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ENFORCEABILITY OF COVENANTS NOT TO COMPETE IN CALIFORNIA

BACKGROUND

California law has a troubled relationship with covenants not to compete. Generally, in the absence of a statutory exception, covenants not to compete are unenforceable in California. Covenants are generally promises to do or not to do something. Covenants not to compete are essentially a way for a buyer of business or an employer to keep competitors at bay. In this article, we explore in some detail the statutory exceptions to the general unenforceability of covenants not to compete in California.

GENERAL RULE OF COVENANTS NOT TO COMPETE

The basic rule in California is that in the absence of a statutory exception, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Bus & P C §16600; Edwards v. Arthur Andersen LLP (2008) 44 C4th 937, 955. This restriction is applicable to both companies and people.

EXCEPTIONS FOR TRANSFER OF INTEREST IN BUSINESS

In spite of the unenforceability of covenant not to compete, there are situations where such covenant is found to be valid:

- **Substantial or Entire Sale of Business:** The substantial or entire sale of operating assets together with goodwill of business or its subsidiary or subdivision (Bus & P C §16601);

- **Sale of Goodwill:** Sale of goodwill of business by a seller who agrees not to compete (Bus & P C §16601);
- **Sale of or Other Disposition of All of Covenentor's Interest in the Business:** Sale of all interest of the person/entity covenanting not to compete (Bus & P C §16601);
- **Disassociation of Partner from a Partnership** (Bus & P C §16602);
- **Disposition of Partner's Interest in a Partnership** (Bus & P C §16602);
- **Dissolution of Partnership** (Bus & P C §16602);
- **Dissolution of a Limited Liability Company** (Bus & P C §16602.5); and
- **Termination of a Member's Interest in a Limited Liability Company** (Bus & P C §16602.5).

In the above situations covenant not to compete is permissible, only if:

The covenant not to compete is for all or part of the specified geographical area the business has been carried on during the time Seller continued to do business there. Case law, generally, has defined such specified geographical area in the above situations as reasonable and not a per se restriction on competition.

SALE OR MERGER OF BUSINESSES

In a merger of two or more businesses covenants not to compete are generally valid. In Monogram Indus., Inc. v Sar Indus. (1976) 64 CA3d 692, the Bus & P C §16601 exception for sales of shares, was held to prevent selling shareholders from competing with the corporation that purchased the shares as well as from competing with the corporation whose shares were purchased. The two corporations in this case were engaged in almost identical businesses, and the court considered such a construction necessary to protect the purchasing corporation from suffering a reduction in the value of the property right it had bought.

In another case, the court applied strict interpretation of Bus & P C §16600 and Bus & P C §166001 to find a covenant not to compete to be unenforceable in a stock redemption agreement between a radiologist and a professional corporation. In Hill Med. Corp. v Wycoff (2001) 86 CA4th 895, under a stock redemption agreement, a radiologist was required to sell his stock back to the corporation and the corporation was required to repurchase the stock in the event of a "buyout," which was defined to include the end of the radiologist's employment. The covenant not to compete provision in the agreement provided that, on a "buyout event," the radiologist would be barred from practicing radiology within a 7–1/2-mile radius of any of the corporation's facilities for 3 years. The court concluded that the covenant not to compete was unenforceable under Bus & P C §16600, and it did not fall within the exception of Bus & P C §16601 because the repurchase price did not include any payment for goodwill and the covenant contained no indication that goodwill was part of the repurchase agreement.

NOT WITHIN EXCEPTION, BUT IS PARTIAL RESTRICTION ON COMPETITION ENFORCEABLE???

Generally, as explained, CA Bus & P C Section 16600 prohibits covenants that restrain a person or entity from engaging in "a lawful profession, trade, or business," unless one of the exceptions contained in Bus & P C §§16601–16602.5 applies.

Now, a rather vexing question that often arises for businesses and their legal counsel alike is whether a non-compete clause that does not fit within the delineated exceptions, but is not a restriction per se, but a partial restriction, would pass muster. The response most probably, based on case law, is in the negative.

The California Supreme Court in a seminal case, Edwards v Arthur Andersen LLP (2008) 44 C4th 937, rejected an exception to Bus & P C Section 16600 that would only apply to a small or limited part of a profession. Edwards held that "if the Legislature intended [§16600] to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect." 44 C4th at 950. The court left it "to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to" §16600. 44 C4th at 950.

SALIENT NOTE

This article NEITHER supplants NOR supplements the breadth or depth of such rarefied topic. In fact, this article ONLY provides a rudimentary analysis of such esoteric subject matter.

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