify denial of enforcement of the choice of forum provision, although a failure to do so might not constitute an abuse of discretion; but section 25701 [of the Corporation Code], which renders void any provision purporting to waive or evade the Corporate Securities Law, removes that discretion and compels denial of enforcement."[83]

Hall's public policy rationale is consistent with the United State Supreme Court's holding in *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth Inc.*[84] Prior to *Mitsubishi*, courts across the nation, including in California, held that antitrust claims, like security fraud claims, were not arbitrable.[85] They reasoned that antitrust laws, more so than security laws, reflected the strong public policies of the enacting forum; that private enforcement of antitrust laws played a critical role in the enforcement of those policies; and that arbitration was not a suitable forum for this purpose. The Supreme Court rejected this analysis.[86] The Supreme Court recognized that arbitration clauses require "no more than submission to an arbitral, rather than a judicial forum, without requiring the parties to forego the substantive rights afforded by statute."[87] However, following the public policy rationale in *Hall* and acknowledging that arbitration provisions operate like specialized forum selection clauses, the Supreme Court expressly cautioned: "[I]n the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of a party's right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy."[88]

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80 *CQL Original Prods.,* 39 Cal. App. 4th at 1357.

81 *America Online*, 90 Cal. App. 4th at 13-14; *Hall v. Super. Ct. (Imperial Petroleum)*, 150 Cal. App. 3d 411, 416-17 (1983) (citing *Frame,* 20 Cal. App. 3d at 673).

82 *Hall*, 150 Cal. App. 3d at 417.

83 *Id.* at 417-19 (citations omitted and emphasis original).

84 473 U.S. 614 (1985).

85 *E.g., Bos Material Handling Inc. v. Crown Controls Corp.*, 137 Cal. App. 3d 99, 110-11 (1982).

86 *Mitsubishi,* 473 U.S. at 635-36 ("[w]ithout doubt, the private cause of action plays a central role in enforcing [antitrust laws] . . . "; however, the importance of private enforcement "does not compel the conclusion [against arbitration]," because the antitrust claims remain "under the control of the individual litigant . . . . It follows that . . . the prospective litigant may provide in advance for a mutually agreeable procedure whereby he would seek his antitrust recovery . . . .").

87 *West v. Lloyd's*, 1997 WL 1114662, at *6-7 (1997) *(unpub.)* (following *Hall* after *Mitsubishi*).

88 *Mitsubishi*, 473 U.S. at 637 n.19.

In *Wimsatt v. Beveral Hills Weight Loss Clinics Int'l, Inc.*,[89] the Fourth Appellate District applied the evasion of statute rationale of *Hall's* holding to an area of California law not involving fundamental policy, but simply statutory rights and a remedial scheme. Relying solely on the antiwaiver provision in the Franchise Investment Law (FIL), the court reversed an order enforcing a forum selection clause that was coupled with a choice-of-law provision. The reversed order was issued in accordance with the United State Supreme Court's decision in *Bremem v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), which imposed a "'heavy burden" on plaintiffs to avoid forum selection clauses. The court reasoned that if the franchisee bore the heavy burden typical in forum selection cases, then "[t]he forum selection provision would become the effective equivalent of a choice of law provision stripping the franchisee of rights under California law." "Given California's inability to guarantee application of its Franchise Investment Law in the contract forum, its courts must necessarily do the next best thing. In determining the 'validity and enforceability' of forum selection provisions in franchise agreements, its courts must put the burden on the franchisor to show that litigation in the contract forum will not diminish in any way the substantive rights afforded California franchisees under California law."[90]

Subsequent decisions have applied both the public policy and evasion of statute rationales of *Hall's* holding, and the burden-shifting approach adopted in *Wimsatt*. For example, in *America Online*, the First Appellate District refused to enforce a forum selection clause that was coupled with a choice of law provision in a class action suit against an Internet service provider (ISP) under the Consumer Legal Remedies Act (CLRA). After the plaintiffs established that "the CLRA, like the FIL, embeds in its statutory scheme a provision prohibiting waivers [of California law]," the court held that it was incumbent upon AOL to demonstrate that "the rights afforded to California citizens against unfair business practices [would not] be diminished or avoided by [enforcement of the] contract."[91] Similarly, in *GMAC Commercial Finance LLC v. Super. Ct. (Mountain High Hosiery, LTD.)*,[92] the Second Appellate District refused to enforce a forum selection clause that was coupled with a choice of law provision in an action brought under the Finance Lenders Law (FLL). After the plaintiffs showed that the Corporations Commissioner had adopted a regulation prohibiting waivers of the FLL, the court shifted the burden and, like in *Wimsatt* and *American Online*, the "defendant failed to meet its burden [that rights would not be diminished]."[93]

Under *Hall, Wimsatt* and *America Online,* a forum selection clause accompanied by a choice-of-law provision in a non-competition agreement should not be enforced. The right at issue is *not* a statutory right, but a fundamental right of all citizens in California.[94] Like each one of the statutory rights or remedies enacted by the Legislature under the

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89 32 Cal. App. 4th 1511 (1995).

90 *Id*. at 1522.

91 *America Online*, 190 Cal. App. 4th at 11, 15.

92 2003 WL 21398319 (July 19, 2003)*(unpub.)*

93 *Id*. at 4-5 & n.3.

94 *See Nedloyd,* 3 Cal. 4th at 466; *Application Group,* 61 Cal. App. 4th at 902; *Frame,* 20 Cal. App. 3d at 673; *Hollingsworth*, 622 F.2d at 1338; *Davis*, 300 F. at 3; *Scott*, 732 F. Supp. at 1041; *see also New Method Laundry Co. v. MacCann*, 174 Cal. 26, 31 (1916) (most zealously protected property right of every citizen); *Morlife, Inc. v. Perry*, 56 Cal. App. 4th 1514, 1520 (1997) (section 16600 protects "one of the most cherished commercial rights we possess"); *Metro Traffic Control*, 22 Cal. App. 4th at 859 (every citizen has right "to pursue any lawful employment and enterprise of their choice").

Corporation Securities Law, the CLRA, the FIL and FLL, the right to work in California in one's chosen profession, trade or business cannot be waived by contract and is both protected and implemented by statute (Section 16600 and the UCL). As indicated in *Mitsubishi*, California courts should "have little hesitation in condemning the agreement as against public policy." Moreover, to enforce such a forum selection clause, the former employer should have to show that the rights of the California plaintiffs would *not* be substantially diminished or avoided if the case were litigated in another forum, a burden the former employer could rarely meet.

California Law Should Apply To Restraints In California

The central and most critical issue at the preliminary injunction hearing will be choice of law. If California's public policy against restraints of trade (Bus. & Prof. Code § 16600) and unfair competition laws (Bus. & Prof. Code §§ 17200 *et seq*.) do not apply to the dispute, then the former employer's post-employment non-competition agreement will likely be enforced against the employee, and deprive the employee of a job opportunity in his chosen profession, putting him out of work in his field and depriving California and the new employer of a beneficial and an otherwise lawful business relationship.

