Enforceability of Covenants Not To Compete in California

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Introduction

Many employers consider covenants not to compete in employment agreements essential to protecting their companies, their confidential information, and their top employees from former employees whose departures raise the threat of unfair competition.

It is important for employers relying on such clauses in employment agreements to realize that California courts disfavor covenants that restrain competition and generally refuse to enforce them. This is true even if the employer is located outside of California but employs California residents. To be enforceable in California, a covenant not to compete must fall within an exception to the blanket rule of unenforceability without overstepping that exception's narrow bounds.

This article addresses the California law rendering covenants not to compete unenforceable, when covenants not to compete can be valid in California, the difference between California's and the Ninth Circuit's treatment of such covenants, and some practical suggestions employers may use to protect their businesses.

I. Covenants Not To Compete Are Generally Invalid

California Business and Professions Code section 16600 ("Section 16600") provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." California courts typically interpret the statute broadly and refuse to enforce covenants not to compete. Except in narrowly drawn, statutorily defined circumstances, discussed below, California courts deem them to violate California's public policy that promotes freedom of competition and an employee's right to move between jobs. Consequently, California courts typically invalidate covenants not to compete. *Hill Medical Corp.* v. *Wycoff*, 86 Cal. App. 4th 895 (2001).

II. Courts Will Not Rewrite Non-Competition Agreements To Make Them Enforceable

Even if an employment agreement contains a clause evidencing the parties' desire to rewrite a covenant not to compete should it be deemed unenforceable, California law prohibits such revision. A clause that is invalid under Section 16600 is illegal and California courts have deemed the rewriting of illegal covenants unacceptable. *Hill Medical Corp.* v. *Wycoff*, 86 Cal. App. 4th 895 (2001); *Kolani* v. *Gluska*, 64 Cal. App. 4th 402 (1998).

For example, in one case, a California employer attempted to incorporate a clause into a covenant not to compete that granted the court permission to rewrite the covenant if the court found it to be unreasonable. The court invalidated and refused to rewrite the covenant. The court reasoned that permitting employers to include broadly written non-compete clauses in employment agreements and allowing them to rewrite the clauses if

challenged would violate Section 16600. The court foresaw employees feeling obligated to honor the broad clauses without seeking the advice of counsel. To prevent this practice, the court refused to permit the revision of illegal covenants not to compete. *Kolani*, 64 Cal. App. at 407.

Although California courts will not rewrite non-competition agreements to make them legal, they have narrowly construed such clauses in order to keep them within permissible bounds of the exceptions that permit restrictive covenants. *Loral Corp.* v. *Moyes*, 174 Cal. App. 3d 268 (1985); *General Paint Corp.* v. *Seymour*, 124 Cal. App. 611 (1932).

III. If Enforcement of a Covenant Not To Compete Is Sought in a California Court, California Law Will Be Applied

California courts will apply California law in order to enforce its public policy favoring competition even if a contract designates the law of another state or country as the applicable law. Thus, when a contract designates law other than California law to govern a covenant not to compete, a California court will apply California law and render the covenant void unless the agreement falls within an exception or the other state's interest is more significant than California's.

For example, where an employment agreement designating Maryland law as governing was drafted and entered into by an employer and employee in Maryland, the California court declined to enforce the covenant not to compete when the employee left the employer and moved to California to work for a competitor in violation of the agreement. Although Maryland law would have upheld the covenant not to compete, the California court ruled that enforcing it would violate California's public policy of promoting and protecting open competition. The court ruled that enforcing the covenant would more substantially impair California's interest in enforcing its public policy than Maryland's interests in upholding the covenant. As a result, the court applied California law and voided the clause. *Application Group, Inc.* v. *Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998).

Even though they have refused to enforce covenants not to compete governed by the laws of other states, California courts have not gone so far as to enjoin the courts of another state from enforcing covenants not to compete. In one case, an employee left his Minnesota employer to work for a California competitor. The employee tried to use California law to prevent the application of a covenant not to compete. Rather than waiting to challenge the covenant's enforcement, the employee sued in a California court to enjoin the Minnesota employer from starting proceedings to enforce the covenant in a Minnesota court. The Supreme Court of California bowed to principles of comity and judicial restraint in not upholding the injunction even though its application would promote California public policy. The court reasoned that it would have been disrespectful to deem the law of California so much more worthy than that of another state and that doing so was an indirect challenge to the dignity and authority of the tribunal of the other state. *Advanced Bionics Corp.* v. *Medtronic, Inc.*, Cal. 4th 697 (2002).

