Enforcing Covenants Not To Compete Against Dissociating California Partners

Robert M. Ungar
Los Angeles

Introduction

California partners usually want the protection of a contractual commitment that a departing partner will not take away partnership customers or compete with the partnership business. The partnership has spent substantial resources, time and capital to build a customer base, its “book of business”, and reasonably wants to prevent years of work from simply walking out the door with a departing partner who will start a competing firm on the other side of town. Many attorneys drafting California partnership agreements, particularly professional service partnerships, include a covenant preventing a partner from competing with the partnership while a partner and after leaving the partnership.

Over the last thirty years, California appellate courts have repeatedly expressed their disfavor of covenants that restrain competition. The courts consistently refuse to enforce covenants not to compete unless the covenant falls within a narrow exception.

This article addresses one of those narrow exceptions --- when a partner dissociates from a partnership.

Covenants Not To Compete Generally Can Not Be Enforced Under California Law

California Business and Professions Code section 16600 ("16600") provides "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.
These non-compete covenants are considered to violate California’s public policy that promotes freedom of competition and a person’s right to freely practice their occupation, trade or profession. Therefore, California courts have consistently invalidated covenants not to compete. *Silguero v. Creteguard, Inc.* (2010) 187 Cal. App.4th 60.

Even when an agreement containing a covenant not to compete includes a clause evidencing the parties’ desire to rewrite the covenant should it be deemed unenforceable, California courts have not used a “blue pencil” remedy to save the otherwise unenforceable restraint. A clause that is invalid under 16600 is illegal and California courts have deemed the rewriting of illegal covenants unacceptable. *Hill Medical Corp. v. Wycoff* (2001) 86 Cal. App.4th 895 (2001).

The Partnership Dissociation Exception To Unenforceable Restraints On Trade

California Business and Professions Code section 16602 (“16602”) sets forth a narrow exception to California’s policy disfavoring covenants not to compete. 16602 provides: “(a) Any partner may, upon or in anticipation of any of the circumstances described in subdivision (b), 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, or any person deriving title to the business or its goodwill from any such other member of the partnership, carries on a like business therein. (b) Subdivision (a) applies to either of the following circumstances: (1) A dissolution of the partnership. (2) Dissociation of the partner from the partnership.”

Under 16602, a provision in a partnership agreement restraining partners from engaging in future competition with the partnership will be enforceable when and if (1) the partner dissociates from the partnership; and (2) the partner is being restrained from carrying on a similar business within a specific geographic area where the partnership business has been transacted; and (3) if any member of the partnership carries on a like business.

When A Partner Dissociates From The Partnership

Under the Uniform Partnership Act (California Corporations Code section 16100 et. seq.) there are many circumstances when a partner dissociates from a partnership. Corporations Code section 16601 (“16601”) sets forth a lengthy list of events resulting in dissociation including (1) notice of the partner's express will to withdraw as a partner or on a later date specified by the partner; (2) An event agreed to in the partnership agreement as causing the partner's dissociation; (3) a partner's expulsion pursuant to
the partnership agreement; (4) a partner's expulsion by the unanimous vote of the other partners under prescribed circumstances; (5) a partner's expulsion by judicial determination because of specific causes; (6) a partner is the subject of certain insolvency proceedings; (7) a partner's death or incapacity; (8) a trust that distributes its entire interest in the partnership; (9) an estate in the case of a partner that is an estate that distributes its entire interest in the partnership; and (10) termination of a partner that is not an individual, partnership, corporation, trust, or estate.

This lengthy list points out that in virtually every circumstance when a partner leaves a partnership, whether voluntary or involuntary, the partner is deemed to have dissociated from the partnership. Under the Uniform Partnership Act, if there is a dissociation of a partner, as contrasted with a dissolution of the partnership, the remaining partners have a right to continue the business and the dissociated partner has a right to be paid the buy-out price of his or her partnership interest. Corporations Code section 16701.

Carrying On A Similar Business Within A Specific Geographic Area Where The Partnership 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. The geographic area may extend beyond the city or town where the partnership's business is physically located. Roberts v. Pfefer (1970) 13 Cal. App.3d 93. A similar business is "carried on" in those counties in which a partnership has been selling its products to its customers in substantial amounts. Similarly, a service partnership is carrying on business where services are performed and where partnership clients reside. Kaplan v. Nalpak Corp. (1958) 158 Cal. App.2d 197; Swenson v. File (1970) 3 Cal.3d 389

Although a covenant not to compete must have a limit to a "specific geographic area", it is unclear whether a specific area must be designated or whether it is sufficient for the covenant to specify that it applies in geographic areas where the partnership has transacted business. Although the statute's language, "specific geographic area," would appear to require explicitness, California courts have not yet decided whether a specific area must be defined in the partnership agreement.