As the *Advanced Bionics* case showed, the outcome of the choice-of-law issue in non-compete cases is controlled by local law, and driven by different choice-of-law standards and predilections of the forum conducting the analysis. In Minnesota, the Minnesota appellate court followed Minnesota choice-of-law precedent and affirmed the application of Minnesota law as directed by the Minnesota trial court. In California, the Second Appellate District followed California choice-of-law precedent and affirmed the trial court's application of California's public policy to the restraint of trade in California. Even before *Advanced Bionics*, where the conflict of law arose in the same dispute, choice-of-law precedent in non-compete cases across the Nation has been in conflict for some time.

As previously noted, California courts have consistently affirmed the application of California's fundamental policy in favor of free competition and employee mobility to all covenants not to compete that have a substantial anti-competitive effect in California, whether or not the parties to the contract resided in California.[95] Under California choice-of-law precedent, the critical issue is *not* where the post-employment restraint was executed, or where the contracting parties currently reside, though those are relevant factors. Because post-employment restraints concern the *future* rights of the contracting parties, the critical questions are (a) where would the non-compete obligation be performed; (b) whether enforcement of the contract would injure a party entitled to the protections of California's public policy; and (c) whether applying California's public policy would be consistent with legitimate expectations of both the new and former employer and the employees subject to the restraint.[96]

Some courts in other states, such as Oregon and Minnesota, apply a much different choice-of-law standard. In these jurisdictions, the inquiry basically begins and ends with whether the employee knowingly and voluntarily entered into a non-competition agreement that contained a choice-of-law provision with an employer based in their state. To

95 *See supra,* note 30 and cases cited therein.

96 *See Application Group*, 61 Cal. App. 4th at 902, 904-05, 908.

these courts, it appears immaterial whether the employee was a resident of California when the non-competition agreement was executed.[97]

While it is easy to fault courts in every jurisdiction as being "provincial," that does not effectively explain the difference in jurisprudence. Justice Brown obviously did not offer her concurring opinion in *Advanced Bionics*—which not a single other Justice followed, which departed from choice-of-law precedent in California, including the First Appellate District's decision in *Application Group* and the Second Appellate District's decision in *Advanced Bionics*, and which conflicted with the California Attorney General's Amicus Curiae Brief that endorsed the opinions of both the First and Second Appellate Districts—because she favors Minnesota. The difference in jurisprudence lies elsewhere.

With respect to post-employment covenants not to compete that out-of-state employers have required California residents to sign (Interstate Problem #1 identified in Part I of this Article), courts in restraint friendly states simply refuse to give California's public policy and unfair competition laws full faith and credit. The Full Faith and Credit Clause it is believed does not require them to apply California's public policy if the dispute has sufficient minimal contacts or "nexus" to their forum.[98] They refuse to apply California law employing the following reasoning: (a) Although their states generally favor free competition and disfavor covenants not to compete, their states, like California, have allegedly made a policy choice, but unlike California, their choice is that certain competitive interests of their employers are paramount (or depending upon the circumstance, could be paramount) to the interests of their states in free competition and employee mobility, (b) regardless of which policy decision is better or makes more economic sense (or should be applied in California), California's policy decision cannot be "materially greater" than the decision made by their states, thus (c) choice-of-law clauses pointing to the laws of their states are enforceable, and (d) the new employer in California, although it did not sign any of the non-competition agreement or agree to its competitor's choice of law, must recruit employees in California and elsewhere as it finds them.[99]

With respect to employment and business opportunities in California, which are sometimes filled by U.S. citizens who migrate to California from another state (Interstate Problem #2), Justice Brown in her concurring opinion framed the issue as follows: California should not be "a political safe zone" from "legal duties our sister states recognize."[100] Even though out-of-state employers can recruit any employee of any California business for employment in California and elsewhere free from contractual restraints of trade, Justice Brown's concurring opinion advocates splitting the applicant pool of California businesses in thirds. Justice Brown apparently would (a) continue to enforce California's public policy against restraints of trade and unfair competition laws to protect *long-standing* California residents, but (b) forgo California law and permit the enforcement of post-employment restraints against *newly arrived residents* of California, thus depriving

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97 *E.g., Machado-Miller v. Mersereau & Shannon, LLP*, 43 P.3d 1207, 1213 (Or. App. 2002) (Oregon court may enforce Oregon-based company's non-competition agreement against California resident hired to work in Sacramento); *Medtronic, Inc. v. Gibbons*, 684 F.2d 565, 568 (8th Cir. 1982) ("Minnesota clearly has the 'significant contact or significant aggregation of contacts'" to permit enforcement of Minnesota choice-of-law provision against California resident in California).

98 *See Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1980).

99 *See supra,* note 97 and cases cited therein.

100 *Advanced Bionics*, 29 Cal. 4th at 710 (Brown, J., concurring).

California and California businesses of otherwise beneficial and lawful business relationships, and (c) deny residents in other states the right to work *in California* for a California-based business like Pike in *Application Group*, even though out-of-state businesses can similarly recruit California residents to fill *any* position in their companies.

The forced waiver of a fundamental right of a California resident (Interstate Problem #1), the discrimination against U.S. citizens who travel to California (Interstate Problem #2), the uneven playing field advocated by Justice Brown and foreign courts (Interstate Problem #3), and the *in terrorem* effect on free competition and employee mobility caused by such decisions (Interstate Problem #4), do not concern them. Their concerns lie solely in enforcing a purported public policy decision in favor of restraints of trade made (or more likely not made) by the legislatures of foreign states, and in protecting foreign businesses from unrestrained competition and employee mobility. California courts should not hesitate to reject these decisions and Justice Brown's concurring opinion in *Advanced Bionics*.

Restraints on California Residents are Void and Unenforceable

Even Justice Brown would recognize that foreign companies have no right to contract with California residents to create legal duties not to compete in California after their employment is terminated. It is an unlawful object of a contract. Foreign companies, in fact, owe legal duties not to (a) include post-employment covenants not to compete in employee agreements in California, (b) threaten to enforce a contract against a California resident in disregard of California's public policy, and (c) otherwise use contracts to restrain trade in California in violation of California's public policy.[101]

Foreign companies doing business in California cannot contract around these obligations, so as to create obligations in California that are not recognized in this state.[102] California's Unfair Competition Law requires them to comply with California's regulatory scheme governing restraints of trade. It is irrelevant whether courts in other states would recognize such an obligation.

The First Appellate District made this clear in *Yu v. Signet Bank/Virginia*,[103] a case challenging the practice, engaged in by Virginia banks, of filing credit-card collections actions against California residents in Virginia state courts. California residents and consumers brought an action in California asserting claims for abuse of process and violation of the UCL challenging the banks' practice as a form of "distant forum abuse." The trial court granted summary judgment in favor of the Virginia banks on the ground that the practice complied with Virginia law. The First Appellate District reversed, holding that "[i]t is irrelevant whether the conduct was lawful in other states." The Court of Appeals rejected the

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101 *See, supra,* notes 55 and 56, and cases cited therein.

