

### Covenants Not To Compete In Limited Liability Company Operating Agreements May Be Enforceable Without Payment For Goodwill

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Covenants not to compete are commonly seen in partnership agreements and LLC operating agreements. Typically, these non-compete provisions are triggered when the partnership or LLC terminates the interest of a withdrawing partner or member and the non-compete provisions are tied to the receipt of post-withdrawal distributions. Such provisions are not intended to punish the withdrawing partner or member but serve to protect the goodwill of the partnership or LLC.

In California, non-compete covenants are regulated by California Business and Professions Code (“Business and Professions Code”) sections 16600 through 16602.5.<sup>1</sup> Section 16600 generally forbids non-compete provisions subject to certain limited exceptions.<sup>2</sup> Section 16602 allows partnerships to enforce such limited non-compete provisions against a partner upon dissolution of the partnership or the partner’s dissociation from the partnership.<sup>3</sup> Section 16602.5 addresses LLCs and allows limited non-competes against a member “upon or in anticipation of a dissolution of, or the termination of his or her interest in, a limited liability company.”<sup>4</sup> Section 16601 allows limited non-compete provisions in the context of the sale of a business.<sup>5</sup>

Specifically, section 16601 permits buyers to enforce non-compete provisions against a person selling the goodwill of a business, all of his ownership interest in a business entity, all or substantially all of the operating assets of a business entity together with goodwill, or the operating assets or ownership interest in a business entity subsidiary.<sup>6</sup> Section 16601 defines “business entity” to include corporations, partnerships and LLCs.<sup>7</sup> To enforce a non-compete provision pursuant to section 16601, the purchase price must include fair value of the seller’s interest in the company’s goodwill.<sup>8</sup> There is no express requirement under section 16602 or section 16602.5 that the partnership’s repurchase price or the LLC’s terminating price include a goodwill valuation.

It has been argued that, as a result of amendments to sections 16601 and 16602.5, the language in section 16601 regarding “sale” of an interest encompasses the repurchase of a member’s interest upon *voluntary* withdrawal, while section 16602.5’s “termination” language encompasses the repurchase of a member’s interest upon *involuntary* withdrawal.<sup>9</sup> The consequence of this argument is that payment for goodwill would be required for a voluntary withdrawal, but not an involuntary withdrawal, in order to enforce a non-compete against a departing member.

However, the above assertion and its consequence are inaccurate, as case law and the canons of statutory construction lead to the conclusion that section 16601 was intended to address non-compete provisions in the context of sales to third parties, while section 16602.5 was intended to address non-compete provisions triggered by the termination, voluntary or involuntary, of a withdrawing member’s interest. Consequently, payment of goodwill should not be required for an LLC to enforce a non-compete provision against a voluntarily

withdrawing member.

A long history of partnership case law, discussed below, has held that under section 16602, a departing partner is not entitled to goodwill in order for a partnership to enforce a non-compete provision, whether the withdrawal was voluntary or involuntary. Because section 16602.5 is substantively identical to section 16602, the holdings of partnership case law should apply equally to the LLC context. There is no indication that the amendments to sections 16601 and 16602.5 were intended to overrule this precedent or to exclude voluntary withdrawals from section 16602.5's purview. Rather, the plain language and legislative history of the statutes support that section 16601 governs asset and interest transactions with third parties, while section 16602.5 governs transactions with the member's own LLC. This argument is further supported by the public policy behind sections 16602 and 16602.5; that is, that the goodwill of an LLC may be damaged whenever a partner or member withdraws. Thus, requiring payment of goodwill for a voluntary withdrawal and not an involuntary withdrawal would be illogical.

### **A. Like Section 16602, an LLC Need Not Pay Departing Members For Goodwill in Order to Enforce a Non-compete Pursuant to Section 5**

To enforce a non-compete provision under the business sales exception of section 16601, the purchase price must include the payment of goodwill.<sup>10</sup> In contrast, partnerships need not pay departing partners for goodwill in order to enforce a non-compete provision pursuant to section 16602, whether or not the partner's departure was voluntary. For instance, in *Farthing v. San Mateo Clinic*, the court found that a partnership was entitled to simultaneously enforce a non-compete provision and withhold payments from a voluntarily withdrawing partner.<sup>11</sup> The partnership agreement's non-compete provision provided that departing partners would receive monthly payments of accounts receivables, provided they did not practice medicine in a specified geographic area.<sup>12</sup> The departing parties withdrew voluntarily from the partnership and set up a medical practice in the same city.<sup>13</sup> The Court of Appeal concluded that the non-compete provision was enforceable under Business and Professions Code section 16602, despite the lack of continued payment.<sup>14</sup>

