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# California Contracts Not to Compete Staff

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# CALIFORNIA CONTRACTS NOT TO COMPETE

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California's Business and Professions Code, Section 16600, provides generally 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, except as provided in this chapter."

Certain exceptions are specified in Sections 16601 and 16602, enacted as part of the Code in 1941, the year in which similar provisions were repealed from the Civil Code.[1] In effect they prescribe what will be allowed as a reasonable contractual restraint of trade and preclude the California courts from applying the "Rule of Reason" by which the legality of similar transactions is tested in cases under the federal Sherman Act.[2]

The present Section 16601 of the Business and Professions Code makes valid certain agreements not to compete, incident to the sale of the good will of a business or of all the stock of a corportation. Where the contract for the sale of the business contains no restrictions on the seller's right to carry on the same line of business, however, no agreement not to compete will be implied by the courts, nor can its existence be established by oral proof.[3]

## a. Upon the Sale of a Business

The sale of the business must include the seller's interest in the good will or no incidental restraint, however express, will be enforced. In *Haas v. Hodge*,[4] a doctor's promise not to practice within a given area upon the termination of an association was held invalid where the agreement closely resembled an employment contract and the defendant had renounced any interest in the association's professional practice. It was determined that Section 16601 did not apply since the defendant had no interest in the good will of the practice to sell to the plaintiff. Furthermore, the defendant had not and could not have sold any good will acquired by his personal skill.

In *Kaplan v. Nalpak Corporation*,[5] a seller's agreement to refrain from competition in all cities and counties in which the business was carried on within the state was upheld as valid under Section 16601. The former Civil Code Section 1674 specifically limited the area of such agreements to a "county, city or part thereof." When the present Section 16601 was enacted in the Business and Professions Code, however, the wording was changed to "a specified *county or counties, city or cities*, or a part thereof, in which the business . . . has been carried on." (Emphasis added.) In light of the policy to protect a purchaser within reasonable limits in the enjoyment of the good will which he has purchased, the court held that the seller's agreement could validly extend to include all those counties in which there were customers to whom the business made sales in substantial amounts.

And in *Dillion v. Summer*,[6] a doctor had orally promised, pursuant to the sale of his medical practice, not to engage in the practice of medicine, ex-

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1. Cal. Civ. Code §§ 1674, 1675.
2. 26 U.S. Stat. 209 (1890).
   The leading case setting forth the "Rule of Reason" is Standard Oil Company of New Jersey v. United States, 221 U.S. 1, 31 S. Ct. 502, 55 L. Ed. 619 (1910).
3. Kaye v. Tellsen, 129 Cal. App. 2d 115 (1955).
4. 171 Cal. App. 2d 478 (1959).
5. 158 Cal. App. 2d 197 (1958).
6. 153 Cal. App. 2d (1957).

pressing no limitations with respect to the territory included. His promise was enforceable to the extent of the area allowed under Section 16601, which included the cities and counties in which the practice had been carried on. The language of Section 16600, to the effect that a contract would be declared invalid *to the extent* that it was an illegal restraint may have been persuasive.

### b. Upon the Dissolution of a Partnership

Section 16602 excepts certain similar agreements not to compete upon the dissolution of a partnership. Comparatively restricted territorial limits are imposed, however, upon such agreements. An agreement pursuant to the sale of a partnership interest in which the seller promised not to engage in the same type of business in any county in which the partnership had conducted its business was held unenforceable in the recent case of *Anderson Crop Dusters, Inc. v. Mately*.[7] An injunction against the seller who was competing in the crop-dusting business in the same county in which the partnership had its place of business was denied. In this situation, the present Section 16602 of the Business and Professions Code is a verbatim re-enactment of its predecessor. Section 1675 of the Civil Code which was repealed in 1941:

> Partners may, upon or in anticipation of dissolution of a partnership, agree that none of them will carry on a similar business within the *same city or town* or a specified part thereof. (Emphasis added.)

The early case of *Du Bois v. Padgham*[8] had construed the statute to mean the city or town in which the partnership had its principal place of business; not any town in which a substantial amount of business was carried on, as the defendant there contended. Although the court in the *Anderson Crop Dusters* case cast some doubts upon the aptness of that construction, it held that since the legislature in 1941 re-enacted the provision after it had been so interpreted, the court was not free to disturb that interpretation.

In the *Haas* case, the defendant had set up an office only five miles from the plaintiff's office, but across the city line. If there had been a partnership relation between the parties, would this distance be beyond the enforceable limits of an agreement not to compete upon dissolution of the partnership? It would seem to be so, in light of the interpretation of Section 16602 followed in the *Anderson Crop Dusters* case.

