



CAVEAT EMPTOR: COMMON COMMERCIAL CONTRACT RESTRICTIONS INCLUDING EXCLUSIVE LICENSES MAY BE VOID

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California Business and Professions Code section 16600 (Section 16600) has far-reaching implications in both the employment and commercial contexts of which every lawyer should be aware. Parties have used Section 16600 to support the position that commercial contract obligations most people take for granted, such as exclusive broker or license agreements, are void.

Section 16600 is short and simply worded as far as statutes typically go, stating “[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.” Section 16600 is best known for restricting the use of non-competition agreements in the employment context, especially since the seminal 2008 California Supreme Court case *Edwards v. Arthur Andersen LLP*.¹ Section 16600 reaches beyond the employment arena, however, and can be a powerful tool in the commercial context. Understanding the scope of Section 16600 could enable a savvy lawyer to use it to the benefit of a client who seeks to avoid a contractual obligation and to defend against the argument that a bargained-for contractual provision crucial to a client’s business is invalid. Additionally, Section 16600’s potential implications in the commercial context make knowledge of them important for transactional

lawyers to ensure they properly advise clients when drafting and/or negotiating agreements.

This article provides a brief background on Section 16600 in the employment context. It then focuses on the inconsistent application of Section 16600 in the commercial context, including examples of commercial applications of Section 16600, trends in the use of Section 16600, and strategies for defending against claims that Section 16600 invalidates an undesirable contract provision.

Employment Non-Competes Generally Are Void

Section 16600’s reach in the employment context is well established in case law and there are few questions regarding its scope. Most commonly, California’s Section 16600 is notorious for making non-competition clauses invalid after termination of employment, with limited exceptions. Three statutory exceptions allow properly tailored non-competition clauses even when restrictions on employment are involved, for example, when in connection with dissolving a partnership or interest in a LLC and in connection with the sale of the goodwill of a business. Cal. Bus. & Prof. Code §§ 16602, 16602.5, 16601. Case law also establishes that contractual provisions restricting employees’ use of employer trade secrets during and post-employment are

generally valid.² This article does not focus on the employment context since that area already has been extensively analyzed.

Inconsistent Legal Landscape in Commercial Cases

Application of Section 16600 outside the employment context is far less common. Without a post-*Edwards* California Supreme Court case directly on point, cases interpreting the statute in commercial contexts have reached different outcomes. The resulting inconsistencies in the case law provide an opening for creative parties to use Section 16600 as a sword or a shield to argue for results that at times defy logic and common business practice.

Notwithstanding Section 16600’s broad language that any contract that restrains a person’s ability to practice their trade is void, subject to the limited statutory exceptions discussed above, there are a few commonly allowed exceptions to the general rule outside the employment context, namely: (1) radius or exclusive use clauses in conjunction with real property leases;³ (2) franchise or franchise-like agreements;⁴ and (3) dividing property in the family court setting in order to preserve property value.⁵ Outside of these enumerated areas, courts are inconsistent in their application of Section 16600 to commercial restraints. Some courts use an approach similar to the rule of

reason in the antitrust context, looking carefully at the purpose, fairness, and implications of a restraint. However, particularly after *Edwards*, most courts strictly construe Section 16600 to void any restraint on trade no matter how limited its scope. Even though the limited issue involving Section 16600 before the California Supreme Court in *Edwards* was whether a post-termination restraint on an employee's ability to engage in his profession was valid, subsequent courts have used the *Edwards* opinion's strong and uncategorical language condemning agreements that restrain trade with equal force in the commercial context.

Below is a representative sample of commercial Section 16600 cases, focusing on those cases decided after *Edwards*. The observable patterns in the case law are limited. Consequently, it is difficult to predict how a court will rule when faced with the argument that Section 16600 voids a commercial contract provision that limits a party's ability to engage in some aspect of business.

Rule-of-Reason Type Analysis

There are a limited number of cases, mostly federal, that interpret Section 16600 to allow reasonable restraints on trade. These cases analyze the restraint consistent with existing antitrust law, which applies a "rule-of-reason" analysis and looks at the pro-competitive aspects of restraints as well as their limitations, and voids few restraints as per se illegal. Earlier this year, the Eastern District of California took this approach in *Ixchel Pharma v. Biogen, Inc.*,⁶ where the court explicitly held that, outside the employment context, the rule of reason should be used to evaluate the restraint. Finding that the agreement at issue was "merely a restriction that prevents [plaintiff] from competing with defendant in very limited and defined circumstances," the court held that the restriction does not offend Section 16600.

In a published opinion, a judge in the Northern District of California took a similar approach in *Hendrickson v. Octagon*, doing an extensive analysis of a fee-sharing agreement in the sports agency context (which included colorful sports analogies and movie references for those interested in an entertaining opinion) before holding that portions of the purported restraint were void and other portions were not, even though they were part of an employment agreement. The court considered the fairness of the provisions in the context of the industry, and the need to ensure that the parties to the agreement were

properly compensated.⁷ Commercial litigants could advance a similar argument.