Further support for the conclusion that the goodwill requirement of section 16601 should not be read into section 16602 is in *South Bay Radiology Medical Associates v. Asher*.<sup>15</sup> There, the partnership agreement contained a non-compete provision and expressly provided that the partnership's repurchase of dissolving partner's interest would not include compensation for goodwill.<sup>16</sup> Plaintiff, who was declared by the partnership to be a "dissolving partner" after suffering permanent injury, argued that the non-compete provision was unenforceable absent compensation for goodwill.<sup>17</sup> However, the Court of Appeal refused to read section 16601's goodwill requirement into section 16602.<sup>18</sup> In reaching its decision, the court recognized that partners may legitimately protect themselves from the risk of paying departing partners for goodwill that others produced and/or the risk that the partnership's goodwill may be diminished by competition from a withdrawing partner.<sup>19</sup> The court also noted that sections 16601 and 16602 have stood together for nearly 120 years without the California State Legislature expressly making payment for goodwill a requirement of section 16602.<sup>20</sup>

The California Supreme Court reaffirmed the holding of *South Bay* in *Howard v. Babcock*, 6 Cal. 4th 409 (1993). In *Howard*, the partnership agreement required withdrawing partners to forego withdrawal benefits if they competed with the partnership within one year of their departure.<sup>21</sup> Withdrawing partners who competed with the partnership were entitled to receive only their capital contributions.<sup>22</sup> Citing *South Bay*, the Court held that the non-compete provision was enforceable to the extent the agreement assessed a toll on competition within a specified geographical area.<sup>23</sup> The Court explained that a reasonable toll was permitted "to compensate the [partnership] for losses that may be caused by the withdrawing partner's competition with the firm."<sup>24</sup>

The foregoing demonstrates California's long history of enforcing non-compete provisions against resigning partners without payment for goodwill under section 16602, regardless of whether the withdrawal was voluntary or involuntary. Because section 16602.5 provides the same benefits in the LLC context as section 16602 in a partnership context, the partnership case law should apply equally to the LLC context.

## **B. The Amendments to Sections 16601 and 16602.5 Do Not Result in the Exclusion of Voluntary Withdrawals from Section 5's Purview**

Before 2002, a third party purchaser of a corporation's assets could enforce a non-compete provision against the seller; however, a similar right did not exist for third parties who purchased the assets of a partnership or LLC. While the sale exception set forth in section 16601 applied to both equity and asset transactions, the exception was limited to transactions involving corporations and shareholders. At the same time, sections 16602 and 16602.5 set forth the anticipatory bases for enforcing a non-compete term in the partnership and LLC contexts, but these bases were limited to dissolution of the partnership or LLC or to a partner or member's transfer of equity interests to any person or entity (but did not include a sale of the assets of the partnership or LLC). The latter basis was embodied in the provision "sale or other disposition of the partner's interest" for section 16602 and "sale of his or her interest" for section 16602.5.

In 2002, the Legislature expanded section 16601's coverage to include partnerships and limited liability companies so that these entities could obtain a non-compete in the asset sale context.<sup>25</sup> At the same time, "conforming" changes were made to sections 16602 and 16602.5 to eliminate "sale of interest" as a basis for obtaining a non-compete.

Despite the elimination of the "sale of interest" provision, sections 16602 and 16602.5 continue to cover repurchases by the partnership or membership and the rights to obtain non-competes in that context. First, the removal of the "sale" language has no effect on the line of cases supporting that partnerships and LLC's need not pay departing members for goodwill in order to enforce a non-compete provision. *Farthing*, *South Bay*, and *Howard* were all decided under a version of section 16602 that did not contain "sale of interest" as an anticipatory base for obtaining a non-compete. When these cases were decided, section 16602 allowed a non-compete provision only in anticipation of the "dissolution" of the partnership. Thus, the holdings were not dependent upon any "sale" language. It was not until 1996 that the Legislature amended section 16602 to include "a sale or other disposition of the partner's interest in the partnership" as anticipatory grounds for obtaining a non-compete provision. Because this case law was built without reference to any "sale" language, the removal of that language should not suddenly invalidate the long established rule that partner and member withdrawals, whether voluntary or involuntary, are governed by sections 16602 and 16602.5.