IV. Employers May Not Force an Employee To Sign a Covenant Not To Compete

Generally, California employers may not force their California employees to sign non-compete agreements. Making the signing of an unlawful agreement a condition of employment warrants a claim for wrongful termination. Even asking an employee to sign a covenant not to compete or using a signed covenant against an employee or subsequent employer may lead to suits for unfair competition.

For example, an employee sued his employer for wrongful termination alleging that his employer violated public policy when it fired him for refusing to sign a confidentiality agreement that contained a non-compete clause. The court ruled that an employer could not lawfully make the signing of an employment agreement containing an unenforceable covenant not to compete a condition of continued employment. It made this finding even though the agreement not to compete also

contained a choice of law provision specifying the law of a state that enforces such covenants and a severability provision enabling the court to void the problematic clause. The court held that an employer's termination of an employee who refuses to sign an agreement that is contrary to California law and policy constitutes a wrongful termination. *D'Sa* v. *Playhut, Inc.*, 85 Cal. App. 4th 927 (2000); *Kolani* v. *Gluska*, 64 Cal. App. 4th 402 (1998).

Because covenants not to compete between an employer and employee are invalid, the inclusion of such a covenant subjects the employer to claims of unfair competition under California Business and Professions Code section 17200 ("Section 17200"). Section 17200 deems *any* unlawful practice by a business to be unfair competition. Because Section 17200 covers an employer's business practices concerning its employees, this section subjects employers to suits for unfair competition should they include an unlawful covenant not to compete in their employment agreement. *Application Group, Inc.* v. *Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998). Remedies for unfair competition under Section 17200 include restitution or an injunction preventing the covenant's enforcement. *Cortez* v. *Purolator Air Filtration Products Co.*, 23 Cal. 4th 163 (2000).

V. Covenants Not To Compete Arising From the Sale of a Business May Be Valid

California Business and Professions Code section 16601 ("Section 16601") permits an exception to the blanket non-enforcement of covenants not to compete. It provides that any person who sells the goodwill of a business, any owner of a business selling or otherwise disposing of all of his or her ownership interest in that business, or any owner of a business that sells, together with the goodwill of the business, all or substantially all of its operating assets, all or substantially all of the operating assets of a division, or all of the ownership interest in a subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business in that area. In short, this exception permits a buyer of a business interest to enforce a covenant not to compete against the seller.

Included within this exception are merger arrangements in which an employee sells his business interest in a company by exchanging his shares in that company for shares of the newly merged company. For example, an insurance company sought a preliminary injunction against its former employee to enforce a covenant not to compete entered into in conjunction with a merger. The court held that, although the covenant arose in a merger rather than an outright sale, the transaction was included within Section 16601's ambit. The employee's exchange of his shares in the pre-merger company for stock in the new company served as consideration for the non-compete agreement and did not prevent the transaction from being a sale under Section 16601. Thus, the covenant not to compete accompanying the merger was enforceable. *Hilb, Rogal and Hamilton Ins. Servs., Inc.* v. *Robb*, 33 Cal. App. 4th 1812 (1995).

Courts have rejected a literal interpretation of Section 16601 that would make all sales of assets sufficient to bind sellers to covenants not to compete. Instead, courts have interpreted Section 16601 to require the sale of a business entity's goodwill along with its assets. The court may find the existence of goodwill in a transaction through the examination of all aspects of the transaction, particularly the purchase or repurchase price of stock, the structure and context of the transaction, and the relative substantiality of the seller's portion of the business. *Hill Medical Corp.* v. *Wycoff*, 86 Cal. App. 4th 895 (2001); *Bosley Medical Group* v. *Abramson*, 161 Cal. App. 3d 284 (1984). In a sale of shares, fair market value can indicate that goodwill was part of the transaction because one can infer that that price incorporates the value of goodwill. *Hill Medical Corp.*, 86 Cal. App. 4th at 904.

In one case, after a doctor who sat on a medical corporation's board of directors resigned and

sold back his stock in that corporation for its book value, the corporation sought to enforce a covenant not to compete entered into upon the share sale. Because the book value was below the market value of the shares, the court determined that the sale did not include goodwill. Accordingly, the resigning doctor was not bound by the covenant not to compete. *Id.* at 906-907.