Further, in *Vasili v. ART Corporate Solutions, Inc.*,⁸ a Central District of California court upheld a commercial restraint on providers of a patented chiropractic technique, explaining that unlike the employment context, "exclusive-dealing" contracts between business associates are not necessarily invalid. There are also a handful of pre-*Edwards* cases that take the rule of reason approach in the commercial context and that have not been overruled, though one could argue they are of questionable precedent after *Edwards*.⁹

Strict Interpretation of Section 16600

Many cases, especially after *Edwards*, literally construe Section 16600 and find that *any* restraint on trade is illegal.¹⁰ A few illustrative examples:

- *Robinson v. U-Haul Co. of Cal.*, 4 Cal. App. 5th 304 (2016): A provision prohibiting

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the plaintiff from renting anything other than U-Haul trucks while a U-Haul advertisement for his business was still running (and for a year after) violated Section 16600.

- *Total Recall Techs. v. Luckey*, 2016 U.S. Dist. LEXIS 5659 (N.D. Cal. Jan. 16, 2016): The plaintiff entered into an agreement with the defendant whereby the plaintiff would pay the defendant to create a prototype. The contract gave the plaintiff the exclusive rights to the defendant's design. The court would not grant a motion to dismiss because issues of fact existed regarding implications of intellectual property (IP) rights, but did explain that the exclusivity clause would be illegal at least in part if it were found not to implicate IP rights.
- *Cole Asia Bus. Ctr., Inc. v. Manning*, 2013 U.S. Dist. LEXIS 85818 (C.D. Cal. June 16 2013): This involved a non-solicitation

agreement between the plaintiff's business and the defendant's business. The defendant sent a mass mailing to the plaintiff's clients. The court found the non-solicitation covenant in the parties' agreement was void pursuant to Section 16600 because it did not involve protection of IP as the client list had been provided to third parties.

- *SriCom, Inc. v. eBisLogic, Inc.*, 2012 U.S. Dist. LEXIS 131082 (N.D. Cal. Sep. 13, 2012): The plaintiff agreed to find consultants for the defendant's clients and the parties' agreement contained a one-year restraint on the defendant's ability to hire employees of the plaintiff who were performing services through the defendant. The court held that the contract "unequivocally purports to restrain" and is therefore invalid under Section 16600, holding that post-*Edwards*, the rule of reasonableness is not used even for restraints between businesses.

Some pre-*Edwards* cases followed a similar analysis.¹¹

Trends and Strategies

Most cases are trending towards strict interpretation of Section 16600, but there is room for arguments on both sides. As Justice Brandeis observed, every agreement concerning trade restraints, and in commercial contexts, contracts are due course, therefore a strict interpretation of Section 16600 is seemingly absurd in some contexts. The following are some examples of Section 16600 arguments we have seen

in our practice over the last few years, including in pleadings and demurrers, where parties have used Section 16600 creatively in an effort to avoid a disfavored contract provision.

- Section 16600 invalidates restrictions in an exclusive license agreement that allocated a limited segment of the market for a limited time period to the party who funded the development of the product and thereby enabled the product to make it to market in the first place, in exchange for royalty payments to the product developer. Exclusive license agreements are commonplace in practice, but a strict read of Section 16600 could render them unenforceable unless the restraint is based entirely on IP rights.
- Section 16600 invalidates contract limitations on company operations within a limited geographic area. Radius limitations are generally upheld in the property/lease context, but a strict read of Section

16600 could render such restrictions illegal outside the real property context.

- Section 16600 invalidates an exclusive personal service contract or limitations on rights to publicity. However, there is case law supporting exclusive personal service contracts, in particular in the sports context; therefore, Section 16600 is less likely to invalidate these types of unique agreements.¹²
- Section 16600 invalidates a no-hire provision in an employment litigation settlement agreement. Most employers want to protect themselves from having to re-hire an employee who sued them and therefore put no-hire provisions in any settlement agreement. But one federal case, *Golden v. California Emergency Physicians Medical Group*,¹³ questions the validity of a no-hire provision in a settlement agreement if it provides a substantial restriction on the employee's ability to work in his or her chosen profession. In *Golden*, the court seemed to take issue with a restriction that allowed the employer to terminate the employee if the employee ended up working for the employer through an acquisition, but the issue was remanded so the court never made a final holding.

What happens if the court does find that a restriction is illegal per Section 16600? You may try to have the restriction reformed to eliminate whatever aspect is illegal, while preserving any non-offensive portions, if doing so is possible.¹⁴ But rather than reforming the contract, courts are likely to void or sever the offending provisions altogether as illegal¹⁵ to avoid encouraging parties to overreach when drafting restrictions in the first place.

