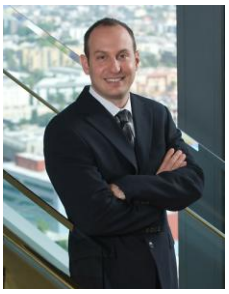
Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Calif. Noncompete Clauses — Still Unenforceable

--By Adam S. Bloom, Milbank Tweed Hadley & McCloy LLP*



Adam S. Bloom

Law360, New York (February 04, 2013, 10:55 AM ET) -- Section 16600 of the California Business & Professions Code is, on its face, quite succinct. It states: "[e]xcept as provided in this chapter, 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 interpreted quite literally the language of Section 16600 of the California Business & Professions Code in its Raymond Edwards II v. Arthur Anderson LLP, 44 Cal 4th 937 (2008) decision. Specifically, the Raymond Edwards court stated that Section 16600 "is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad," rather than every contract that restrains anyone from engaging in a lawful profession, trade, or business of any kind, "it could have included language to that effect." Raymond Edwards at 950.

Even before the Raymond Edwards decision, California courts' had been reluctant to enforce noncompete clauses in the employee/employer context because the courts deem noncompete clauses to violate California's public policy of promoting freedom of competition among an employee and an employer, and an employee's ability to freely pursue any lawful employment and enterprise of his or her choice.[1]

But, prior to the Raymond Edwards decision, noncompete clauses in the employee/employer setting (and, particularly in cases before the Ninth Circuit) were given a bit more leeway under a court-created "narrow-restraint" exception. The narrow-restraint exception upheld the enforceability of noncompete clauses if such noncompete clauses were narrow enough so as to not entirely bar a person from practicing his or her profession, business or trade. The Raymond Edwards decision, however, made clear that "California [state] courts have not embraced the Ninth Circuit's narrow-restraint exception." Raymond Edwards at 949.

Following the California Supreme Court's Raymond Edwards decision, several articles emphasizing that noncompete clauses are generally unenforceable in employment agreements in California (subject to the enumerated exemptions found immediately following Section 16600 in the California Business & Professions Code) were published. This commentary was not surprising since the Raymond Edwards decision involved the contract between an employee and an employer.

But such articles don't really paint a full picture with respect to the enforceability of noncompete clauses, since employment agreements are not the only types of agreement that contain noncompete clauses. Importantly, the Raymond Edwards decision did not address the enforceability of noncompete clauses in commercial contracts between sophisticated business parties.

There are several types of agreements, in addition to employment agreements, where the inclusion of noncompete clauses is common. Noncompete clauses are frequently included in merger and acquisition agreements, commercial real property lease agreements and license agreements, to name a few. This article discusses the likelihood of enforceability in California of noncompete clauses in certain commercial contracts, namely, merger and acquisition agreements, commercial real property lease agreements and license agreements in particular.

Merger & Acquisitions Agreements

Perhaps the type of commercial agreement that is most likely to contain a noncompete covenant is a merger and acquisition agreement. Generally speaking, pursuant to the terms of a merger and/or acquisition agreement, one party (the buyer) agrees to buy all (or substantially all) of the assets of the other party's business or the stock of the entity that owns the other party's business (the seller). Often, the buyer wants to be sure that as soon as it consummates the purchase of the business from the selling party, the selling party will not immediately start a business similar to the one it just sold, thereby competing with the buyer that just paid the seller to acquire the seller's prior business.

Recognizing the concern a purchaser would have if a seller could immediately start a new, competing business, the California legislature has enacted Section 16601 of the California Business & Professions Code. This section exempts non-competition clauses contained in merger and acquisition agreements from voidability under Section 16600 by permitting the seller to agree with the purchaser "to refrain from carrying on a similar business within a specified geographic area in which the business so sold … has been carried on, so long as the buyer … carries on a like business therein." California Business & Professions Code § 16601.