102 Cal. Bus. & Prof. Code § 16600 ("every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void"); Cal. Civ. Code § 1668 ("[a]ll contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own . . . violation of law, whether willful or negligent, are against the policy of the law"); Cal. Civ. Code § 3513 ("[a]ny one may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement").

103 69 Cal. App. 4th 1377 (1999).

banks' defense that "California cannot 'regulate' conduct 'that is lawful in other states,'" finding that "a defendant who is subject to jurisdiction in California and who engages in out-of-state conduct that injures a California resident may be held liable for such conduct in a California court."[104]

The refusal of some out-of-state courts to give California's public policy and unfair competition laws full faith and credit is constitutionally suspect. A Problem #1 situation does not involve a question of which state's public policies will govern the individual rights of the parties, such that the laws of many different states might apply depending on contacts to each forum. It presents a conflict of law question involving California's sovereign right to regulate trade in California and the alleged "freedom of contract" of a company doing business in California to "opt out" of California's regulatory scheme.

In *Hughes v. Fetter*,[105] the United States Supreme Court recognized that there are instances when the "strong unifying principal embodied in the Full Faith and Credit Clause," which looks "toward maximum enforcement in each state of the obligations or rights created or recognized by the statutes of sisters states," overrides local policy concerns, even when there are sufficient contacts to a state to otherwise "measure the substantive rights involved."[106] For example, the Full Faith and Credit Clause bars a court from applying local law that would offend another's states exercise of regulatory power over conduct occurring in that state.[107] Courts cannot permit local companies doing business in another state to, in effect, "opt out" of a regulatory scheme governing their conduct. It is irrelevant whether the local company extracted an unlawful promise from a resident of that state and filed a lawsuit in another state where such promises might be enforced.[108] No state has a valid interest of *projecting* their laws into another *soverign state* to condone unlawful conduct *in that state*.[109]

Simply put, post-employment non-competition agreements signed by California residents are void *abinitio*, regardless of whether such a restraint of trade in California would be enforced in another state. Out-of-state decisions to the contrary are wrongly decided and should be disregarded.

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104 *Id*. at 1388-91.

105 341 U.S. 609 (1951).

106 *Id*. at 610, 612 & n.10, 613.

107 *Bradford Elec. Light Co. v. Clapper*, 286 U.S. 145, 154-55 (1932) ("*Clapper*") (in workers compensation action between Vermont employer and Vermont resident filed in New Hampshire, Full Faith and Credit Clause required application of Vermont statute regulating employers and employees in Vermont); *cf. Pac. Employers Ins. Co. v. Indus. Accident Comm'n*, 306 U.S. 493, 502 (1939) (Full Faith and Credit Clause does not bar California courts from applying California's workers compensation law to Massachusetts resident injured in California while on temporary assignment by Massachusetts employer).

108 *See Carroll v. Lanza*, 349 U.S. 408, 411 (1955) ("[t]he Clapper case allowed a State to fix one exclusive remedy for personal injuries involving its residents, and required the other States to refuse to enforce any inconsistent remedy"); *Pac. Employers Ins.,* 306 U.S. at 504 (*Clapper* decided "that a state statute applicable to employer and employee within the state, which by its terms provides compensation for the employee if he is injured in the course of his employment while temporarily in another state, will be given full faith and credit in the latter when not obnoxious to its policy").

109 *See Pearson v. Northeast Airlines, Inc.*, 307 F.2d 131, 134-35 (2nd Cir. 1962) (Full Faith and Credit Clause required application of Massachusetts law to wrongful death action brought in New York against Massachusetts corporation for plane crash in Massachusetts; "the essence of the Full Faith and Credit Clause is that certain transactions, wherever in the United States they may be litigated, shall have the same legal consequences as they would have in the place where they occurred").

Restraints on California Employments are Void and Unenforceable

Central to the resolution of a Problem #2 situation, where a U.S. citizen residing in another state accepts employment in California, is the application of California's power to regulate out-of-state activity that has anticompetitive effects in this state. Like any other state, California "has jurisdiction to apply its local law to determine a particular issue if the issue is within the reasonable scope of the state's regulatory power."[110] This jurisdiction includes the power to apply the UCL to enjoin "unfair competition consisting of conduct occurring in other states that cause[s] injury in California."[111]

The basic difference between Justice Brown's concurring opinion in *Advanced Bionics* and the First and Second Appellate Districts' choice-of-law decisions in *Application Group* and *Advanced Bionics* is in the exercise of this power. Justice Brown expressed the view that foreign companies can enter into nationwide non-competition agreements with U.S. citizens residing in other states and create legal obligations not to compete in California. She also expressed the view that California courts should enforce these contracts that are valid in other states and limit the pool of qualified candidates for employment in California, even if the subject employee traveled to California and became a resident of this state. The First and Second Appellate Districts, along with the California Attorney General, disagreed. Following California precedent and applying the plain language of Section 16600 and the UCL, they expressed the contrary view that nationwide post-employment restraints are "void in California" whenever and to the extent that they have anticompetitive effects in California.

Underlying Justice Brown's concurring opinion are flawed assumptions. First, it assumes that enforcing California's public policy against restraints of trade in California would offend a public policy of another state. Even in restraint friendly jurisdictions, however, non-competition agreements are disfavored. They are just not viewed as poorly as they are in California. In fact, even Minnesota courts cite nothing for the proposition that requiring Minnesota employers to comply with California's higher standards, so as to compete fairly in California, would offend Minnesota public policy.

Second, it is wrong for Justice Brown and out-of-state courts to equate California's fundamental policy in favor of free competition and employee mobility, which was enacted to override the general interest that each state shares in enforcing private agreements, with another state's general interest in enforcing a contract. In fact, it deeply offends notions of comity that to avoid applying a fundamental policy of another state, courts in Minnesota have treated their state's generalized interest in enforcing a contract as a fundamental policy of that state for purposes of a choice-of-law analysis. Although a majority of states do not view the right to work in one's chosen profession, trade or business as a fundamental right of each citizen in their state, that decision does <u>not</u> increase their state's interest in enforcing a contract, particular a disfavored one. California still has a materially greater interest in enforcing its public policy, than any other state has in enforcing a private agreement, in California.

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110 *See* Rest. 2d Conflicts of Law § 9, comt.d. (1971).

111 *Norwest Mortgage, Inc. v. Super. Ct. (Conley),* 72 Cal. App. 4th 214, 223 (1999); *Yu*, 69 Cal. App. 4th at 1391 ("a defendant who is subject to jurisdiction in California and who engages in out-of-state conduct that injures a California resident may be held liable for such conduct in a California court").

