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You May Think That All Non-Compete Agreements Are Unenforceable Under California Law, But You Would Be Wrong

Co-authored by Betsy Johnson* and Viktoria Lovei.

Contrary to popular perception, California law does not bar all restrictive covenants in the employment context. Rather, in certain very narrow circumstances (i.e., non-competes arising in connection with the sale or dissolution of certain businesses), non-competes are permissible under California law.

The General Prohibition of Non-Competes Under California Law

Under California Business and Professions 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. Bus. & Profs. Code § 16600 (2008). In *Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937 (2008), the California Supreme Court confirmed the viability and breadth of section 16600 and expressly rejected a line of Ninth Circuit cases which had upheld sufficiently narrow restrictive covenants that only barred a party from pursuing a small or limited part of its business. *Id.* at 948-49. The California Supreme Court in Edwards held that "noncompetition agreements are invalid, even if narrowly drawn, unless they fall within the applicable statutory exceptions of section 16601, 16602, or 16602.5." *Id.* at 955. These three exceptions are discussed below.

Non- Competes Arising From the Sale of a Business

The first exception arises in the context of the sale of a business entity. Section 16601 permits a party selling the goodwill or all of their ownership interest in a business to agree to refrain from competition within the business's geographic area, so long as the buyer intends to carry on a like business therein. Cal. Bus. & Profs. Code § 16601. *See Vacco Industries, Inc. v. Van Den Berg*, 5 Cal.App.4th 34, 47 (1992) (upholding the enforceability of a non-compete agreement lasting as long as the employer conducted business in the area against shareholder/officer who sold all of his shares in the company pursuant to a stock sale). A merger agreement, whereby an employee sells his business interest in a company in exchange for shares of the newly merged company, is considered to be a transaction within the exception of section 16601. *Hilb, Royal & Hamilton Ins. Services v. Robb*, 33 Cal.App.4th 1812, 1824-1825 (1995) (upholding agreement entered into in conjunction with merger which prohibited competition in several countries for a 3-year period of time). Section 16601 thereby allows the buyer of a business to protect its investment by enforcing a covenant not to compete against the seller. However, this exception is only applicable to business owners (or persons who own at least a material portion of business); it would not, for

example, be used to justify a non-compete for a seller (or selling employee) who only owns a very small percentage of a business entity. There is no "bright-line" definition for determining what is a material portion of the business.

Non-Competes Arising in Conjunction With the Dissolution Of Or Dissociation From a Partnership

Section 16602, the partnership exception to California's ban on non-compete agreements, permits, in the event of a dissolution of or dissociation from a partnership, an agreement that the departing partner not compete within the specified geographic area of the partnership's business, so long as any other member of the partnership intends to carry on the business in the specified area. Cal. Bus. & Profs. Code § 16602. Unlike section 16601, there is no requirement under the partnership exception that compensation for goodwill in the partnership be transferred. *South Bay Radiology Medical Associates v. Asher*, 220 Cal.App.3d 1074, 1083 (1990). Section 16602 has been held applicable to partnerships involving accountants, attorneys, and physicians. *See Swenson v. File*, 3 Cal.3d 389 (1970); *Howard v. Babcock*, 6 Cal.4th 409 (1993); *South Bay Radiology*, 220 Cal.App.3d 1073. Courts have found that such covenants, rather than prohibiting competition, place a price on competition by, for example, permitting the departing partner to contract for compensation in return for refraining from engaging in competing business activity, or vice versa. *Babcock*, 6 Cal.4th at 417-24.

Non-Competes Arising in the Context of the Dissolution Of a Limited Liability Company

Like the partnership exception to California's non-enforcement of covenants not to compete, section 16602.5 provides that in the event of the dissolution of a limited liability company, any member may agree not to carry on a similar business within the specified geographic area where the company's business was transacted, so long as any other member intends to carry on the business in the specified area. Cal. Bus. & Profs. Code § 16602.5. Currently, there is no case law interpreting section 16602.5, which became effective in 2007. However, the section's similarity to section 16602 indicates that it will be applied in a comparable manner by courts.

Despite California's general hostility towards the enforcement of covenants not to compete in the employment context, these exceptions provide employers with valid methods under California law to protect their business interests from potential competitive harm caused by sellers and departing partners or members. Nevertheless, given the scarcity of case law interpreting these provisions, employers should proceed cautiously before relying on them.

* Betsy Johnson is a Member of the Firm in its Los Angeles office. She can be reached at 310-557-9580.