Thus, as long as a noncompete clause contained in a merger and acquisition agreements falls within the parameters of Section 16601 of the California Business & Professional Code, it should be upheld by a California court, should the restricted seller subsequently attempt to challenge the non-competition clause's enforceability.

Of the three types of agreements on which this article focuses, only noncompete clauses found in merger and acquisition agreements are specifically exempted from voidability in certain circumstances under Section 16601 of the California Business & Professions Code.

To be sure to fall within the Section 16601 safe-harbor, the drafter of a noncompete clause to be contained in a merger and acquisition agreement should take care to make sure that the provision is not overbroad and follows the criteria set forth in Section 16601 of the California Business & Professions Code, particularly in his or her description of the "business" and "specified geographic area in which the business so sold … has been carried on." See, for example, Monogram Industries Inc. v. SAR Industries Inc., 64 Cal. App. 3d 692, 702 (1976) (Holding that "the area where a business is 'carried on' is not limited to the locations of its buildings, plants and warehouses, nor the area in which it actually makes sales," but rather encompasses "the entire area in which the parties conducted all phases of their business including production, promotional and marketing activities as well as sales").

There are limits, however, on the applicable geographic scope for noncompete clauses that rely on the exemption afforded by Section 16601 of the California Business & Professions Code. Noncompetition covenants must be limited to the area where the sold company carried on its business. See Alliant Insurance Services Inc. v. Gaddy, 159 Cal. App. 4th 1292, 1301 and NewLife Sciences v. Weinstock (197 Cal. App. 4th 676 (2011) (citing Gaddy).

Failure to tie the geographic scope in which the sold company carried on its business could place restrictions on the seller that render the restrictions voidable under Section 16600 of the California Business & Professions Code and outside the exemption afforded by Section 16601 of the California Business & Professions Code. Accordingly, a draftsman should succinctly describe (i) the geographical area in which the seller is not allowed to complete, (ii) the type of "new" business that the seller is forbidden from running, which should be substantially similar to the business that the seller is selling to the buyer and (iii) the term of the noncompete, which should be reasonable.

Commercial Leases

Commercial leases between lessors/landlords and lessees/tenants, particularly in malls or other retail establishments owned by lessors with multiple lessees, often specify the business of each lessee and will prohibit each lessee from conducting any other business. The purpose of imposing these requirements is to prevent tenants from competing for customers with one another.

Since, oftentimes, the rent payable by a tenant to the lessor is based on a percentage of such tenant's sales, prohibiting tenants from selling the same goods or offering the same services as one another is expected to maximize the revenue of each tenant, and, in turn, the amount of rent payable by each tenant to the lessor. That tenants are not permitted to compete with one another by selling similar goods or services is a side-effect of this arrangement actually intended to promote the profitability of all tenants and, in turn, the landlord.

Indeed, where landlords have prohibited tenants from selling certain types of goods or selling certain types of services, California courts have found that such agreements have only a "'trivial noncompetitive effect'" and do not prohibit the lessee from engaging in its lawful trade or business. See, for example, Martikian v. Hong, 164 Cal. App. 3d 1130 (1985). In that case, one tenant in a shopping center agreed not to sell beer in his store if another tenant in the same shopping center agreed not to sell middle eastern grocery items in his store. Id. at 1131.

Whether California courts will maintain a similar view of these agreements following the Raymond Edwards decision remains to be seen. However, initial court decisions, although not officially reported, suggest that the scope of Raymond Edwards will be limited and will only apply to noncompete provisions contained in employment agreements.

In any event, and especially until the scope of Raymand Edwards is made clear, draftsman of commercial leases should take care to make sure that the noncompete provision contained in a commercial lease are not so broad so as to impair a lessee's ability to engage in a "trade" or "business" in any more than a trivial, noncompetitive way. To do so, noncompete clauses should (i) succinctly describe the type of business that a tenant is required to run, or better yet, the specific items or services that the tenant is forbidden from offering or selling and (ii) provide for a reasonable term for such restriction, which may be the duration of the lease.

