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Less is More: When Embedding Restrictive Covenants in Multiple Agreements Can Lead to Choppy Waters for Employers

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When seeking to protect against unfair competition from former employees through the use of restrictive covenants, companies often take a "belts and suspenders" approach. For example, an employer may require an employee to agree to the same (or substantially similar) covenants in an employment agreement, a stock plan, an incentive award agreement, and any other agreements executed by the employee. The theory behind this approach is straightforward: if one agreement is found to be unenforceable for whatever reason, employers can seek to enforce the covenants in other agreements. Furthermore, if the applicable agreement requires forfeiture of specified benefits (such as severance pay or equity awards) in the event of a restrictive covenant breach, that may provide another reason for including the same restrictive covenant in multiple agreements.

However, a recent Delaware Chancery Court decision illustrates certain perils that may arise from this kind of fortress approach. Rather than creating layers of protection, employers may face simultaneous, extended enforcement battles in multiple jurisdictions, and be left at the end without a clear path to relief. This complication is compounded by the increasing number of states that have adopted legislation limiting an employer's ability to enforce non-competition provisions against former employees, as employees are now more likely than in the past to find hospitable jurisdictions in which to challenge these restrictive covenants. Employers may therefore consider whether they might be better served having just one set of restrictive covenants, to avoid the possibility of getting caught in the maelstrom of simultaneous litigations. The Chancery Court opinion also raises the question of whether these covenants are best included in the company's governing documents, where possible, as the Chancery Court may be more likely to enforce choice-of-law and venue selection provisions in these types of corporate formation documents under the Court's deference to the "internal affairs" of Delaware companies.

AG Res. Holdings, LLC v. Terral

Thomas Terral was the co-founder of an agricultural lending business based in Louisiana. In 2015, the business was acquired by a private equity firm and restructured as a holding company (AG Recourse Holdings, LLC) and an operating entity (AG Resource Management, LLC), both of which were formed in Delaware. Terral remained as a manager of the LLCs, and also served as Chief Executive Officer and Executive Chairman of the company, working out of its headquarters in Louisiana.

The LLC agreements for the Delaware entities contained a "good faith" clause that required the company's managers to "act in good faith and within the scope of [the manager's] authority. The LLC agreements also contained non-competition covenants preventing members from competing with the company, as well as Delaware choice of law and forum selection provisions. Terral was also subject to an employment agreement, which contained the same non-compete covenant as the LLC agreements, as well as non-solicitation, non-disparagement, non-interference, and confidentiality obligations. The employment agreement also contained a Delaware choice of law provision, but no choice of forum clause.

On September 9, 2020, the company terminated Terral for allegedly secretly planning to compete or otherwise "steal [the company's] business." Terral promptly filed a declaratory judgment action against the company in Louisiana state court, seeking declarations that (i) the non-competition covenant in his employment agreement was unenforceable, (ii) the Delaware choice of law provision in the employment agreement was null and void, and (iii) the company did not have "cause" to terminate him. Terral also sought a preliminary injunction barring the company from enforcing the non-compete provision in his employment agreement. The company filed a separate action in Delaware Chancery Court four days later, seeking to enforce the covenants in the LLC and employment agreements. Both sides filed motions seeking to stay the litigation in their non-preferred forum.

The Louisiana court ruled first, denying the company's motion to stay the Louisiana action and granting Terrel's application for a preliminary injunction, finding under Louisiana law that the choice of law provision in the employment agreement was void and the non-compete was likely unenforceable. *See AG Res. Holdings, LLC v. Terral*, 2021 WL 486831, at *2 (Del. Ch. Feb. 10, 2021) (discussing the Louisiana court's ruling). Less than two months later, the Delaware Chancery Court stayed the company's claims in the Delaware action based on the employment agreement, holding that Louisiana was "best suited to address the claims" under that agreement because the Louisiana court had already issued a ruling and should be allowed to complete its adjudication without the risk of competing or confounding rulings. *Id*, at *6.