Such a result raises the question of whether a flexible "Rule of Reason" would not be the more desirable measure of legality in each case, at least with respect to allowable limitations of territory and duration. The principle that primary consideration must be given in every case to the protection of the public interest is urged in support of the fixed legislative standard. The contention is persuasive where the standard is applicable to a relatively foreseeable field of conduct. The desirability of such a standard is diminished, however, where the transactions within its scope become so diverse that foreseeability becomes a practical impossibility. At this point it is physically possible for the courts alone to balance the relative merits of each case in light of the expressed legislative policy. Without a flexible rule of reasonableness, there is a possibility that a preconceived legislative fiat may invalidate agreements which under the circumstances may in fact be reasonable and entirely compatible with the primary public interest.

7. 159 Cal. App. 2d 811 (1958).
8. 18 Cal. App. 298 (1912).

### c. Other Restraints on Competition

While statutory enumeration of exceptions to the rule invalidating contracts in restraint of trade would appear exclusive according to customary rules of construction, the judicial recognition of certain other agreements not to compete raises the inquiry whether additional exceptions will be countenanced by the courts. These cases may be reconciled with the view that there are no exceptions outside the statute on the theory that they do not fall within its purview in the first place. Thus, a covenant restricting the business use of property sold under a conditional sales contract was held valid in the case of *Fidelity Credit Assurance Co. v. Cosby*,[9] in which the court reasoned that since seller could have withheld the sale completely, he could also make it conditional. The same result should obtain where such a covenant is regarded as a limitation to the original grant, instead of a restriction superimposed upon an outright grant. Under the "bundle of rights" theory of property ownership, the withholding of certain rights in the first instance could not comfortably be classified as a "restraint" on trade, or upon the use of the land. Similarly, it was decided in the case of *Associated Oil Co. v. Myers*[10] that a lessor could limit the lessee's business use of the leased premises. Such agreements were held not to entail a restraint on trade within the meaning of Section 1673 of the Civil Code, the substantially identical predecessor of Section 16600 of the Business and Professions Code.

In *Keating v. Preston*[11] the language of a lease was determined to fairly evidence the intention of the parties that the lessee was to have the exclusive right to operate a restaurant in a particular hotel building. The lessor was enjoined from leasing another part of the building to a competing enterprise. Viewing the agreement as beyond the pale of Section 1673, the court followed the rule of *Great Western Distillery Products Inc. v. John A. Wathen Distillery Co.* [12].

> Statutes are interpreted in the light of reason and common sense, and it may be stated as a general rule that courts will not hold to be in restraint of trade a contract between individuals, the main purpose and effect of which are to promote and increase business in the line affected, merely because its operations might possibly in some theoretical way incidentally and indirectly restrict trade in such line.

There appears to emerge from such language a judicial "Rule of Reason" which is applied to detemine the *existence* of a restraint on trade within the meaning of the statute, rather than to inquire into its *reasonableness* once a restraint can be made out.

### d. Upon Termination of Employment

Noticeably absent from the Business and Professions Code, is a section which gives validity under any circumstances to contracts by an employee not to compete upon the termination of his employment. Thus in *Morris v. Harris*,[13] a covenant in an employment contract which rendered the employee liable for liquidated damages if he solicited or accepted a certain type of work from the employer's clients, was held void under Section 16600. It made no difference that this was only a partial restraint on the em-

9. 90 Cal. App. 22 (1928).
10. 217 Cal. 297 (1933).
11. 42 Cal. App. 2d 110 (1940).
12. 10 Cal. 2d 442 (1937).
13. 127 Cal. App. 2d 476 (1954).

ployee's right to engage in a lawful business. Section 16600 makes no exception for contracts which create only partial restraints of trade.

There are certain agreements in employment contracts which, although they restrict the means of competition which a former employee may use upon termination of the employment, are not invalidated by Section 16600. The case of *Gordon v. Landau*[14] involved the validity of a covenant in an employment contract by which the defendant was engaged as a salesman of merchandise to the employer's customers. He had agreed not to solicit business from these customers for one year after termination of his present employment. The agreement was held to be valid and enforceable for the reason that it did not prevent the defendant from engaging in a lawful business or profession but only from using the employer's confidential lists to solicit customers.

And it was held in *State Farm Mutual Automobile Insurance Co. v. Dempster*[15] that Section 16600 does not invalidate provisions in an employment contract protecting trade secrets or a special trust. Apparently the right to recover in these cases is fundamentally based upon the right to be protected from tortious conduct in the form of unfair competition or the violation of a confidential relationship. Provisions of this nature also fall within the class of agreements which are held not to be restraints of trade or business within the meaning of the Business and Professions Code.

14. 49 Cal. 2d 690 (1958).
15. 174 Cal. App. 2d 418 (1959).