Calif. Out-Of-State Noncompete Ban Faces Several Hurdles

By **Jennifer Redmond and Gal Gressel** (August 7, 2024, 5:42 PM EDT)

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California last year sought to bolster its long-standing ban on noncompetes by enacting Section 16600.5 of the Business and Professions Code, which provides California residents with the right to void a noncompete agreement, "regardless of where and when the contract was signed."

The California Legislature's intent behind this new law was to protect employee mobility, and to solve the problem of "employers outside of California attempting to prevent the hiring of former employees," according to S.B. 699, Section 1.[1]

Since its effective date on Jan. 1, parties attempting to leverage this new law have encountered significant procedural and constitutional challenges.

These hurdles are exemplified by the complex procedural history in the highly publicized DraftKings Inc. and Fanatics Inc. noncompete dispute.

Earlier this year, former DraftKings executive Michael Hermalyn moved to California to begin working for competitor Fanatics, and filed a declaratory relief action in state court in California, which was then removed to federal court and remanded, twice, back to state court.

DraftKings quickly filed an action against Hermalyn in Massachusetts, which applied Massachusetts — not California — law and enforced the noncompete.

The DraftKings v. Hermalyn decision is now on appeal to the U.S. Court of Appeals for the First Circuit, while Hermalyn's California case has been tied up in procedural disputes, and he has yet to obtain a ruling on whether he can void the Massachusetts noncompete under Section 16600.5.

Background

Before Section 16600.5 was enacted, the enforceability of an out-of-state noncompete against a California resident, regardless of whether the resident lived and worked in California for one day or their entire life, depended largely on three factors:

- Any choice-of-law or forum-selection provisions in the noncompete agreement;
- Whether the action to invalidate the noncompete would be decided in state or federal court; and
- For noncompetes signed or modified after Jan. 1, 2017, whether the resident could invoke the protections of Labor Code Section 925.

Section 16600.5 adds another layer to this complex analysis, by purporting to offer California residents the right to directly void their out-of-state noncompetes.

However, due to procedural and constitutional challenges, whether Section 16600.5 will have its intended effect remains uncertain.

Procedural Challenges

Out-of-state noncompetes often contain choice-of-law and forum-selection provisions that specify the dispute will be resolved in another state's forum, under that state's laws.

The U.S. Supreme Court's 2013 ruling in Atlantic Marine Construction v. The U.S. District Court for the Western District of Texas established that in cases where the parties have a valid forum-selection provision, the district court should ordinarily transfer the case to the specified forum.[2]

Following Atlantic Marine, federal courts consistently transferred actions involving out-of-state noncompetes, holding that while California had a strong public policy interest in banning noncompetes, that interest was not at issue when determining whether to enforce the forum-selection provision.[3] The result was that California residents were left without the protections of Section 16600.5 in federal court.

State courts are not bound by Atlantic Marine, and consider other factors in the transfer analysis, such as, in the 2015 Verdugo v. Alliant Group, LP decision in California's Fourth District Court of Appeals, that "enforcement would be unreasonable or unfair."[4]

However, given that out-of-state noncompete disputes typically arise between a California resident and an out-of-state employer, these disputes will often be removed to federal court under diversity jurisdiction, meaning Atlantic Marine controls.

And, while a forum-selection provision is unenforceable where "enforcement would contravene a strong public policy of the forum in which suit is brought," as per the Supreme Court's 1972 decision in M/S Bremen v. Zapata Off-Shore Co, it remains to be seen whether district courts will find that the public policy embodied in new Section 16600.5 complies with Bremen.[5]

Personal Jurisdiction Challenges

Out-of-state companies may also assert they are not subject to personal jurisdiction in California. This is a highly fact-sensitive analysis that depends on the party's contact with California.

Employees who seek to void their noncompetes in California will likely focus on the effects the defendant has in California due to their efforts to enforce the noncompete, including a claimed violation of Section 16600.5.

By contrast, defendants will likely focus on the party's contacts with California at the time they entered

into the noncompete agreement.

California Labor Code Section 925 and Out-of-State Employees

In 2017, California enacted Labor Code Section 925, which provides that an employee who (1) was not represented by counsel, and (2) "primarily resides and works in California" has the right to void choice-of-law and forum-selection provisions that would require adjudication of a dispute "arising in California."[6]

In the 2022 decision in DePuy Synthes Sales Inc. v. Howmedica Osteonics Corp., the U.S. Court of Appeals for the Ninth Circuit held that by invoking Section 925, a California employee may void a forum-selection provision such that it no longer exists and cannot be enforced — and therefore Atlantic Marine does not apply.[7]

The forum-selection analysis is then decided based on traditional public and private interest factors, which typically result in denying the motion to transfer and applying California law.[8] However, Section 925 has been interpreted to date to apply only to employees who resided and worked in California at the time they entered into the agreement at issue.[9]

This means that employees who signed noncompetes out-of-state — when they did not primarily reside and work in California — may not be protected by Section 925 and are therefore unable to use Section 925 to void their choice-of-law and forum-selection clauses.