Commercial Licenses

Under a commercial license agreement, a licensor will grant to a licensee the right to use the licensor's product (which may include software) or other intellectual property rights (which may include rights under patents, copyrights, trademarks or trade secrets).

In consideration for the ability to use the licensor's product (or intellectual property rights), the licensee (i) will agree to pay a fee (which may be a fixed fee, whether monthly, annually or payable at any other time throughout the term of the lease, or may be based on the licensee's revenue in addition to possible service fees) and (ii) may agree with the licensor that the licensee will not to use the licensed product to produce, manufacture, market, use, promote or sell any items that compete with the licensor's product that the licensee is licensing.

Like any other noncompete clause, the noncompete clause found in a commercial license would restrain the business or trade activities of one (or both) of the licensee or licensor. However, it should be noted, first and foremost, that intellectual property rights are protected by other state and Federal statutes, including the Uniform Trade Secrets Act and Unfair Competition Law.

An intellectual property owner seeking to enforce its right to prevent the competition of its licensee, comparable to the prohibition afforded by a noncompete clause, should seek an injunction for the tortuous conduct of the counterparty under such Federal statute. See Retirement Group v. Galante, 176 Ca. App. 4th 1226, 1239 (2009) (Section 16600 of the Business & Professions Code "bars a court from specifically enforcing (by way of injunctive relief) a contractual clause purporting to ban a former employee from soliciting former customers to transfer their business away from the former employer to the employee's new business, but a court may enjoin tortious conduct (as violative of either the Uniform Trade Secrets Act and/or the Unfair Competition Law)").

A licensor (or licensee) of intellectual property rights should seek to enforce a noncompetition clause contained in a contractual agreement with its counterparty (in addition to seeking an injunction for tortuous conduct under Federal and state laws) for several reasons.

First, as a matter of course, a litigant will often allege each cause of action it has against its counterparty, and a cause of action for breach of contract should not be omitted, and should not be assumed to be voidable at the outset. Second, based on the particular facts and circumstances, the aggrieved plaintiff may not be able to satisfy all of the statutory elements required to demonstrate a breach of federal or state intellectual property law statutes, thus leaving only the cause of action for a claim of a breach of the contractual noncompete provision.[2]

If a litigant claims that the counterparty breached its contractual noncompete covenant, one can posit on possible decisions a California court could reach when determining whether a noncompete clause found in a commercial license agreement would be enforceable, and the reasons a California court may reach its decision.

On one hand, it is possible that a California court would scrutinize the license between a licensee and licensor in the same way it would scrutinize a lease between a lessor/landlord and lessee/tenant. Described simply, a commercial license could be viewed by a California court as a lease of intellectual property (or personal property) as compared to a traditional lease of real property.

In such a case, the draftsman of a noncompete clause in a commercial license should make sure that the noncompete clause is not so broad so as to impair a licensee's ability to engage in a business in any more than a trivial, non-competitive way, as was the standard articulated by the court in Martikan. To do so, noncompete clauses should (i) succinctly describe the type of business that a licensee is required to run, or better yet, the specific items or services that the licensee is forbidden from offering or selling and (ii) provide for a reasonable term for such restriction, which may be the duration of the license.

On the other hand, it is possible, and perhaps more likely, that a California court could determine that a licensee could not have engaged in a "lawful" business or trade (as required under Section 16600 of the California Business & Professions Code) without a license from a licensor ab initio, if such California court opted not to enjoin the unlawful, tortious activity instead (which it would first consider). For example, a patent gives the licensor (or inventor) the right to exclude others from using, selling, offering for sale, or importing the licensor's patented invention. Herman v. Youngstown Car Mfg Co., 191 F. 579 (6th Cir. 1911); Siemens Medical Solutions USA, Inc. v. Saint-Gobain Ceramics & Plastics Inc., 647 F.3d 1373, 1375 (U.S. Court of Appeal, Fed. Cir. 2011).