However, the Chancery Court considered the company's claims under the LLC agreement to be "a different story." *Id*. The Chancery Court held that Delaware law must apply to claims under the LLC agreements, because those agreements were part of the "constitutive documents of a Delaware entity" and Louisiana has no interest in regulating the governance or internal affairs of a Delaware entity. *Id*. The Chancery Court explained: "To state the distinction most directly, the claims under the Employment Agreement rest on Terral's conduct as employee (regardless of whether he occupied a fiduciary status), while the claims under the LLC Agreement rest on Terral's status as a member of the Company's Board of Managers." *Id*. at *6, n.47. Accordingly, the Chancery Court denied Terral's motion to stay the claims relating to the LLC agreements.

Choice of Law Provisions Are Not a Panacea

Employers are well aware of the impact that governing law can have on adjudication of restrictive covenants. As discussed in the October 2020 and January 2021 Employer Updates, state legislation limiting the ability of employers to enforce restrictive covenants is on the rise. Mindful of the growing state-level legislation in this area and of the complications that can arise when managing a multi-state workforce, many employers include choice-of-law provisions in their restrictive covenant agreements with employees, in the hopes that courts will apply the laws of the identified (presumably employer-friendly) jurisdiction.

Choice-of-law provisions, however, are not always enforced. California, a state notorious for its prohibition on employee non-compete clauses (subject to narrow exceptions), enacted a statutory prohibition (effective January 1, 2017) on choice-of-law provisions that apply another state's law as a condition of employment when an individual primarily resides and works in California, unless the employee is represented by legal counsel in negotiating the clause. *See* Cal. Lab. Code §925. Similarly, when

employers and employees within Louisiana designate a state other than Louisiana as the governing law in an employment contract, that choice of law is enforceable only if the breaching party ratifies the provision after the alleged wrongful conduct. *See* LA. STAT. ANN. § 23:921(A)(2) (2020). Even in jurisdictions where out-of-state choice-of-law provisions are not prohibited by statute, courts often decline to enforce such provisions when the application of another state's laws would be contrary to the forum state's fundamental public policies. Some courts have found that a state's opposition to enforcing restraints on trade represents such a fundamental public policy. *See, e.g., Cabela's v. Highby*, 801 Fed.Appx. 48 (3rd Cir. 2020).

That was the case for Terral and AG Resource Management. Even though Delaware is often perceived as generally favorable to contractual provisions designating Delaware as the governing law, the Chancery Court held that Louisiana had the most significant relationship to claims under the employment agreement, and that Louisiana "maintains a more compelling public policy interest in ensuring that its laws were enforced with respect to the employment rights of its citizens working within the state." *Terral*, 2021 WL 486831, at *5. That decision was not the first occasion on which the Delaware Chancery Court has disregarded a Delaware choice-of-law provision in the context of employee restrictive covenants. *See, e.g., FP UC Hldgs., LLC v. Hamilton*, 2020 WL 1492783, at *1, 8–11 (Del. Ch. Mar. 27, 2020) (declining to enforce choice-of law provisions selecting Delaware law in a unit grant agreement and an employment agreement where former employees of a Delaware entity started a competing business in Alabama, and agreements contained restrictive covenants that would be invalid under Alabama law); *NuVasive, Inc. v. Miles (NuVasive II)*, 2019 WL 4010814, at *7 (Del. Ch. Aug. 26, 2019) (declining to enforce employment agreement choice-of-law provision selecting Delaware law that would have validated non-solicitation provision in contract that otherwise would be governed by California law); *Ascension Ins. Hldgs, LLC v. Underwood,* 2015 WL 356002, at *5 (Del. Ch. Jan. 28, 2015) (holding that California's interest in protecting its employees was materially greater than Delaware's interest in the restrictive covenants at issue, even though the covenants appeared in an agreement that governed the purchase of an equity interest in a Delaware entity).