Sometimes, the specifics of the transaction indicate a sham by which a party is trying to circumvent California law to restrain an individual's ability to engage in business rather than to protect a legitimate interest in the value of a purchase. In such a case, the covenant will not be enforceable regardless of its literal alignment with Section 16601's exception. *Bosley Medical Group*, 161 Cal. App. 3d at 291-92 (reasoning that a doctor who was forced to buy shares and who was not provided any real benefit from the stock, could not be bound by a covenant not to compete accompanying a sale of those shares far below market price).

The particular shareholder's interest itself also cannot be a sham for a sale to fall within Section 16601's exception. This, however, does not mean that a shareholder needs an extraordinary or majority interest. This issue was addressed when a purchasing company entered into an agreement with a selling company and several of its key employees agreed not to compete with the purchasing company upon leaving the company. The court determined that the operations manager, also a corporate officer, of the selling company who owned 3% of the outstanding shares held a sufficient interest in the selling company to render a covenant prohibiting him from competing enforceable. Although the employee argued that his 3% interest in the company and the fact that he received less than $500,000 of the $23 million purchase price made his interest too slight to enforce the covenant, the court found that because he was a substantial shareholder, owning the ninth largest share, and because he was a principal officer in the company, the purchaser had a legitimate interest in restraining the officer's competition following the company's sale. *Vacco Indus. Inc.*, v. *Van Den Berg*, 5 Cal. App. 4th at 48-49.

Finally, the validity of a covenant not to compete associated with the sale of an interest in a company does not depend on the covenant's location in a particular type of agreement. For example, one court upheld a covenant not to compete, even though the covenant was contained in an employment agreement as opposed to the merger agreement. The court ruled that the validity of the covenant did not depend on its location, since Section 16601 does not explicitly prescribe a mandatory form for a covenant not to compete. The court reasoned that courts should look to the purpose of the statute over a covenant's form in determining whether to enforce covenants not to compete. *Hilb, Rogal*, 33 Cal. App. 4th at 1825-26; *Vacco Indus.*, 5 Cal. App. 4th at 49.

VI. Covenants Not To Compete Arising In Conjunction With The Dissolution Of Or Dissociation From A Partnership May Be Enforceable

Another exception to California's policy disfavoring covenants not to compete is found in the context of the dissolution of a partnership or a partner's dissociation from a partnership. California Business and Professions Code section 16602 ("Section 16602") reads: "Any partner may, upon or in anticipation of a dissolution of the partnership or dissociation of a partner from a partnership, agree that he or she will not carry on a similar business within a specified geographic area where the partnership business has been transacted, so long as any other member of the partnership, carries on a like business therein." This exception applies to all partnerships, including those of physicians, accountants, and attorneys. *Howard* v. *Babcock*, 6 Cal. 4th 409 (1993) (applying the exception to a partnership of attorneys); *Swenson* v. *File*, 3 Cal. 3d 389 (1970) (accountants); *South Bay Radiology Medical Assocs.* v. *Asher*, 220 Cal. App. 3d 1074 (1990) (physicians); *Haight, Brown & Bonesteel* v. *Superior Court*, 234 Cal. App. 3d 963 (1990) (attorneys).

Unlike the sale of a business exception, the partnership exception does not rely on the departing partner being compensated for goodwill. When a physician's disability rendered him unable to continue practicing in his area of medicine, the partnership agreement deemed him a dissolving partner, restrained him from competing with his former partners, and did not compensate him for goodwill. The court upheld the covenant not to compete, ruling that the partnership was free to agree to a covenant not to compete that did not pay a withdrawing partner any amount for goodwill. *South Bay Radiology*, 220 Cal. App. 3d at 1084.

California law has not only permitted the restraint of competition by departing partners, but it has permitted departing partners to enter into agreements to pay the partnership for the money it is expected he or she will take away from the partnership through competition. This allows a departing partner to accept or solicit work without restraint while protecting the interests of the partnership by replacing the income and capital that will likely be taken by the withdrawing partner. *Haight, Brown*, 234 Cal. App. 3d at 969; *Farthing* v. *San Mateo Clinic*, 143 Cal. App. 2d 385 (1956).

VII. Covenants Not To Compete Arising in Conjunction with the Sale of a Limited Liability Company May Be Enforceable

California's Business and Professions Code allows for another exception to the non-enforceability of covenants not to compete in section 16602.5 ("Section 16602.5"). It sets out that "[a]ny member may, upon or in anticipation of a dissolution of a limited liability company, agree that he or she or it will not carry on a similar business within a specified geographic area where the limited liability company business has been transacted, so long as any other member of the limited liability company, or any person deriving title to the business or its goodwill from any such other member of the limited liability company, carries on a like business therein."