In order to use or sell the licensor's patent invention, the licensee must obtain a license to do so from the licensor. Otherwise, the licensee could not enter into the business of using or selling the patented invention without violating the licensor's patent rights. Usually, the license grant, and not a noncompetition clause, would restrict the licensee from using or selling the licensor's patented invention outside a specified geographical region and may specify that the license from the licensor to the licensee is "exclusive" as to that region.

Following this reason, and in contrast to Martikan, the licensee-seller of a patented invention of "widgets" is prohibited from selling those widgets by the very fact that the licensor's holds patent rights to widgets, not because of a contractual arrangement between parties whereby one agreed not to sell widgets (or beer, as was the case in Martikan) in his shop that would compete with another merchant in the same shopping center. Under Martikan, a merchant could sell beer at another location, outside the scope of the noncompete clause, if he or she wished to do so, but a widget merchant could not sell widgets from any location, whether that location is in the same shopping plaza or a location one hundred miles away, without a license from the licensor. Otherwise, such licensee/retailer would violate the licensor's patent rights.

However, it may be the case in a commercial license that it is not the licensee that is subject to a noncompete, but rather the licensor that agrees not to compete with the licensee. In this scenario, a licensee may request that the licensor agree to a noncompete clause in favor of the licensee, prohibiting the licensor from selling its own patented invention in competition with the licensee. After all, the licensor, as the patent owner, does not need a license to use or sell its own patented invention; it could use or sell the patented invention any where it chooses.

However, if the licensor receives a royalty (or license fee) from the licensee, it may not be in the best interest of the licensor (or licensee) for the licensor to compete in the use or sale of the patented invention with the licensee. Accordingly, the noncompete clause agreed upon by a licensor to not compete with its licensee may be viewed by the Martikan court as having only a trivial noncompetitive affect.

Similarly, a licensee cannot profit from a licensor's copyrighted work (such as the pirated sale of a copy of a movie or music) or use a licensor's trade secrets or proprietary software (such as the sale of copies of Microsoft Windows or World of WarCraft) without a license from the licensor. If a licensee wishes to sell movies, it must have a license to do so from the content-owner/licensor, and that license may contain a noncompete clause, which clause could, for example, prohibits the licensee from selling movies outside a specified geographical location so as to not interfere with the movie sales of a different licensee (or the licensor itself) at another, nearby location.

Although there may be some significant legal differences that justify applying a less stringent level of scrutiny toward a commercial license than would be applied to a commercial lease, one cannot be certain that a court in California would do so. Based on the California Supreme Court's Raymond Edwards decision, a California court could void a commercial license if the noncompete clause in such commercial license runs afoul of a literal reading of Section 16600 of the California Business & Professions Code, even though the noncompete clause may not have added any substance to the commercial license that is not already inherent in the exclusionary rights afforded to patent holders, copyright owners or other owners of intellectual property rights. In fact, as previously mentioned and as was the case in Galante, California courts tend to enjoin tortious conduct rather than specifically enforcing a contractual obligation.

To avoid this bizarre result, a draftsman should consider omitting a noncompete clause in a commercial license and relying instead on the exclusionary principal inherent in intellectual property rights. Alternatively, and in the instance where a commercial licensee has a legitimate concern that the licensor may intend to sell the patented invention in the same geographical area as the licensee, the licensee should assume that a license agreement would be viewed akin to a commercial lease and, in that case, include a noncompete clause that is narrowly tailored so as to only trivially restrict the licensor's ability to conduct its business. To do so, noncompete clauses should (i) succinctly describe the specific items (e.g., "widgets") or services that the licensee (or licensor, as applicable) is forbidden from offering or selling and (ii) provide for a reasonable term for such restriction, which may be the duration of the license.

Practice Suggestions

First and foremost, any noncompete clause contained in a commercial agreement governed by the law of the state of California should be narrowly tailored so as to not be overbroad, should specify a precise geographical region in which the restricted party must refrain from engaging in its business, should narrowly specify the business or trade in which the restricted party must refrain from engaging and should not impair the restricted party in more than a trivial, noncompetitive way and should expire after a reasonable period of time of not more than a few years.