Because of the lack of certainty concerning whether a court will follow a choice-of-law provision, employers may face a "race to the courthouse" in which the company and a former employee each seek to have the question of restrictive covenant enforceability determined in a more "friendly" jurisdiction. The specter of a possible "race to the courthouse" can be a complicating factor in any restrictive covenant dispute, but particularly in situations where companies are looking to privately resolve issues with departing employees, as each side may be quick to abandon negotiations in order to file suit first in their venue of choice.

Practical Considerations of Multiple, Simultaneous Actions

In certain respects, the "belts and suspenders" approach in the *Terral* action may have been beneficial to the company. Even though the covenants in the employment agreement appeared unlikely to be enforced in Louisiana, the company continued to pursue enforcement of the covenants in the LLC agreements in Delaware. However, it is too early to tell what the outcome of this dispute will be. As the Chancery Court acknowledged in its opinion, "there may be some overlap in the litigation and adjudication of claims arising under the employment agreement on the one hand, and the LLC agreements on the other." As the Louisiana and Chancery Court actions progress, the company may now be forced to review and produce documents, prepare witnesses, engage in motion practice, and develop legal briefs in two different venues governed by two different sets of laws.

The company may face even more motion practice if the Louisiana court issues its opinion first and rules that the restrictive covenants are unenforceable, in which case Terral may argue that the Louisiana judgment should preclude any inconsistent ruling in Delaware. An adverse ruling for the company in

Louisiana could also provide troubling precedent with respect to the enforceability of covenants in other employees' employment agreements, particularly those that may not be subject to the LLC agreements.

The complicated nature of the dispute between Terral and AG Resource Management suggests that, at least under the facts at issue in this case, the employer may have been better positioned had it simply included all of its restrictive covenants in the LLC agreements. Terral's action in Louisiana focused solely on his employment agreement, likely because Terral believed the court was more likely to reject the Delaware choice-of-law provision in the employment agreement than in the LLC agreements. If Terral had tried to make the same public policy arguments with respect to the LLC agreements, the Louisiana court may have ruled differently and deferred to Delaware law with respect to the company's internal affairs.

In Some Instances, Corporate Governance Documents May Be The Preferred Vehicle for Enforceable Covenants

Setting aside for a moment the complicated thicket of litigation in which AG Resource Management is enmeshed, there was a silver lining for employers: the Chancery Court's holding that Louisiana had "no interest" in regulating the internal affairs of a Delaware entity. As noted above, more and more states are passing legislation limiting enforcement of restrictive covenants against former employees, and the Chancery Court will not always enforce Delaware choice-of-law provisions in employment and interest award agreements. But Delaware courts have afforded a fair amount of deference to such provisions in corporate governance documents for Delaware entities, based on the so-called "internal affairs" doctrine. The Chancery Court's opinion in *AG Resources* taps into this distinction, holding that even though Terral lived and worked in Louisiana, those facts had no bearing on his conduct as a manager of the LLC – even though the same alleged wrongful conduct was at issue under both agreements.

This opinion may open the door for employers to enforce restrictive covenants against executives who are also managers of LLCs, even if those managers reside and even perform employment duties and responsibilities in jurisdictions that are hostile to restrictive covenants (though California Labor Code § 925 may still pose an obstacle to Delaware forum selection clauses if execution of an LLC agreement is a "condition of employment" for a California-based executive). Employers choosing to adopt this approach, should be deliberate in tying the restrictive covenant provisions to an individual's obligations and responsibilities as a manager of the LLC, rather than just as an employee of the entity. Employers should also be mindful that merely holding membership interests in an LLC may not be sufficient for Delaware law to apply if the interest holder has no actual role or influence in the management or governance of the LLC. *See Focus Fin. Partners, LLC v. Holsopple,* 241 A.3d 784, 792 (Del. Ch. 2020) (applying California law to restrictive covenants contained in an interest award agreement granting an employee interests in a Delaware LLC).