Looking Ahead

If challenges to out-of-state forum-selection provisions fail and cases are transferred to out-of-state courts that decline to apply California law, the Legislature's intent to void noncompetes "regardless of where and when the contract was signed" may be frustrated simply by:

- Filing an enforcement action in the contracted-for venue outside California;
- Removing a declaratory relief action filed in California to federal court and then seeking transfer or dismissal; or
- Successfully challenging personal jurisdiction in California.

Whether further legislative amendments could resolve this issue, or whether such amendments would be futile, remains an open question. For example, the Legislature could amend Section 16600.5 or Section 925 to permit all California residents the right to void any contractual choice-of-law or forum-selection provisions, regardless of where or when they signed the agreement.

Any such amendment could run into the same constitutional issues that are already being raised to challenge the new Section 16600.5, more specifically that the statute impermissibly seeks to regulate out-of-state conduct in violation of the U.S. Constitution.

In its 1989 decision in Healy v. Beer Institute Inc., the Supreme Court said the "Commerce Clause precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State."[10]

Parties that seek to enforce out-of-state noncompetes in the face of Section 16600.5 have argued — and will continue to argue — that the statute impermissibly seeks to regulate commercial transactions "outside of the States' borders," the Healy decision says.[11]

Likewise, the Constitution provides that states may not pass any law "impairing the Obligation of Contracts," according to Article 1, Section 2.[12]

According to the Supreme Court's 1992 decision in General Motors Corp. v. Romein, "This inquiry has three components: whether there is a contractual relationship, whether a change in law impairs that contractual relationship, and whether the impairment is substantial."[13]

Here, parties raising constitutional challenges to Section 16600.5 may argue that Section 16600.5 constitutes a substantial impairment to a contractual relationship because enforcing the statute means voiding the noncompete provision in the parties' agreement.

While these issues will almost certainly arise in adjudication of Section 16600.5 disputes, they may also arise with respect to any amendments to existing laws to permit employees to void choice-of-law and forum-selection provisions in agreements that were not signed in California.

Takeaways

Parties litigating these disputes must carefully analyze not only the restrictive covenants contained in their agreements, but also the forum-selection and choice-of-law provisions.

If it appears that those provisions could require adjudication of the dispute in another forum, the parties will need to consider and plan for whether the case could be removed to federal court, and how they will argue their positions on a transfer motion in either state or federal court.

Parties must also be prepared for personal jurisdiction disputes, which will involve not only their contacts with California, but also whether courts will be persuaded that a violation of Section 16600.5 has an effect on California that triggers personal jurisdiction.

Attorneys who seek to take advantage of Section 16600.5 on behalf of their clients should understand that despite the seemingly straightforward nature of the new law, its application is rife with potential pitfalls and uncertain outcomes, and careful planning and managing client expectations is essential.

The challenges faced in implementing new Section 16600.5 highlight what has always been true in California: While California's ban on employment noncompetes is substantively straightforward — they are not allowed — the attendant procedural and constitutional issues implicated in drafting and litigating noncompetes in California continue to be complex and ever-changing.

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[1] SB 699, § 1 (d), (f).

[2] Atlantic Marine Construction Co. v. U.S. Dist. Ct. for W. Dist. of Texas, 571 U.S. 49, 62 (2013).

[3] E.g., Rowen v. Soundview Commc'ns, Inc., 2015 WL 899294, at *5 (N.D. Cal. Mar. 2, 2015) (collecting cases).

[4] Verdugo v. Alliantgroup, L.P., 237 Cal. App. 4th 141, 147 (2015).

[5] M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972).

[6] Lab. Code § 925(a), (e).

[7] DePuy Synthes Sales, Inc. v. Howmedica Osteonics Corp., 28 F.4th 956, 966 (9th Cir. 2022), cert. denied, 143 S. Ct. 536 (2022).

[8] E.g., id.

[9] Bromlow v. D & M Carriers, LLC, 438 F. Supp. 3d 1021, 1030 (N.D. Cal. 2020) (citing cases).

[10] Healy v. Beer Inst., Inc., 491 U.S. 324, 336 (1989).

[11] Id.

[12] U.S. Const. art I, § 10.

[13] Gen. Motors Corp. v. Romein, 503 U.S. 181, 186 (1992).