Further, there is no indication that the Legislature amended the Business and Professions Code to limit section 16602.5's governance over voluntary withdrawals of partners or LLC members. To the contrary, legislative history demonstrates that the amendments were intended to affect transactions with *third parties*, specifically to extend section 16601's non-compete rights to third party purchasers of partnership or LLC assets. The legislative history describes the goal of the amendments as extending "the same rights to enter into valid non-competition agreements to buyers and sellers of any business entity, thereby eliminating any 'unfair and unnecessary' distinctions between corporations and LLCs and partnerships."<sup>26</sup> The legislative history further provides that "[t]his bill would extend the right of non-competition covenants in these instances involving LLCs and partnerships so that any business trying to purchase another would be protected against unknown liabilities."<sup>27</sup>

The legislative history nowhere addresses the repurchase of a member or partner's interest by the LLC or partnership itself, and nowhere expresses a desire to distinguish between voluntary and involuntary withdrawals from these entities. This silence suggests that the Legislature had no intent to disrupt existing case law that goodwill is not required to enforce non-competes arising from a partnership or LLC's repurchase of interest, notwithstanding the voluntariness of the partner's or member's withdrawal from the company.

Indeed, this analysis of the 2002 amendments is supported by the 2006 amendments to section 16602.5. Following the 2002 amendments, section 16602 was left with dissociation or dissolution as the two bases for obtaining a non-compete provision and section 16602.5 was left with dissolution as the only basis. In 2006, section 16602.5 was amended again, to add "termination of his or her interest" as an additional basis for obtaining a non-compete provision. There is no legislative history generally available on this change, although logic suggests that it is the Legislature's attempt to make clear that sections 16602 and 16602.5 are substantively identical.<sup>28</sup>

### **C. The California Corporations Code Does Not Limit the Scope of Section 5**

Section 16602.5 allows the enforcement of non-compete provisions against a member "upon or in anticipation of a dissolution of, or the termination of his or her interest in, a limited liability company." The relevant Business and Professions Code sections do not contain a definition for "termination," nor do the California Corporations Code ("Corporations Code") provisions addressing limited liability companies.

Corporations Code section 17100(c) provides that "the operating agreement may provide for the termination in whole or in part of the membership interest or economic interest of a member in the limited liability company. If a member's economic interest in the limited liability company is terminated pursuant to the operating agreement, the member may demand and shall be entitled to receive a return of that member's contribution." Notably, this provision may be varied by the articles of organization or the operating agreement.<sup>29</sup> Thus, section 17100(c) merely provides guidance, rather than mandatory requirements. There is no basis to conclude that this guidance was amended by the Legislature to govern the scope of Business and Professions Code section 16602.5.

Further, the Corporations Code defines "withdrawal" to include "the resignation or retirement of a member as a member."<sup>30</sup> The definition of "withdrawal" presupposes a certain level of voluntariness. And, Corporations Code section 17252 clearly states that unless the operating agreement provides otherwise, a withdrawing member is not entitled to payment for his or her interest in the company.<sup>31</sup> Rather, the withdrawing member has only an interest with respect to distributions; thus, under the Corporations Code, a voluntarily withdrawing member is not entitled to payment for goodwill. Given this provision, there is no basis to read into Business and Professions Code section 16602.5 any requirement that a termination of a member's interest must be involuntary.

### **D. In Light of the Case Law and Legislative History, Section 16601 Governs "True Sales" and Section 16602.5 Governs an LLC's Repurchase of a Member's Interests**

The long line of cases refusing to impose a goodwill requirement to section 16602 was decided without reference to any "sale" language. Consequently, the removal of such language from sections 16602 and 16602.5 does not invalidate this precedent. Nor does the legislative history of these amendments evince an intent to overrule these cases.

Instead, the legislative amendments indicate an intent for section 16601 to cover third party sales and the rights to obtain non-compete provisions in that context; while sections 16602 and 16602.5 cover termination and any accompanying repurchases from departing partners or members by the partnership or LLC and the right to obtain non-compete provisions in that context. Doing so achieves internal harmony within the statutory scheme – each provision addresses a different transaction. Further, this argument is supported by the legislative history, which expressly permits asset sales for LLCs and partnerships, and is silent regarding payment of goodwill for voluntarily departing partners or members.