Third, Justice Brown erroneously assumes that the purported interest of another state in restraining "the free movement of personnel laterally across an industry" is the same as an interest in restraining "the free movement of personnel laterally across [state lines]."[112] They are not the same, but involve different considerations. If a U.S. citizen travels to another state, she is entitled to the same fundamental benefits and protections offered by that state to other residents, including the right to ply her trade on an equal footing with them.[113] Justice Brown's concurring opinion, like the opinions of courts in Oregon and Minnesota, simply fails to take into consideration the new resident's constitutional right to travel and its effect on the choice-of-law analysis. The pertinent questions they fail to answer are (a) whether the former employer has a valid expectation that it can contractually restrain trade in California, (b) whether the U.S. citizen has a valid expectation that she can compete against her former employer in California, (c) whether the California employer has a valid expectation that it can employ the most qualified candidate to work in California, regardless of where that candidate is from, and (d) whether the other state has a valid interest in restraining trade in California.

Merely invoking a stated state interest of restricting "the free movement of personnel laterally across an industry" is not the end of the analysis in a Problem #2 situation.[114] Rather, Justice Brown and out-of-state courts must go on to determine whether that is a compelling state interest (which is doubtful considering that it is based solely on a disfavored private agreement), and whether restricting competition in California would actually be necessary to protect that stated interest under the circumstances.[115] Obviously, if the job responsibilities of the U.S. resident would be entirely local to California, then the Problem #2 situation would hardly be distinguishable from a Problem #1 situation. The difference would be that the out-of-state employer imposed a direct restraint on a U.S. citizen's right to travel to California and enjoy the same privileges and immunities of U.S. citizens already residing in California when, or if, they were required to sign the same nationwide non-competition agreement. The United States Supreme Court in *Saenz v. Roe* was clear that such a restriction on a U.S. citizen's right to travel would be unconstitutional.[116]

At bottom, Justice Brown's concurring opinion is based on a jaundice view of California's public policy against restraints of trade, and a misconception of how California's fundamental policy codified in Section 16600 is enforced in this state. She wrote: "I can think of several contexts in which a person might relocate to California but remain obligated under contracts entered into in the place of his or her form residence. California courts

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112 *Advanced Bionics*, 29 Cal. 4th at 709 (Brown, J., concurring).

113 *Saenz v. Roe*, 526 U.S. 489, 502 (1999); *Supreme Ct. of N.H. v. Piper*, 470 U.S. 274, 279-80 (1985); *Hicklin v. Orbeck,* 437 U.S. 518 (1978); *Doe v. Bolton*, 410 U.S. 179, 200 (1973).

114 *See Braun v. Headley*, 750 A.2d 624, 632 (Md. Ct. Spec. App. 2000) (while child custody laws did not violate right to travel, the constitutional right to travel "should not be ignored in custody decisions involving the decision of one parent to relocate").

115 *Saenz*, 526 U.S. at 499 (neither state governments nor private parties may deprive a new resident of a fundamental right unless it is "shown to be necessary to promote a *compelling* government interest . . . .") (internal citation omitted, emphasis original).

116 *Id.* at 502, 506-07 ("substantial reason for discrimination [must be] beyond the mere fact that [persons claiming benefits] are citizens of other States"; the right to travel, which is enforceable against private parties, "does not tolerate a hierarchy of [50] subclasses of similarly situated citizens based on the location of their prior residence") (internal citations omitted).

cannot then reach out and nullify those foreign obligations simply because the same obligations, if entered into here, would run afoul of important California policies."[117]

Justice Brown treated California's fundamental policy in favor of free competition and employee mobility as a law enacted by the Legislature simply for the benefit of the contracting parties. It is apparent that she was not referring to the enforcement of a foreign obligation in California that is repugnant to California's antitrust laws, which are not intended to protect contracting parties, but to protect California, its economy, and the consumers and businesses in this state. The United States Supreme Court has recognized that no state has to enforce a contract or permit another state to project its laws into their state when it would be repugnant to a fundamental policy of that state.[118]

Moreover, the United States Supreme Court is clear that where a contract is intended to have a nationwide effect, courts may enforce their state's public policies and alter the effect of such a contract within their state's borders without offending notions of comity.[119] For example, in *Watson v. Employers Liability Assurance Corp.,* the Supreme Court recognized that "[s]ome contracts made locally, affecting nothing but local affairs, may well justify a denial to other states of power to alter those contracts. But, as this case illustrates, a vast part of the business affairs of this Nation does not present such simple local situations. Although [this] contract was issued in Massachusetts, it was to protect Gillette and its Illinois subsidiary against damages on account of personal injuries that might be suffered by users of [Gillette products] anywhere in the United States . . . ."[120] In such situations, each state may properly enforce its own public policies and alter the effect of a contract within its own borders.

Consistent with the teaching of the United States Supreme Court in *Watson*, the First and Second Appellate Districts in *Application Group* and *Advanced Bionics* simply held that foreign companies doing business in California did *not* have a valid expectation that they could restrain competition in California through the execution of post-employment covenants not to compete in another state. They held that the California employers had a valid expectation that they could recruit the most qualified candidates to work in California, regardless of where a candidate resided before accepting employment. Moreover, all U.S. citizens who travel to California have a valid expectation that they will be entitled to the same privileges and immunities enjoyed by other U.S. citizens residing in California, including the right to ply their trade on an equal footing with them. In fact, given the historical context of Section 16600—whose predecessor statute was enacted in 1872, following the Gold Rush and after the Civil War—it is clear that Section 16600 was intended, not just to protect the mobility of U.S. citizens within California, but to protect U.S. citizens who migrated to California to live and work.

Justice Brown's concern that the enforcement of Section 16600 in a Problem #2 situation will result in an unseemly number U.S. citizens migrating to California to "break" their

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117 *Advanced Bionics*, 29 Cal. 4th at 709 (Brown, J., concurring).

118 *Bond v. Hume*, 243 U.S. 15, 21 (1917); *Griffin v. McCoach*, 313 U.S. 498, 506-07 (1941).

119 *Watson v. Employers Liab. Assurance Corp.,* 348 U.S. 66, 71 (1955) (upholding Louisiana statute authorizing direct actions against out-of-state insurance companies notwithstanding the public policies of Massachusetts forbidding direct actions against insurance companies who entered into insurance contracts in Massachusetts with Massachusetts-based businesses).

120 *Id.*

non-competition agreements is misplaced. To begin with, Justice Brown erroneously assumes that many U.S. citizens would uproot their lives and relocate to another state to pursue a job opportunity. More importantly, even if citizens would relocate for that reason, it is not a legitimate concern of any court in this Nation to deprive a U.S. citizen of a fundamental benefit or protection provided to the residents of another state. If California attracts U.S. citizens by virtue of the economic opportunity it provides the residents of California, then that is simply a reality of our federal system. It should be viewed no differently than the way California also attracts less fortunate citizens by offering desired welfare benefits.

