ALERT: COVENANTS NOT TO COMPETE

I. COVENANTS NOT TO COMPETE: FREQUENTLY CONTEMPLATED, RARELY ENFORCED

A recent decision by the California Court of Appeal for the First Appellate District, in *Robinson v. U-Haul*,[1] provides a sobering reminder of the general illegality of noncompetition agreements by exemplifying the potential severity of attempting to enforce such an invalid agreement. In finding that the defendant U-Haul negotiated, threatened to enforce, and filed suit to enforce invalid noncompetition agreements *knowing* of their illegality, the court upheld plaintiff's award of $195,000 in damages for malicious prosecution, *and* over $800,000 in attorney's fees for privately prosecuting a class action brought under California's Unfair Competition Law ("UCL"). Another noteworthy feature of *Robinson* stems from the court's approval of permanent injunctive relief because the lawsuit not obtain the requisite judicial certification as a class action,[2] and suggests the judiciary's willingness to overlook otherwise "harmless" procedural errors in causes of action arising from violations of the UCL.

Due diligence requires that clients considering the formation, sale, purchase or reorganization of a business investigate the presence, and inquire as to the terms and conditions, of any preexisting or proposed noncompetition agreements. Transactions involving the retention, termination or engagement of personnel frequently include the negotiation of various restrictive covenants, such as noncompetition and nondisclosure agreements, as a precondition to employment. Perhaps less apparently, restrictive covenants also bear upon the rights of owners; particularly within partnerships, closely-held corporations and limited liability companies in which owners often serve in a managerial capacity or work as employees. The following commentary reviews California's statutory prohibition against covenants not to compete, its narrowly prescribed exceptions, and recent case law expanding the potential scope of liability for the enforcement of invalid noncompetition agreements.

II. THE QUALIFIED PROHIBITION OF COVENANTS NOT TO COMPETE: LEGISLATIVE HISTORY, RULES, AND EXCEPTIONS

Although restrictive covenants serve primarily to safeguard against the misappropriation of proprietary business information by former employees or owners in a rival venture, California generally disfavors agreements that may impede free markets and/or operate as a restraint on trade. By imposing limitations on the nature, scope and geographic boundaries of parties' prospective employment, or endorsement of or involvement with industry competitors, covenants not to compete inherently restrict the freedom to compete, and, therefore, directly conflict with the state's ardent commitment to protecting free enterprise. The state legislature codified this policy in 1941 by adopting section 16600 of the California Business and Professions Code, and pursuant to which, "…*every* contract by which anyone is restrained from

[1] *Robinson v. U-Haul Co. Cal.* (Oct. 18, 2016, A141396, A145828).

[2] Section 17204 of the California Business and Professions Code requires class representatives prosecuting class actions under the UCL satisfy the class action certification criteria prescribed in section 382 of California's Code of Civil Procedure.

engaging in a lawful profession, trade, or business of any kind is to that extent *void*."[3]

Subject to a limited exception in section 16601, courts may uphold noncompetition agreements as valid consideration for the purchase of a business' "goodwill",[4] or where reasonably necessary in order to prevent the misappropriation of confidential trade secrets.[5] If challenged, courts will scrutinize the entire structure of a transaction, including the original intent of the parties when consenting to the restrictions, as well as the enforcing party's knowledge or reasonable belief of the challenging party's misuse of confidential information. Modernly, courts have expounded upon the statutory prohibition against noncompetition agreements by finding that parties seeking to enforce an invalid agreement may also incur liability under the state's Unfair Competition Law ("UCL"),[6] and thereby reaffirming that, "…the remedies or penalties provided by this [chapter] are *cumulative* to each other and to the remedies or penalties available under all other laws of this state."[7]

III. EXPANDING THE SCOPE OF LIABILITY UNDER THE UCL: *ROBINSON V. U-HAUL COMPANY OF CALIFORNIA*

After terminating a rental dealership contract with U-Haul and entering into a subsequent rental dealership agreement with Budget soon thereafter, Robinson successfully rebuked U-Haul's attempted enforcement of their contract's generic noncompetition clause as void under section 16600. Under the blanket noncompetition clause, Robinson agreed, "…not [to] represent or render any service either on its *own behalf* or in *any capacity* for the duration of the then-existing or contracted-for telephone directory [advertising]."[8]