Although there is no case law on this particular exception, it shares much of the same language as Section 16602, implying that Section 16602.5 will be treated in the same manner as Section 16602.

VIII. The Permissible Scope Of The Statutory Exceptions

A. Territory

California's Business and Professions Code allows a buyer of a company's goodwill, a partner, or member of a limited liability company to restrict sellers of business interests or departing partners or members from carrying on similar business "within a specified geographic area" in which the business, partnership, or limited liability company has transacted business. Under this rule, California courts have upheld covenants not to compete encompassing the entire United States and beyond. So long as a party can show that some business was conducted in those areas, the court may uphold the covenant.

Because the exceptions serve to protect goodwill, they cover the area in which goodwill is in need of protection. This has been construed to be the area in which a business' goodwill has been established, evidenced by where sales, production and phases of the business have been conducted, as well as the area where the business reasonably established its goodwill based on particular business activities being carried on there, such as promotional and marketing activities. Allowing the scope of the covenant to span the breadth of the practice or business comports with the reasonableness requirement of a covenant not to compete's geographic scope. *Monogram Indus., Inc.* v. *Sar Indus., Inc.*, 64 Cal. App. 3d 692 (1976) (upholding a covenant against a challenge that its geographic scope was overly broad by showing that the company's goodwill extended or could reasonably be expected to extend to the areas restricted by the agreement); *Roberts* v. *Pfefer*, 13 Cal. App. 3d 93 (1970) (allowing a covenant falling within Section 16602 to span beyond the city or town in which the partnership was physically located).

Although a covenant not to compete must have a limit to its geographic scope, it is not clear whether a covenant not to compete must actually designate a specific area of application or whether it is sufficient for the covenant merely to specify that it applies in all areas where a company has transacted business. The statute's language,

"specific geographic area," would appear to require explicitness but courts have not answered this question. Because of the uncertainty in this area, it may be best for someone seeking to enforce a covenant not to compete to be specific when designating the geographic scope of the covenant. *Fleming* v. *Ray-Suzuki, Inc.*, 225 Cal. App. 3d 574 (1990).

B. Time

Sections 16601, 16602, and 16602.5 specify that covenants not to compete can prohibit competition for as long as the buyer of the interest, or anyone gaining title to the interest, other partners, or other members of the limited liability company carry on a like business. Thus, covenants under these sections potentially may last for numerous years.

In one case, two brothers engaged in business together agreed that the brother leaving the business would not participate in a competing business in the San Diego area. The final written contract mistakenly omitted the clause. The court found there was sufficient evidence that the covenant was part of the agreement and narrowed the duration so that the brother leaving the business was only prevented from competing with his former business for as long as it carried on a like business in the area. *Martinez* v. *Martinez*, 41 Cal. 2d 704 (1953); *see also Loral Corp.* v. *Moyes*, 174 Cal. App. 3d 268 (1985) ("We also observe the Legislature has allowed business sellers to promise non-competition to their buyers without time limitation other than for the period 'so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein.'").

C. Activity

Sections 16601 through 16602.5 provide that covenants may prohibit sellers of business interests, former partners or former members from engaging in any competing business activity in a specified geographic area. *Monogram Indus., Inc.* v. *SAR Indus., Inc.*, 64 Cal. App. 3d 692 (1976). Thus, although courts may adhere to the concept that a covenant must be reasonable in terms of the activity that it limits, courts have interpreted these sections to reasonably exclude all competing activity from appropriate geographic regions.

Isolated instances of competition, however, are not permissibly restricted under the statutory exceptions. The purpose of the exceptions is to allow businesses, partnerships, and limited liability companies to protect themselves from substantial detriment to their competitive position. Because occasional transactions do not typically threaten such an impact, the statute meant to target the solicitation of significant business from the business, partnership, or limited liability company. *Swenson* v. *File*, 3 Cal. 3d 389 (1970).

IX. California's Treatment of Covenants Not To Compete Differs from that of Federal Courts in California

California state courts uniformly invalidate covenants not to compete when an employee is restrained from pursuing an entire business, trade, or profession. Unlike California state courts, however, when the covenant restricts only a small or limited part of the employee's business, California federal courts may uphold these covenants. In one case, the plaintiff challenged a covenant not to compete, claiming that it did not fall within a statutory exception. While the federal court agreed that California law prohibits covenants that restrict trade unless specifically authorized by statute, it read the statute narrowly and held that only covenants not to compete that "entirely" restrain an employee from pursuing his trade, profession, or business are void under Section 16600. *Campbell* v. *Board of Trustees*, 817 F.2d 499 (9th Cir. 1987).