California courts have allowed isolated instances of competition notwithstanding the restraint of a covenant not to compete upon a former partner. Occasional and isolated transactions do not threaten the partnership’s ability to continue
its business in the relevant geographic area. *Swenson*, supra.

**As Long As A Partner Carries On A Like Business**

16602 specifies that a covenant not to compete can prohibit competition as long as other partners carry on a like business. A covenant under this section could last many years --- until all partners have finally stopped engaging in the partnership business. California courts have construed covenants that do not provide a specific time as continuing for so long as the other partner engages in the partnership business. *Loral Corp. v. Moyes* (1985) 174 Cal. App. 3d 268; *Martinez v. Martinez* (1953) 41 Cal. 2d 704.

**Professional Service Partnerships**


Professional service partnership agreements typically do not actually prohibit competition, but instead place a price on competition by imposing a reasonable cost on departing partners who compete with the partnership in a limited geographical area. One California court has explained that a medical partnership cannot withhold the privilege of practicing medicine in the state, but a withdrawing partner “may contract that if he exercises that privilege he will compensate his former partners to some extent at least for the business which he expects to take from them.” *Farthing v. San Mateo Clinic* (1956) 143 Cal.App.2d 385.

Such a provision is not inconsistent with California Rules of Professional Conduct, Rule 1-500 which states that attorneys cannot enter into agreements restricting an attorney's right to practice, nor is it void on its face as against public policy. Although an absolute ban on competition with the partnership would be inconsistent with the legitimate concerns of assuring client choice of counsel and assuring attorneys of the right to practice their profession, to the extent that the agreement merely assesses a toll on competition within a specified geographical area, comparable to a liquidated damage clause, it may be reasonable. Thus, a partner's agreement to pay former partners, or to forgo benefits otherwise due under the contract, in an amount that at the time of the agreement is reasonably calculated to compensate the firm for losses that may be caused by the withdrawing partner's competition with the firm, is permitted. *Howard v. Babcock* (1993) 6 Cal. 4th 409. Liquidated damages have also been enforced against an expelled accountant who had agreed to pay 200% of the last

**Litigating Covenant Not To Compete Claims Against Dissociating Partners**

California courts have consistently enforced claims against withdrawing partners for liquidated damages arising from a breach of the covenant not to compete. *Weber, Lipshie & Co.*, supra. Although 16602 is to be narrowly construed as an exception to 16600’s general prohibition against trade restraints, the courts appear to be more liberal in their application of 16602 to liquidated damage cases than to injunctive relief. The reason for this seemingly disparate treatment probably stems from the fact that exacting a “toll” from the departing partner does not stop the partner from competing, but forces the departing partner to pay for the opportunity to compete. By seeking injunctive relief, the partnership is asking the court to prevent the former partner from engaging in his chosen trade. In this case, California courts will more closely scrutinize the partnership agreement and narrowly define the scope of the restraint under 16602.

Dissociated partners will always seek to limit the restraint by limiting the partnership’s product or service offerings and the area in which the partnership does business. If a dissociate partner can show that the partnership agreement is overreaching, then the court should be unwilling to “blue pencil” an arguably unenforceable covenant and refuse to enjoin competition.

Enforceability of liquidated damages is governed by California Civil Code section 1671, subdivision (b) (“1671”), which provides: “[A] provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.” The objective of a liquidated damages clause is to “stipulate a pre-estimate of damages in order that the contracting parties may know with reasonable certainty the extent of liability” in the event of breach. Courts perform a “reasonable endeavor test” to determine the validity of the liquidated damages provision measured at the time of contracting. The amount set as liquidated damages must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. *El Centro Mall, LLC v. Payless ShoeSource, Inc.* (209) 174 Cal.App.4th 58. The burden is on the dissociating partner to prove that the liquidated damages are unreasonable.

**Conclusion**

Litigating a covenant not to compete contained in a partnership
agreement is complex and requires particular attention to the nature and scope of the partnership’s business, the reach of the specific restraint in the partnership agreement, whether the provision is subject to professional rules and standards, and the remedies sought. Pre-litigation planning is an essential step toward reaching a successful outcome. You are invited to consult with us at UngarLaw. Business Divorce Lawyers.

Robert M. Ungar represents high net worth business people, celebrities, professionals, investors, and entrepreneurs who demand a successful outcome when their business relationships come to an end. Mr. Ungar has been litigating shareholder and partner disputes for over 30 years. For additional information please email Mr. Ungar at rmu@ungarlaw.com visit UngarLaw. Business Divorce Lawyers at www.ungarlaw.com.