Second, practitioners should inform their clients of the harsh scrutiny California courts impose on noncompete clauses so that clients are aware of the possibility that any noncompete clause contained in a commercial agreement may be voided. Practitioners should also include in any commercial agreement that contains a noncompete clause a severability clause to preserve the remainder of the commercial agreement in the event a California court voids the noncompete provision.

In any action for enforcement of a noncompete, practitioners should seek (i) to have a California court enjoin the defendant's tortious conduct, and (ii) to have such California court enforce any contractual right. Currently, California courts are more inclined to enjoin tortious conduct rather than enforce noncompete covenants contained in a contract that may be violative of Section 16600 of the California Business & Professions Code.

Third, proponents of noncompete clauses should opt for federal courts in the state of California to the extent such courts are available. As mentioned earlier in this article, the California Supreme Court in Raymond Edwards emphasized that California courts do not recognize the "narrow-restraint" exception that Ninth Circuit courts have recognized. Raymond Edwards at 950. Accordingly, practitioners should include in commercial agreements choice of venue provisions that favor the Federal courts in the state of California, to the extent such courts may be utilized to resolve a dispute, rather than state courts.[3]

Conclusion

Unless and until the California Supreme Court formally narrows the scope of Raymond Edwards to make clear that Raymond Edwards applies only to noncompete clauses contained in employment agreements, one should generally consider noncompete clauses to be unenforceable in California, subject to the explicit, narrow exceptions described in the California Business & Professions Code immediately following Section 16600.

These exceptions include noncompete clauses contained in merger or acquisition agreements whereby a purchaser is buying all or substantially all of the assets or equity of the seller. Other commercial agreements, like commercial licenses and commercial leases, in which the inclusion of a noncompete provision may be common, may or may not survive scrutiny by a California court in light of Raymond Edwards. Attorneys should advise clients that expect to enjoy the benefits of a noncompete provision of the possibility of such provision being voided by a California court.

** Adam Bloom is an associate in the global corporate group of Milbank Tweed Hadley & McCloy, resident in the Firm's Los Angeles office.*

The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Statutory exemptions to section 16600 include noncompete clauses entered into in connection with: (i) the sale of good will of a business or ownership interest in or operating assets of a business entity or division or subsidiary thereof (Section 16601); (ii) the dissolution or dissociation of a partnership (Section 16602) and (iii) the dissolution or sale of a limited liability company (Section 16602.5).

[2] A discussion of the protections afforded by federal and state intellectual property law statutes, and the requirements for properly stating a claim under such statutes, is outside the scope of this article.

[3] Practitioners should also be wary of the Cartwright Act, Section 16700 et seq. of the California Business & Professions Code. The Cartwright Act is California's antitrust and trade regulation statute, which is based on the Clayton Act (15 U.S.C. § 14) and the Sherman Anti-Trust Act (15 U.S.C. § 1 et seq.). Lloyd Design Corp v. Mercedes-Bens of North America, Inc., 66 Cal. App. 4th 716 (1998); Morrison v. Viacom Inc., 66 Cal App. 4th 534 (1998); Gianelli Distribution Co. v. Beck & Co., 172 Cal. App. 3d 1020 (1985). The Cartwright Act, among other things, makes it unlawful for any person to "lease or make a sale or contract for the sale of goods, merchandise, machinery, supplies, commodities for use within the State … on the condition, agreement or understanding that the lessee or purchaser thereof shall not use or deal in the goods, merchandise, machinery, commodities or services of a competitor or competitors of the lessor or seller …" California Business & Professions Code § 16727. Much like Section 16600, the Cartwright Act also targets agreements that restrain trade, with a focus on those agreements that are violative of anti-trust and unfair competition principals.

All Content © 2003-2013, Portfolio Media, Inc.