Subsequent federal courts in California have applied *Campbell* to uphold covenants not to compete. In one case, a court enforced a covenant not to compete against a crating company because it only limited former employees' ability to work in a narrow segment of the packing and shipping market. Likewise, in a later case, the court upheld a six-month covenant attached to an employee's sale

of his stock options. The court reasoned that the limited scope of the restriction made the covenant enforceable. The court recognized the inconsistency with California state court rulings but stated that the federal courts had to defer to their own precedent. *IBM* v. *Bajorek*, 191 F.3d 1033 (9th Cir. 1999); *General Commercial Packaging, Inc.* v. *TPS Package Eng'g, Inc.*, 126 F.3d 1131 (9th Cir. 1997).

Comparing these federal decisions to California state court decisions shows a difference in the treatment of covenants not to compete. California courts do not follow these federal decisions and the federal courts continue to uphold narrowly drawn covenants. None of the courts have shown a willingness to modify their treatment of these covenants, providing an incentive for employers attempting to enforce a covenant not to compete to file in federal court.

X. Practical Tips and Suggestions

Despite the difficulty in enforcing covenants not to compete in employment agreements, employers have several methods of protecting their interests. These include the following:

- **Confidentiality Agreements** – Employers should include a confidentiality provision in the employment agreement that defines trade secrets to include, if applicable, customer lists, customer contacts, vendor lists, vendor contacts, pricing lists, product information and testing results, and strategic business and other similar information. Although the employee may take employment with a company competitive with the employer, the employee may not use the protected information against the employer. If practical, the employer should restrict access to trade secrets and maintain a log of all trade secrets provided to the employee.
- **Covenant Not to Solicit Customers** – Employers should include in the employment agreement, or as part of the confidentiality provision, a covenant not to use trade secrets to solicit the employer's customers. Such covenants are only enforceable when necessary to protect trade secrets and, therefore, should provide that the employee agrees not to use the employer's trade secrets to solicit the employer's customers.
- **Covenant Not to Solicit Employees** – Employers should include in the employment agreement a covenant not to solicit the employer's employees, providing that "during the term of this agreement and for a period of [1] year after leaving the company, the employee will not solicit the company's employees."
- **Covenant Not to Compete During Employment** – Employers should include in the employment agreement covenants restricting employees from competing during the term of their employment.
- **Return of Property** – Employers should include in the employment agreement a provision requiring employees to return all company property upon leaving the company.
- **Choice of Law Provision** – If the employer desires to include a non-compete agreement in the employment agreement and the company is not exclusively operated in California, or if the employee works and resides in a state other than California, the employer should include in the employment agreement a choice of law provision designating law from a jurisdiction other than California as the controlling law. If suit is brought in another jurisdiction, although not determinative in California, the choice of law provision may control. The employer should be sure, however, that the jurisdiction designated in the employment contract protects trade secrets to the same extent as California.
- **File First** – If an employee is violating a covenant not to compete contained in his or her employment agreement or if it appears that the employee may challenge the validity of a non-compete agreement, the employer seeking to enforce a covenant not to compete that does not fall within an exception should, if possible, file suit outside of California or, at the very least, in

federal court. If the employee sues first in California, it is likely that the California court will assume jurisdiction over the employer and invalidate the covenant not to compete—even with a contrary choice of law provision in the employment contract.

Conclusion

California courts consistently disallow covenants restraining employees from competing against their former employers. As discussed, however, there are limited exceptions to this rule. A buyer of a business interest, partners in a partnership and members of a limited liability company may enforce covenants not to compete against sellers of business interests, departing partners or departing members, respectively. These exceptions allow covenants to restrain such individuals from competing in the same business within the same geographic area as the buyer, partners or members, as long as the buyer, partners or members continue to operate the same business. Moreover, courts may uphold restrictive covenants to protect trade secrets and prevent unfair competition. Thus, buyers, partners, members, and employers may in certain circumstances utilize covenants to protect their business from the potential competitive harm caused by sellers, departing partners, members or employees. Individuals seeking to protect their businesses with restrictive covenants, however, must take care to properly construct the covenants in order to avoid the numerous pitfalls faced when attempting to overcome California's general disfavor of such agreements.