Despite U-Haul's voluntary dismissal of its original action requesting preliminary injunctive relief enjoining Robinson from continuing his relationship with Budget, Robinson filed a class action lawsuit that sought to permanently enjoin U-Haul from enforcing, threatening to enforce, or incorporating similar noncompetition clauses within its contracts with other dealers. The class action alleged, and the trial court agreed, that U-Haul engaged in a deliberate, "…pattern of business activity to…intimidate its former dealers from setting up business relations with [its] competitors."[9] Accordingly, Robinson recovered $195,000 in damages for his claim of malicious prosecution, in addition to the court's instruction that U-Haul pay in excess of $800,000 in attorney's fees under the UCL's private attorney general provision.[10]

In its opinion, the court condemned U-Haul's conduct as particularly egregious because of the company's *knowledge* of such agreements' general illegality and, in spite of this knowledge, effectuated an "ingrained, long-term, knowingly illegal corporate practice" that, "[sought] to enforce [its] noncompetition provisions'…[and

[3] CAL. BUS. & PROF. CODE § 16600 (1941) (emphases added).
[4] CAL. BUS. & PROF. CODE § 16601 (recognizing the right of "[a]ny person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all [or substantially] of his or her ownership interest [or all or substantially all of the business' operating assets]…[to] agree to refrain from carrying on a similar business within a specified geographic area…so long as the buyer carries on a like business therein."
[5] *See, e.g., Metro Traffic Control, Inc. v. Shadow Traffic Network* (1994) 22 Cal.App. 4th 853, 863*; Muggill v. Reuben H. Donnelley Corp.* (1965) 62 Cal.2d 239, 242.
[6] *See, Farmers Ins. Exch. v. Superior Ct.* (1992) 2 Cal. 4th 377, 383 (affirming that unlawful business practices in violation of other law could constitute a separately actionable claim under section 17200 of the Business and Professions Code).
[7] CAL. BUS. & PROF. CODE § 17205 (emphasis added).
[8] *Robinson*, at 3.
[9] *Id*. at 14.
[10] Section 17204 of the California Business and Professions Code authorizes private plaintiffs to prosecute violations of the UCL. If successful, plaintiffs may motion to recoup the costs of litigation, including attorney's fees, pursuant to section 1021.5 of the California Code of Civil Procedure.

would]…'without hesitation,…consider any and all remedies available to it at law and in equity.'"[11] Evidence of U-Haul's culpability arose from its litigious history against other dealers, modification of its existing dealer contracts to include a blanket disclaimer proclaiming to "void where prohibited", and failure to produce sufficient evidence of the company's reasonable belief of its dealers' misappropriation of trade secrets; most notably, prior to the company's threatened or requested judicial enforcement of its covenants not to compete.[12] Furthermore, U-Haul's self-proclaimed remedial conduct (*i.e.*, the inclusion of the clause "void where prohibited" in its dealer contracts and voluntary dismissal of its enforcement proceedings against Robinson) occurred only *after* the trial court declared its noncompetition agreement as invalid *and* Robinson continued to prosecute the class action in pursuit of permanent injunctive relief. While U-Haul characterized its conduct as remedying any and all past and/or prospective injuries resulting from its contracts' noncompetition provisions, the court recognized a less virtuous motivation for adopting such measures. In that regard, the court determined U-Haul's actions more accurately reflected the company's, "*resistance* to amending its policies, and *persistence* in pursuing its anticompetitive litigation strategy…"[13]

IV. CAUTION: *ROBINSON'S* PROSPECTIVE IMPACT

Robinson reaffirms the judiciary's resolute commitment toward upholding California's statutory proscription and public policy against covenants not to compete. As a result of their manifest illegality under section 16600, *Robinson* intimated that courts may presume parties to possess at least constructive knowledge of such agreements' illegality. Absent a qualifying transaction's exception under section 16601 or evidence of the agreement's necessity to protect against the misappropriation of trade secrets, parties requesting judicial enforcement of an agreement may incur liability for malicious prosecution as well as for *knowingly* attempting to enforce an invalid agreement in violation of the UCL. As noted by the court in *Robinson*, even extrajudicial *threats* to file suit for the specific enforcement of a covenant not to compete may constitute a sufficiently improper business practice to trigger liability under the UCL.

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[11] *Id*. at 3–4. Not only did the court charge U-Haul with *actual* notice of the noncompetition agreement's illegality following the trial court's refusal to compel specific performance of its terms, but also that case law reinforced the well-established statutory prohibition against "garden variety noncompetition covenants" (the origins of which date back to 1872 in former section 1673 of the state Civil Code) and imparted *constructive* notice of the agreements' illegality. *Id*. at 11–12.

[12] *Id*.

[13] *Id*. at 12.