Of course, not all employees of an LLC can or should be designated as managers of the LLC. But for companies seeking to prevent high-level executives from competing unfairly, designating those executives as managers of the LLC and including restrictive covenants in the LLC's corporate governance documents may enhance the prospects of such covenants being enforced, regardless of where the executive might bring suit.

Aftermath of *Ixchel Pharma, LLC v. Biogen, Inc.* and the "Rule of Reason" Analysis

By Bambo Obaro, An Tran, and Shireen Leung

Under California Business and Professions Code Section 16600 ("Section 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." In 2008, the California Supreme Court held in the seminal decision, *Edwards v. Arthur Anderson LLP*, that Section 16600 prohibits employee non-competition agreements unless they fall within one of the enumerated statutory exceptions.[1] 44 Cal. 4th 937, 955 (2008). It was not until recently, however, that California's highest court addressed the question of whether non-compete provisions in commercial contracts between businesses are subject to the same prohibitive scope of Section 16600.

In *Ixchel Pharma, LLC v. Biogen, Inc.*, for the first time, the California Supreme Court addressed this question. 9 Cal. 5th 1130, 1139-40 (2020). Specifically, the California Supreme Court held that, while Section 16600 does apply to restrictive covenants in commercial contracts between businesses, the enforceability of such non-compete provisions should be assessed under a "rule of reason" standard, rather than finding them to be *per se* invalid. In this article, we discuss the *Ixchel* decision, examine how California's lower courts have applied *Ixchel*, and offer some practical suggestions regarding *Ixchel*'s potential impact on restraint on trade provisions.

The *Ixchel* Decision

Ixchel involved two biotechnology companies, Ixchel Pharma LLC ("Ixchel") and Forward Pharma ("Forward"), who had both entered into an agreement to jointly develop a drug containing dimethyl fumerate ("DMF") as an active ingredient. *Id.* at 1138. The collaboration agreement authorized Forward to terminate the agreement "at any time" so long as it provided notice to Ixchel 60 days in advance. *Id.* At the same time that Forward and Ixchel were working together, Forward was negotiating with Biogen Inc. ("Biogen"), another biotechnology company, to settle a patent dispute related to the use of DMF for the treatment of multiple sclerosis. *Id.* Forward subsequently entered into a settlement agreement with Biogen that required Forward to terminate its existing collaboration with Ixchel (or any other entity) to the extent the partnership related to the development of any pharmaceutical product using DMF. *Id*. at 1137-38.

Ixchel filed suit in the Eastern District of California, alleging that the Forward-Biogen settlement provision was an unlawful restraint on trade under Section 16600. *Ixchel Pharma, LLC v. Biogen Inc.*, 2018 U.S. Dist. LEXIS 13548, at *7-8 (E.D. Cal. Jan. 25, 2018). Applying the rule of reason, the Eastern District found that the plaintiff failed to establish how the Forward-Biogen agreement caused harm to competition. *See id.* at *11-12. On appeal, the Ninth Circuit certified the following question to the California Supreme Court: What is the proper standard to determine whether Section 16600 voids a restraint on trade contained in a business-to-business contract? *See Ixchel*, 9 Cal. 5th at 1140.[2]

Even though neither party disputed that Section 16600 applied to business-to-business contracts, the California Supreme Court nevertheless affirmed as a threshold matter that Section 16600 does apply to business-to-business contracts. *See id.* at 1149. The Court reasoned that if Section 16600 did not apply to contracts between businesses, then the enumerated exceptions to Section 16600, which are not expressly limited to the employment context, would have been unnecessary. *See id.* The Court then turned to the crux of the dispute: "Does section 16600 of the California Business and Professions Code void a contract by which a business is restrained from engaging in a lawful trade or business with another business?" *Id.* at 1148. The Court held that contractual restraints in business-to-business dealings are not *per se* illegal; instead, they are subject to a "rule of reason" analysis. *Id.* at 1150. While the Court recognized that more recent cases interpreting Section 16600, including *Edwards*, have held agreements restricting an employee's ability to