In fact, Justice Brown's concurring opinion, if followed (not Section 16600), would result in unseemly migration—corporate migration out of California. If Section 16600 does not protect the rights of California businesses to compete on an even playing field with their out-of-state competitors, then California employers that do business in other states will have a strong incentive to relocate. They will increasingly relocate their headquarters to restraint friendly states where they do business, so that they, too, can use non-competition agreements to restrain trade in California. The net effect will be a California "brain drain" in favor of business headquartered in other states, with more and more California residents unwittingly becoming subject to post-employment covenants not to compete.

California courts should continue to focus on whether enforcement of a choice-of-law provision in a non-competition agreement would have anticompetitive effects in California. In conducting the choice-of-law analysis, the determinative factors should remain where the non-compete obligation would be performed, whether its enforcement would injure a party entitled to the protections of Section 16600, and whether applying California's public policy would be consistent with legitimate expectations of the parties. Historical events, such as where the contract was executed, the former employer is headquartered, and the former employee used to work, should be given little or no weight.

Conclusion

California's long-standing policy against restraints of trade is a cornerstone of California's economy and its antitrust and unfair competition laws. To ensure that the promise of Business and Professions Code section 16600 is fulfilled, courts and litigants must understand this statute and the tools available to vindicate the rights protected by it. As stated in *Application Group*, "[t]he effect of Business and Professions Code section 16600 can be imagined [as] an addendum to [an out-of-state employer's] non-compete clause to add the words 'void in California.'" In the wake of the California Supreme Court's decision in *Advanced Bionics*, it is now clear that California trial courts have the tools necessary to enforce California's fundamental policy against out-of-state employers.

JRS PRODUCTS V. MATSUSHITA ELECTRIC CORPORATION OF AMERICA: CONTRACT, NOT TORT DAMAGES FOR FRANCHISE TERMINATIONS

By: Shawn D. Parrish and Adrienne S. Leight[*]

In *JRS Products, Inc. v. Matsushita Electric Corporation of America*,[1] the Third District Court of Appeal clarified two previously unresolved issues regarding terminations of franchisees. First, it held that under the California Franchise Relations Act,[2] a terminated franchisee may recover full contract damages. Its remedy is not limited to repurchase of inventory. The court implied, however, that parties may agree to waive any contract remedies, thus limiting a terminated franchisee's recovery to repurchase of inventory. Second, the court threw out the tortious interference claims, signaling that tort remedies are not ordinarily available for improper termination of a franchise.[3]

1. The Scope of Franchise Litigation

Franchise relationships have spawned a huge amount of litigation, legislation and legal commentary. This is partly a function of the importance of franchise relationships in the economy. Nearly ten years ago, one commentator observed: "Franchising is rapidly becoming the dominant mode of distributing goods and services in the United States. According to the International Franchise Association, one of every 12 businesses in the United States is a franchise. In addition, franchise systems now employ over eight million people and account for approximately 41% of retail sales in the United States."[4]

Conflict between franchisors and franchisees also stems from a sharp divide in the economic interests of the two groups. One commentator has observed that franchisors' principal aim is to establish a distribution system that will maximize the use of their products on an aggregate basis; whereas franchisees of necessity have a more "personal and parochial view of profit maximization opportunities."[5]

2. The Case Law Context

Historically, much of the California case law involving termination of the franchise relationship focused on extra-contractual theories. Among the causes of action considered and rejected by courts were whether a franchise termination amounted to a breach of fiduciary duty,[6] whether a "special relationship" existed between franchisor and franchisee that would

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1 *JRS Products, Inc. v. Matsushita Elec. Corp.,* 115 Cal. App. 4th 168 (3d Dist. 2004) ("*JRS*").

2 Cal. Bus. & Prof. Code §§ 20000 *et seq*. (1980).

3 *Id*.

4 David Hess, The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors, 80 Iowa L. Rev. 333 (1995) (footnotes omitted) quoted in *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704, 1715 (1996).

5 Don T. Hibner, Jr., Franchisee Protection: 'A Lion In The Street': Analysis of the Proposed Small Business Franchise Act of 1999, 9 Competition, No. 1, 53-68 (Summer/Fall 2000).

6 *Premier Wine & Spirits v. E. & J. Gallo Winery,* 846 F.2d 537, 540-541 (9th Cir. 1988) (a franchise relationship is not a fiduciary relationship).

7 *Martin v. U-Haul Co. of Fresno,* 304 Cal. App. 3d 396, 413 (1988) (no special relationship exists between franchisor and franchisee, such as exists between insurer and insured, to justify tort liability for breach of the covenant of good faith and fair dealing.)

allow the imposition of tort liability for a breach of the covenant of good faith and fair dealing,[7] and whether a franchisee could claim tortious termination for its refusal to violate the law.[8] For the most part, franchisees had little success in extending tort principles to terminations of the franchise relationship.

There is also an extensive body of case law that analyses the role of the antitrust laws in connection with franchises. Franchisee terminations have most frequently been analyzed as vertical refusals to deal, even when the franchisor employs a dual distribution system involving direct distribution to purchasers as well as franchisees, thus giving the arrangement some of the characteristics of a horizontal arrangement.[9] The elements of a Section 1 vertical refusal to deal claim include (1) a demonstration that the franchisor agreed with others, such as other franchisees, to terminate a franchisee to achieve an unlawful objective; and (2) the termination unreasonably restrains trade.[10] Termination of a franchisee is not *per se* unlawful "unless it includes some agreement on price or price levels."[11] When the franchisor has substantial market power, its decision to terminate franchisees might also be challenged as monopolization or attempted monopolization under Section 2.

Without question, a franchise termination taken in furtherance of a price fixing conspiracy is a per se violation. For example, in *Monsanto Co. v. Spray-Rite Service Corp.*,[12] a terminated distributor prevailed on a Section 1 claim following its termination based on evidence that the manufacturer had published a suggested resale price, and that other distributors were told they would not receive adequate supplies of the product unless they adhered to the suggested resale price.[13] And in *State Oil Co. v. Kahn*,[14] the U.S. Supreme Court reversed a grant of summary judgment, and held that a terminated gas station operator who claimed that the supplier's contractual requirement imposing maximum prices on the sale of various grades of gasoline might be able to state a claim for illegal vertical price-fixing.[15]

Many franchisees have also contended that the terms imposed by franchisors constitute an unlawful tying arrangement. For a brief period, the Ninth Circuit recognized that a franchisor's trademark was distinct from the products it sells as a matter of law.[16] However, the Ninth Circuit reversed itself ten years later in *Krehl v. Baskin-Robbins Ice Cream Co.*,[17] and held that a more fact-intensive analysis was required before a court could conclude a trademark was a separate product.