Finally, this interpretation is supported by the practical application of these statutory provisions and the public policy behind them. The goodwill of business is damaged whether a partner or member's withdrawal is voluntary or involuntary. Thus, it is counterintuitive to require payment for goodwill upon a voluntary withdrawal since the goodwill of the business has been damaged by the withdrawal itself. An LLC is not punishing a member when it does not pay for goodwill; rather, by using the statutorily recognized scheme, it is protecting the goodwill of the ongoing LLC.

## Endnotes

1. West 2008
2. Cal. Bus. & Prof. Code § 16600 (West 2008) provides: "Except 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."
3. § 16602 provides:
  1. 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.
  2. Subdivision (a) applies to either of the following circumstances:
    1. A dissolution of the partnership.
    2. Dissociation of the partner from the partnership.
4. § 16602.5 provides:

Any member may, upon or in anticipation of a dissolution of, or the termination of his or her interest in, a limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction recognizing such a series), agree that he or she or it will not carry on a similar business within a specified geographic area where the limited liability company business has been transacted, so long as any other member of the limited liability company, or any person deriving title to the business or its goodwill from any such other member of the limited liability company, carries on a like business therein.
5. 16601 provides:

Any person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree

with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold, or that of the business entity, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein.

For the purposes of this section, “business entity” means any partnership (including a limited partnership or a limited liability partnership), limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction that recognizes such a series), or corporation.

For the purposes of this section, “owner of a business entity” means any partner, in the case of a business entity that is a partnership (including a limited partnership or a limited liability partnership), or any member, in the case of a business entity that is a limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction that recognizes such a series), or any owner of capital stock, in the case of a business entity that is a corporation.

For the purposes of this section, “ownership interest” means a partnership interest, in the case of a business entity that is a partnership (including a limited partnership a limited liability partnership), a membership interest, in the case of a business entity that is a limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction that recognizes such a series), or a capital stockholder, in the case of a business entity that is a corporation.

For the purposes of this section, “subsidiary” means any business entity over which the selling business entity has voting control or from which the selling business entity has a right to receive a majority share of distributions upon dissolution or other liquidation of the business entity (or has both voting control and a right to receive these distributions.)

5 *Id.*

6 *Hill Group v. Wycoff*, 86 Cal. App. 4th 895, 903-04 (2001).

7 See note 4.

8 See Richard Darwin, *The Enforceability of Covenants Not to Compete in Limited Liability Company Operating Agreements*, Bus. Law News (State Bar of California, S.F., Cal.), Issue 3, 2010, at 5.

9 *Hill*, 86 App. 4th at 901-04.

10 *Farthing San Mateo Clinic*, 143 Cal. App. 2d 385, 392-93 (1956).

11 *Id.* at 387.

12 *Id.*

13 *Id.* at 392-93.

14 *South Bay Radiology Medical Associates Asher.*, 220 Cal. App. 3d 1074 (1990).

15 *Id.* at 1077-78.

16 *Id.* at 1078.

17 *Id.* at 1080.

18 *Id.* at 1083-84.

19 *Id.* at 1083.

20 *Id.* at 412.

21 *Id.*

22 *Id.* at 424-25.

23 *Id.* at 425.

24 AB 601, Floor, 2001-2002 Reg. Sess. (Cal 2002), *available at* [http://www.leginfo.ca.gov/pub/01-02/bill/asm/ab\\_0601-0650/ab\\_601\\_bill\\_20020715\\_chaptered.html](http://www.leginfo.ca.gov/pub/01-02/bill/asm/ab_0601-0650/ab_601_bill_20020715_chaptered.html); *see also* Cal. B. Analysis, AB 601, S. Floor, 2001-2002 Reg. Sess. (June 20, 2002), *available at* <http://sfa.senate.ca.gov/whatisthesenateofficeofflooranalysis>; Cal. B. Analysis, AB 601, Assemb. Floor, 2001-2002 Reg. Sess. (June 27, 2002), *available at* <http://sfa.senate.ca.gov/whatisthesenateofficeofflooranalysis>.

25 Cal. B. Analysis, AB 601, Assemb. Floor, 2001-2002 Reg. Sess. (June 27, 2002), *supra*.

26 *Id.*

27 *See People v. Modiri*, 39 Cal. 4th 481, 499 (2006) (explaining that when statutory amendment reconciles statutes on similar subjects and earlier statute has been judicial construed, legislature is presumed to be aware of that construction and incorporate it into the amended statute)

28 *See* Corp. § 17005(b) (West 2006).

29 CAL. CORP. § 17001(a) (Supp. 2012).

30 (West 2006).

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