compete with his employer post-termination to be *per se* invalid, the Court was reluctant to interpret Section 16600 as invalidating *all contracts* that limit the freedom to engage in commercial dealing. *Id.* at 1160. The Court explained that "[i]n certain circumstances, contractual limitations on the freedom to engage in commercial dealings can promote competition." *Id.* Businesses routinely enter into legitimate partnerships or exclusive dealing arrangements, and while such arrangements limit the parties' freedom to engage in commerce with third parties, they can also help businesses leverage capabilities, ensure stability in supply or demand, and protect their research, development, and marketing efforts from being exploited by contractual partners. *Id.* at 1161. In rendering its decision, the Court declined to "disturb the holding in *Edwards* and other decisions strictly interpreting section 16600 to invalidate noncompetition agreements following the termination of employment or sale of interest in a business." *Id.* at 1158-59.

The Court also noted that applying the rule of reason standard in interpreting Section 16600 is consistent with how courts have interpreted the Cartwright Act,[3] which has been construed to permit reasonable restraints of trade. *Id.* at 1151. As the Court noted, California courts have not interpreted the Cartwright Act in its absolute terms, and instead have "taken direction from the common law in establishing a reasonableness standard." *Id* at 1159*.* Specifically, that standard asks whether an agreement unreasonably suppresses competition, by considering the "circumstances, details, and logic of a restraint." *Id.*

Ultimately, the California Supreme Court did not decide whether the settlement provision at issue was invalid under the rule of reason standard, leaving it to the Ninth Circuit to decide. *Id.* at 1162. Following the California Supreme Court's opinion, the Ninth Circuit affirmed the district court's decision to apply the rule of reason analysis to the settlement provision in dispute, and following the district court's reasoning, ultimately concluded that it was not an unreasonable restraint of competition, and therefore did not violate Section 16600. *Ixchel Pharma, LLC v. Biogen, Inc.*, 821 F. App'x 897, 898 (9th Cir. 2020).

How Courts Have Applied *Ixchel*

In the employment context, recent decisions post-*Ixchel* have continued to uphold the *Edwards* decision. For example, in *Whitewater W. Indus., Ltd. v. Alleshouse*, the Federal Circuit invalidated an employment agreement's assignment provision which required a former employee to assign to his former employer all of his rights or interests in any invention he might make or conceive if the invention was either "resulting from or suggested by" his work for the former employer or "in any way connected to any subject matter within the existing or contemplated business" of the former employer. 981 F.3d 1045, 1048 (Fed. Cir. 2020). Citing *Ixchel*, the Court found that the assignment provision "[fell] squarely under the strict employment-agreement standard" and had a broad restraining effect that rendered it invalid under Section 16600 because it impaired the "post-employment liberty of former employees." *Id.* at 1053, 56.

With respect to non-competes between businesses, a few noteworthy cases post-*Ixchel* have applied the "rule of reason" analysis. In November 2020, California's Fourth District Court of Appeal established a framework for *Ixchel*'s rule of reason analysis in *Quidel Corp. v. Superior Court of San Diego Cty.*, 57 Cal. App. 5th 155 (2020). There, the court assessed a commercial non-compete clause that applied during the duration of a manufacturing contract between businesses and held that, like the post-term non-compete clauses discussed in *Ixchel*, in-term covenants not to compete are also subject to a rule of reason analysis. *See id.* at 160-61, 169. The *Quidel* court explained that if a provision (1) tends to restrain trade more than promote it (2) is not necessary to protect the respective parties in dealing with each other, or (3) forecloses a substantial share of the line of commerce, then the provision is an unreasonable restraint on trade in violation of Section 16600.[4] *Id.* at 171.