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8 *Premier Wine & Spirits, supra,* 846 F.2d at 540-541 (predicting that California would not extend the tort of termination of a relationship in violation of public policy beyond the employer-employee relationship).

9 Joseph Angland, (ed.) Restrictions Imposed under a Dual Distribution System, ABA Section of Antitrust Law, Antitrust Law Developments, 160-161 (4th ed. 1997).

10 *Id.* at 160-161.

11 *Business Elec. Corp. v. Sharp Elec. Corp.,* 485 U.S. 717, 735-736 (1988).

12 465 U.S. 752 (1984).

13 *Id.* at 765-766.

14 522 U.S. 3 (1997).

15 The Court recognized that the gas station operator might have a rule of reason claim based, in part, on the evidence that showed that maximizing prices on multiple grades of gasoline tends to prevent gas station operators from lowering prices on the lowest grade. Although the Court of Appeals had opined that the operator would lose under a rule of reason, the Supreme Court remanded the case without commenting upon the soundness of this ruling.

16 *Siegel v. Chicken Delight Inc.*, 448 F.2d 43, 48 (9th Cir. 1971).

17 664 F.2d 1348, 1352-53 (9th Cir. 1982).

In *Eastman Kodak Co. v. Image Technical Services, Inc.*[18], the U.S. Supreme Court recognized that businesses which have "locked in" to a single supplier's products by making significant investments of time and money to that supplier might be able to define that single product as a relevant market for purposes of tying analysis. However, most cases decided after *Kodak* have not authorized tying claims unless it is shown the franchisor imposed onerous or overbearing post-contract changes, or failed to disclose material contract terms and then sought to enforce the undisclosed terms.[19]

The Robinson-Patman Act and its state analogues also arise in franchise litigation from time to time. Franchisees invoke the Robinson-Patman Act by claiming that the franchisor gave preferential pricing to its own subsidiaries, which independent franchisees did not receive. Many, though not all, courts have rejected these arguments, reasoning that intra-enterprise transfers of goods or services do not constitute a "sale" for purposes of the Robinson-Patman Act.[20]

Finally, some terminated franchisees have claimed illegal discrimination on the basis of race or some other protected classification in modifying, renewing or terminating a franchise. One commentator has characterized the track record of such claims thus: "whether independently or as class actions, most franchisee discrimination claims have fared poorly."[21]

Franchisees have had somewhat greater success in relying upon the implied contractual covenant of good faith and fair dealing in connection with terminations or unsuccessful renewals. *In re Vylene Enterprises, Inc.*,[22] held that a franchisor had breached the covenant of good faith and fair dealing when the parties had agreed that the franchisee would have the right to extend the relationship on "terms and conditions to be negotiated." The franchisor offered a renewal under new and different terms that the court found commercially unreasonable.[23] The *Vylene* court held that the franchisor had also breached the covenant when it

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18 504 U.S. 451 (1992).

19 *See*, *e.g.*, *Wilson v. Mobil Oil Corp.*, 984 F. Supp. 450 (E.D. La. 1997); *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 433 (3rd Cir. 1997), *cert. denied*, 523 U.S. 1059 (1998); *Collins v. Int'l Dairy Queen, Inc.*, 939 F. Supp. 875, 883 (N.D. Ga. 1996); *Little Caesar Enters., Inc. v. Smith*, 34 F. Supp. 2d 459 (E.D. Mich. 1998). For a more extended discussion of these cases, see Benjamin Klein, Market Power and Franchise Cases in the Wake of Kodak: Applying Post-Contract Hold-Up Analysis to Vertical Relationships, 67 Antitrust L.J. 283 (1999).

20 *See, e.g., Cariba BMW, Inc. v. Bayerische Motoren Werke Aktiengesellschaft,* 19 F.3d 745 (1st Cir. 1994); *City of Mt. Pleasant v. Assoc. Elec. Co-op., Inc.,* 838 F.2d 268, 277-279 (8th Cir. 1988); *Russ' Kwik Car Wash, Inc. v. Marathon Petroleum Co.,* 772 F.2d 214 (6th Cir. 1985); *Eximco, Inc. v. Trane Co.,* 737 F.2d 505 (5th Cir. 1984); *O'Byrne v. Checker Oil Co.,* 727 F.2d 159 (7th Cir. 1984); *Security Tire & Rubber Co. v. Gates Rubber Co.,* 598 F.2d 962, 965-967 (5th Cir. 1979); *Diehl & Sons, Inc. v. Int'l Harvester Co.,* 426 F. Supp. 110, 123 (E.D.N.Y. 1976). *But see Zoslaw v. MCA Distrib., Corp.*, 693 F.2d 870, 879 (9th Cir. 1982), *cert. denied*, 460 U.S. 1085 (1983) (transactions with subsidiaries are not necessarily immune); *Schwimmer v. Sony Corp. of America*, 637 F.2d 41, 49 (2nd Cir. 1980) (sale to an affiliate potentially subject to Robinson-Patman Act). Some state statutes, but not California, specify that intra-enterprise sales qualify as sales for the purpose of their state analogue Robinson-Patman Act. *See e.g.* Wash. Rev. Code § 19.100.180(2)(c) (1994); Haw. Rev. Stat. § 42 E-6(2)(C) (1995).

21 Robert W. Emerson, Franchise Terminations: Legal Rights and Practical Effects When Franchisee Claims the Franchisor Discriminates, 35 Am. Bus. L.J. 559, 572 (Summer 1998).

22 90 F.3d 1472, 1473 (9th Cir. 1996).

23 Although the court did have concerns that the renewal clause in the contract was too vague to be enforced, the franchisor had accepted a cash deposit, thus waiving or estopping it from relying on the vagueness of the renewal term.

opened a competing restaurant one and a half miles from the franchisee's location. The court acknowledged that the franchise agreement did not contain an exclusive territory clause, but the implied covenant was violated because the opening of the second restaurant was an act designed to "destroy the right of the franchisee to enjoy the fruits of the contract."[24]

3. Overview of California Franchise Relations Act

Legislatures have tended to be more sympathetic to franchisees than the courts have. In 1980, the California Legislature adopted the California Franchise Relations Act ("CFRA" or "the Act"), adding a new chapter to the Business and Professions Code.[25] The CFRA regulates the termination and renewal of franchises created or renewed on or after January 1, 1981.[26] It applies to franchises domiciled in California or when the franchised business "is or has been operated" in California.[27]

> A franchise is defined under the Act as a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: (a) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and (b) the operation of the franchisee's business pursuant to that plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logo type, advertising or other commercial symbol designating the franchisor or its affiliate; and (c) the franchisee is required to pay, directly or indirectly, a franchise fee.[28]

The CFRA excludes certain entities from qualifying as franchises, including nonprofit organizations, some lease departments or licenses with merchandise retail establishments and petroleum franchises regulated by the federal government.[29]

The CFRA performs three functions: first, it prohibits a franchisor from terminating a franchise without good cause, which the Act defines as "the failure of franchisee to comply with any lawful requirement of the franchise agreement" after being given at least 30 days notice and an opportunity to cure, subject to certain exceptions listed in Section 20021.[30] Second, the Act provides a repurchase remedy if the franchisor terminates or fails to renew a franchise other than in accordance with the provisions of the Act.[31] The Act does not expressly provide an injured franchisee with a damages remedy when a franchisor violates the provisions

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24 *In re Vylene Enters., Inc., supra,* 90 F.3d at 1477.

