

Labor & Employment News Alert

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Enforcing Non-Compete Provisions in California

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One of the toughest tasks facing California businesses is preventing their employees from leaving the company and going to work for competitors or starting their own competing businesses. Many companies require employees to sign employment agreements which contain post-employment, non-competition clauses. However, most employers are unaware that such non-competition clauses are unenforceable in California.

Background

It is considered a fundamental policy of the State of California that agreements in restraint of competition are to that extent void. The California Supreme Court, in *Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937, unanimously held that Business & Professions Code Section 16600 invalidated a provision in Edwards' employment agreement that restricted him from servicing customers and competing with Arthur Andersen following the termination of his employment. Notwithstanding the general premise that non-competition agreements are invalid, specific Sections of the B&P Code provide certain exceptions to California's policy against enforcing non-competition covenants which apply in limited circumstances.

Exceptions to the Rule

One example of such an exception involves a person who sells the "goodwill of a business" or otherwise disposes of his/her ownership interest in the business entity. This person may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business is sold. When the goodwill of a business is sold, non-competition covenants are generally enforceable because it would be "unfair" for the seller to engage in competition which diminishes the value of the assets he sold.

Other exceptions concern the dissolution of either a partnership or limited liability company. Again, in these circumstances, the person who is leaving the existing entity agrees that he or she will not carry on a similar business within a specified geographic area where the existing partnership or limited liability company is located.

In order to enforce a covenant not to compete entered into when a shareholder sells his shares in a company there must be a clear indication that the parties valued or considered "goodwill" as a component of the sales price. In contrast, there is no requirement that a withdrawing partner be compensated for his share of partnership goodwill. The courts have also held that so long as all partners are subject to the same limitations, the partners can protect themselves from the risk of paying a withdrawing partner for goodwill and protect themselves from the separate risk that the partnership's goodwill will be diminished by competition from a withdrawing partner by placing the non-competition covenant in the initial partnership agreement.

Cherry Picking Venues

Attempts to skirt California's policy against non-competition covenants by making the contracts in which they are found subject to the laws of a foreign jurisdiction often fail. California courts will enforce a contractual choice of law provision if the chosen state has a substantial relationship to the parties or their transaction, or if there exists any other reasonable basis for the parties' choice of law, unless, the chosen state's law is contrary to the fundamental public policy of California.

Structuring Non-Compete Agreements

Employers are advised to structure non-competition agreements so that they are limited to localities where the business is conducted or is reasonably intended to be conducted, and so that the duration of the non-compete is limited to the period during which the buyer, the other partners or the other members, as the case may be, or any person deriving title to the goodwill, the business, or an

ownership interest in it from the buyer, other partner or member carries on a like business in the geographic area to which the restraint applies. Failure to adhere to the locality and duration restrictions may result in the narrowing or possibly the invalidity of an otherwise enforceable non-competition covenant.

For more information on non-compete agreements or other types of employee-related materials, please contact one of the authors or a member of Venable's **Labor and Employment Group**.