Relatedly, Section 16600's protection of employee mobility can also play a role in courts' application of the rule of reason in business-to-business agreements. In *Nulife Ventures, Inc. v. Avacen, Inc.*, a multi-level marketing firm, sought a preliminary

injunction to enforce its non-solicitation and non-compete provisions with Avecen, Inc. (“Avecen”), former independent contractors of Nulife. 2020 WL 7318122, at *11-12 (S.D. Cal. Dec. 11, 2020). The provisions at issue effectively prevented Avecen from soliciting Nulife’s independent contractors and customers. *Id.* at *11.

In denying the motion, the Court determined that the provisions at issue violated the rule of reason under Section 16600. *Id.* Referencing both the *Quidel* framework and the *Edwards* decision, the *Nulife* court found that the non-compete clause at issue “d[id] not have the purpose and effect of promoting competition.” *Id.* Specifically, the provision deviated from California’s favorable policy towards employee mobility by effectively restricting former independent contractors’ ability to practice their sales profession in the MLM industry, which relied on the recruitment of new sales agents. *Id.* at *11 (citing *Edwards,* 44 Cal. 4th at 946). As a result, the Court ruled that Nulife had not demonstrated a probability of prevailing on the merits of its breach of contract claims, which were grounded on the non-compete clauses, and denied the preliminary injunction. *Id.* at *12. Significantly, *Nulife* demonstrates that, when it comes to the rule of reason, non-compete provisions between businesses that restrain employee mobility may be invalidated as unreasonable restrictions on trade.

Concluding Thoughts

The outcome in *Ixchel* and subsequent cases post-*Ixchel*, demonstrate the balancing act that California courts undertake in continuing to uphold the long-standing public policy of protecting employee mobility while allowing businesses the flexibility to implement reasonable restraints on trade to promote healthy competitions. *Quidel*, in particular, serves as an important case in setting forth a framework that other courts may look to in applying the rule of reason analysis in the context of business-to-business contracts. And while there may be some leeway for businesses to utilize non-compete provisions, companies that do business and hire employees and/or independent contractors in California should keep in mind some key takeaways in drafting and re-evaluating their agreements with employees, contractors, and other business entities:

- Section 16600 applies not only to contracts between a company and its employees, but also to commercial contracts between businesses.
- Enforceability of restrictive covenants in business-to-business contracts is a factual inquiry and will depend on various factors; courts may find restrictive covenants reasonable in business-to-business contracts if their main purpose and effect is to promote and increase business and competition rather than restricting employment mobility—in other words, whether the anticompetitive effects of the agreement outweigh its procompetitive effects.
- Notwithstanding *Ixchel*’s holding that a rule of reason analysis applies to non-competes in business-to-business contracts, the court in *Ixchel* also stated that the holding of *Edwards* with respect to restrictive covenants in employment agreements remains undisturbed.

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[1] Cal. Bus. & Prof. Code sections 16601, 16602 and 16602.5 contain exceptions for non-compete provisions relating to sales of businesses, dissolutions of partnerships or dissociations of partners from a partnership, dissolutions of limited liability companies, and terminations of a member’s interest in a limited liability company.

[2] The other question certified by the Ninth Circuit was whether a plaintiff was required to plead an independently wrongful act in order to state a tortious interference of an at-will contract. *Id.* The California Supreme Court held that for a company to tortiously interfere with an at-will contract between other companies, the act must be independently wrongful, meaning that the act is “proscribed by some constitutional, statutory, regulatory, common law, or other determinable legal standard.” *Id.* at 1142.

[3] Cal. Bus. & Prof. Code §§ 16720 to 16727 (West).

[4] *Cf. Youngevity Int'l, Corp., et al., v. Todd Smith, et al*., 2021 WL 1041712, at *4 (S.D. Cal. Feb. 4, 2021) (finding that a provision preventing current distributors from inducing other current distributors to join external business opportunities “does not invoke section 16600”).

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