25 Cal. Bus. & Prof. §§ 20000 *et seq.* (1980). This was not the first law the California legislature passed regarding franchise relations. Ten years earlier, in 1970, the California Assembly passed the California Franchise Investment Law, California Corporations Code § 31000 *et seq.*, which regulates the purchase and sale of franchises. Federal legislation also governs franchises in certain industries. In 1978, Congress passed the Petroleum Marketing Practices Act, 15 U.S.C. § 2801 *et seq.,* which prohibits terminations and nonrenewals of petroleum franchises by oil company suppliers. The Automobile Dealer Franchise Act, 15 U.S.C. §§ 1221 *et seq.* (1956) requires automobile manufactures to act in "good faith" in terminating, canceling or not renewing a dealer and provides a federal forum for disputes arising out of the Act.

26 Cal. Bus & Prof. Code § 20015.

27 *Id.*; Witkin, Agency, Vol. 2, Supp. § 6A (9th ed. 2003).

28 Cal. Bus & Prof. Code § 20001(a)-(c).

29 *Id.* at § 20001(d)(1)-(3).

30 *Id.* at §§ 20020-20021; *see generally* Witkin, Agency, Vol. 2, Supp. § 6A (9th ed. 2003).

31 *Id.* at § 20035.

of the Act, but it does not "abrogate the right of a franchisee to sue under any other law."[32] Third, the Act sets forth the requirements for renewal and transfer of a franchise.[33]

4. The JRS Case: Contract or Tort Remedies

Although the CFRA has been in effect for nearly a quarter of a century, there is very little case law applying the Act's provisions regarding good cause for termination or the remedies arising out of a termination. The *JRS Products* court was thus writing on a mostly, though not entirely, clean slate.

JRS Products was an authorized "dedicated" dealer of defendant Matsushita (a.k.a. Panasonic) fax machines and related products. "Dedicated dealers" sell only the products of their franchisor.[34] Panasonic gave JRS a letter stating that JRS was an authorized Panasonic dealer. JRS included a copy of its Panasonic authorization letter in solicitations to new customers. JRS began to sell remanufactured Panasonic toner cartridges for use with the fax machines at prices lower than Panasonic sold its new cartridges.

A JRS officer admitted that Panasonic asked JRS to stop using the authorization letter as part of its solicitations. However, that same officer testified that Panasonic never informed JRS the franchise would be terminated unless JRS ceased using the authorization letter, and said that if JRS had known that was Panasonic's position, JRS would have ceased using the letter. There was other evidence that the Panasonic managers who decided to terminate JRS concealed from their superiors the fact that Panasonic had never given JRS a warning to cease using the letter. There was also evidence that Panasonic threatened to terminate JRS and all other dealers who attempted to sell to large customers that Panasonic had decided it wanted to sell to directly. Eventually, Panasonic sent JRS a letter stating that it was terminating the dealership in ninety days. Panasonic gave no reason for the termination to JRS. JRS sought to persuade Panasonic to reinstate the dealership but these efforts were unsuccessful.

JRS sued Panasonic. The two pertinent counts were breach of contract and tortious interference with contractual relations. The trial court granted Panasonic's motion for summary adjudication on the contract claim. The case proceeded to trial, and the jury returned a verdict in JRS's favor on the tortious interference claim. Panasonic appealed the verdict, and JRS cross-appealed the summary adjudication of the contract claim. The Court of Appeal, Third Appellate District, found that both appeals had merit and sent the case back to the trial court for further proceedings.

The court first dealt with JRS's cross-appeal. JRS founded its breach of contract claim not on the express language of the contract creating the franchise agreement, but instead on the CFRA.[35] The CFRA prohibits a franchisor from terminating a franchise without "good cause" and requires the franchisor to provide the franchisee with notice and an opportunity to cure if it believes there is cause for termination.[36] Panasonic did not assert

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32 *Id*. at § 20037.

33 *Id*. at §§ 20025-20027.

34 The dealer contract provided that Panasonic could compete with its dealers, and was therefore in dual distribution. *JRS,* 115 Cal. App. 4th at 171-172.

35 The opinion assumes that a franchise relationship existed between JRS and Panasonic, a predicate to the application of the CFRA.

36 Cal. Bus. & Prof. Code § 20020.

that it had good cause for the termination or that it had given proper notice, but instead argued that JRS's contract damages claim was foreclosed by another provision of the CFRA, California Business and Professions Code § 20035. That section provides that "[i]n the event a franchisor terminates or fails to renew a franchise other than in accordance with the provisions of this chapter, the franchisor shall offer to repurchase from the franchisee the franchisee's resalable current inventory meeting the franchisor's present standards that is required by the franchise agreement . . . "[37]

The court rejected Panasonic's invitation to limit a franchisee's damages to repurchase of inventory. Yet another section of the CFRA, section 20037, states that "[e]xcept as expressly provided herein, nothing in this article shall abrogate the right of a franchisee to sue under any other law."[38] The court held that the plain meaning of this language was that "a franchisee may seek any common law or statutory remedy for wrongful termination of the franchise, including a breach of contract action."[39]

The basis for this ruling was two-fold. First, the plain language of section 20037 could only mean that franchisees are permitted to pursue all common law and statutory remedies in the event of a breach.[40] Second, the court found that the CFRA's purpose was to protect franchisees. A law that permitted franchisors to terminate franchisees at the cost of repurchase of inventory would not be a sufficient disincentive to wrongful termination, since in many cases the franchisors would need the franchisee's inventory to continue the business after the termination.[41]

The Court of Appeal next distinguished two federal precedents. In *Boat & Motor Mart v. Sea Ray Boats, Inc.*,[42] the Ninth Circuit ruled that a franchisee had agreed to waive liability for any loss arising out of the agreement. The CFRA applied to the franchise relationship in *Sea Ray*, and the Ninth Circuit found that the franchisor had violated the termination provision of the CFRA because it had failed to give 180 days notice of termination. However, the Ninth Circuit ruled the waiver of all contract remedies was effective and did not violate the CFRA.[43] This distinguished the franchisee in *Sea Ray* from *JRS*, which had not waived its common law remedies.

The other decision cited by Panasonic, *Dale Carnegie & Associates, Inc. v. King*,[44] involved the non-renewal of a franchise, not its early termination. In the *Dale Carnegie* case, the franchisor had given 180 days notice that it would not be renewing the franchise, and the court ruled that the non-renewal was lawful under the CFRA.[45] The *Dale Carnegie* court proceeded to hold, however, that even assuming the franchisor had not followed the CFRA's requirements for a non-renewal, the only remedy expressly provided for a violation of the CFRA was repurchase of inventory, citing the *Sea Ray* decision.[46]

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37 *Id.* § 20035.
38 *Id.* § 20037.
39 *JRS*, 115 Cal. App. 4th at 174.
40 *Id.*
41 *Id.*
42 825 F.2d 1284 (9th Cir. 1987).
43 *Id.* at 1291.
44 31 F. Supp. 2d 359 (S.D.N.Y. 1998).
45 *Id.* at 363-365.
46 *Id.* at 365.

The court then confronted the most difficult question raised by JRS's appeal. The alleged breach of the contract was premised not on any of the parties' express agreements, but on the statutory requirements of good cause for termination and a right to cure after notice. Nothing in the parties' express contract required good cause or a right to cure: Indeed, the contract gave Panasonic an absolute right to terminate without cause upon 90 days notice and was silent on the right to cure. Nevertheless, the court concluded that a contract cause of action could be founded upon a violation of statutory requirements. "The fact that the [CFRA] renders a provision in [the parties'] agreement void as a matter of law . . . does not convert a common law claim into a statutory claim."[47] The Court cited no authority for the proposition that a breach of contract action could be based on statutory requirements. Rather, it relied upon a case, *Coast Plaza Doctors Hospital v. UHP Healthcare.*[48] That case held that a different statute, the Knox-Keene Health Care Service Plan Act of 1975[49], could form the basis for a cause of action under Business and Professions Code §17200.

The court next considered Panasonic's appeal from the verdict on the tortious interference claim. Panasonic argued that the evidence did not support a tortious interference with prospective advantage claim because one of the elements of the tort was lacking. The elements are: (1) the existence of an economic relationship between the plaintiff and a third party, here, JRS's customers; (2) the defendant knew about the existence of that relationship; (3) the defendant intentionally engaged in wrongful conduct designed to interfere with or disrupt this relationship; (4) the economic relationship was actually interfered with or disrupted; and (5) the wrongful conduct that was designed to interfere with or disrupt the relationship caused damage to the plaintiff.[50] Panasonic claimed JRS had failed to satisfy the third element because it had not shown Panasonic's conduct was "directed at" a third party.[51]

JRS's position was that it had established all the elements of the tortious interference claim, including the third element. It claimed that Panasonic's conduct was independently wrongful because it was anticompetitive. In JRS's view, Panasonic's motive for terminating the franchise was to prevent JRS from pursuing large national accounts and to more easily allow Panasonic to capture that business for itself. Thus, the "'[e]vidence was also substantial that Panasonic engaged in unfair competition. Panasonic had clearly terminated JRS for remanufacturing toner cartridges . . . The evidence was overwhelming that Panasonic terminated JRS in order to put JRS out of business and rid themselves of a competitor.'"[52] The effect was to reduce competition and thus it qualified as a violation of the unfair competition statute, California Business and Professions Code § 17200.

The court disagreed with both parties that Panasonic's subjective intentions were the deciding point. Under the California Supreme Court's decision in *Korea Supply Co. v. Lockheed Martin Corp.*,[53] a plaintiff alleging a tortious interference claim need not prove the defendant acted with the specific intent to disrupt the plaintiff's relationship, but rather can satisfy the

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47 *JRS*, 115 Cal. App. 4th at 176.

48 105 Cal. App. 4th 693 (2002).

49 Cal. Health & Safety Code § 1340 *et seq.* (1975).

50 *JRS*, 115 Cal. App. 4th at 186 (citing cases).

51 *Id.*

52 *Id.* at 183.

53 29 Cal. 4th 1134 (2003).

third element if it shows the defendant knew that interference was certain or substantially certain to occur as a result of its action.[54] The Court of Appeal felt that Panasonic's argument that a plaintiff must establish that the interfering conduct was "directed at" some party contravened the *Korea Supply* case, which had rejected any specific intent requirement.

The court held there was no tortious interference cause of action because Panasonic's only wrongful conduct was to breach the contract with JRS. JRS claimed that Panasonic had violated the CFRA by terminating its franchise contract without good cause and without providing an opportunity to cure. Even though Panasonic's motive might have been to disrupt competition, its wrongful conduct was limited to breaching its contract with JRS. In conclusion, "[t]he termination itself may have been wrongful for any number of reasons, but it remained essentially a breach of contract. Thus, the basis for JRS's claim at trial that Panasonic violated the [CFRA] and engaged in anticompetitive conduct is the very same activity that gave rise to the claim of intentional interference. We agree with Panasonic that, wrongful or not, the termination is not 'independent' of Panasonic's interference with JRS's interest."[55]

5. Implications of the JRS Decision

Though the Court of Appeal restored a franchisee's right to sue for contract damages in this case, its decision left open the possibility that the parties could limit or eliminate contractual remedies through contract. The Court distinguished, but did not disagree with, the reasoning of the Ninth Circuit's decision in *Sea Ray*, which had held that the terminated franchisee in that case had effectively waived its right to contract remedies for any violation of the franchise contract, and had no remedy under the CFRA other than repurchase of inventory.

On the other hand, the *JRS* court did not expressly adopt *Sea Ray*'s reasoning. It merely distinguished Sea Ray on the grounds that the franchise contract at issue in that case contained a waiver of remedies. It is possible that a future court might conclude that a waiver of the sort at issue in *Sea Ray* contravenes the CFRA or public policy. However, this argument does not find any direct support in the text of the Act since the only remedy expressly provided by the CFRA is repurchase of inventory. The CFRA does not expressly address a terminated franchisee's right to sue for contract damages; that right exists only because the CFRA does not purport to eliminate the right to sue under other laws. Since it is perfectly permissible for parties to limit their damages under a contract, it is reasonable to assume that a contract arising in the franchise context should not be an exception.

The decision's other principal holding – that the terminated franchisee could not state a claim for tortious interference – seems to foreclose most obvious avenues for tort liability in the event of a termination, except possibly fraud. As the court stated succinctly, "[t]he termination itself may have been wrongful for any number of reasons, but it remained essentially a breach of contract."[56] The principal implication for terminated franchisees of

54 *Id.* at 1154.

55 *JRS.*, 45 Cal. 4th at 183.

56 *Id.*

a limitation on tort liability is the somewhat narrower scope of recovery afforded to contract claimants over tort claimants.

It is also worthwhile to note that nothing in *JRS* modifies the ability of a terminated franchisee to use the antitrust laws, or Business & Professions Code section 17200, to vindicate its rights. Although the court in *JRS* did consider the claim that the animus of the franchisor in terminating the franchisee was anticompetitive, that argument was considered only in connection with a discussion of whether the elements of whether one of the elements of the tort of interference with prospective advantage was present.