Though more often than not we see Section 16600 used to void commercial restrictions, if you find yourself on the other side of the argument, the following are key facts that courts have emphasized when they find restrictions do not run afoul of Section 16600: (1) the restriction is in-term;¹⁶ (2) the restriction is necessary to properly compensate a party to the transaction;¹⁷ and (3) the restriction is narrowly tailored.¹⁸ Further, a party also could argue that a restriction promotes business and competition more than it restrains, and therefore it is valid, analogizing to antitrust case law. Though the antitrust statute states in absolute terms that restraints on trade are void, just like Section 16600, courts applying antitrust law have used the rule of reason to uphold pro-competitive restraints.¹⁹ If a product never would have been launched but for the party who holds the IP for the product granting an exclusive license to the

product to its funder for a defined period of time in a limited market segment, one could argue these pro-competitive effects outweigh any limitations and should be considered, like they would be in the antitrust context. We have not yet seen a court grapple with the inconsistencies between a strict interpretation of Section 16600 and antitrust law's rule of reason approach, but this is an area ripe for consideration.²⁰

Conclusion

Section 16600 has been popping up consistently in our practice over the last couple of years, including in the commercial context. It can be used as a tool or be a thorn in your side. Additionally, it presents client management challenges since the outcome of a dispute which involves competing interpretations of Section 16600 depends on many variables counsel does not control. Similarly, counsel should alert clients to the uncertainties surrounding interpretation of this statute when drafting agreements and in other commercial transactions. It is ripe for California Supreme Court review to clarify how, if at all, *Edwards* applies outside the employment context. Until the California Supreme Court takes up review, parties can creatively use Section 16600 as yet another tool in business disputes. Lawyers should carefully evaluate how Section 16600 can help promote their clients' interests and how to defend against its use against their clients' interests so that they and their clients are not blindsided.

ENDNOTES

(1) *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937 (2008).

(2) *See, e.g., Fowler v. Varian Assocs.*, 196 Cal. App. 3d 34, 44 (1987).

(3) *See, e.g., Martikian v. Hong*, 164 Cal. App. 3d 1130 (1985); *see also* Cal. Civ. Code § 1997.210(a).

(4) *See, e.g., Comedy Club, Inc. v. Improv West Assoc.*, 553 F.3d 1277 (9th Cir. 2009); *Aussie Pet Mobile, Inc. v. Benton*, 2010 U.S. Dist. LEXIS 65126 (C.D. Cal. June 28, 2010) (finding unreasonable restraint in franchise agreement will be void).

(5) *See, e.g., In re Marriage of Greaux & Mermin*, 223 Cal. App. 4th 1242 (2014).

(6) 2018 U.S. Dist. LEXIS 13548 (E.D. Cal. Jan. 25, 2018).

(7) *Hendrickson v. Octagon Inc.*, 225 F. Supp. 3d 1013 (N.D. Cal. 2016).

(8) 2015 U.S. Dist. LEXIS 90086 (C.D. Cal. July 10, 2015).

(9) *See, e.g., Centeno v. Roseville Cmty. Hosp.*, 107 Cal. App. 3d 62 (1979); *Dayton Time Lock Serv., Inc. v. Silent Watchman Corp.*, 52 Cal.

App. 3d 1 (1975); *Great W. Distillery Prods., Inc. v. John A. Wathen Distillery Co.*, 10 Cal. 2d 442 (1937) (applying predecessor to Section 16600).

(10) *See, e.g., Total Recall Techs. v. Luckey*, 2016 U.S. Dist. LEXIS 5659 (N.D. Cal. Jan. 16, 2016); *Artec Grp., Inc. v. Klimov*, 2016 U.S. Dist. LEXIS 170194 (N.D. Cal. Dec. 8, 2016); *Robinson v. U-Haul Co. of Cal.*, 4 Cal. App. 5th 304 (2016); *Cole Asia Bus. Ctr., Inc. v. Manning*, 2013 U.S. Dist. LEXIS 85818 (C.D. Cal. June 18, 2013); *SriCom, Inc. v. eBisLogic, Inc.*, 2012 U.S. Dist. LEXIS 131082 (N.D. Cal. Sept. 13, 2012); *Richmond Techs., Inc. v. Aumtech Bus. Sols.*, 2011 U.S. Dist. LEXIS 71269 (N.D. Cal. July 1, 2011); *Reguieg v. Sears*, 2009 Cal. App. Unpub. LEXIS 2225 (Mar. 19, 2009) (not citable but provides insight regarding how a court might approach the issues).

(11) *Kelton v. Stravinski*, 138 Cal. App. 4th 941 (2006); *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Cal. 1990); *Beatty Safway Scaffold, Inc. v. Skrable*, 180 Cal. App. 2d 650 (1960).

(12) *MCA Records, Inc. v. Newton-John*, 90 Cal. App. 3d 18 (1979); *see also Lemat Corp. v. Barry*, 275 Cal. App. 2d 671 (1969).

(13) 782 F.3d 1083 (9th Cir. 2015).

(14) *Comedy Club, Inc.*, 553 F.3d 1277.

(15) *Kolani v. Gluska*, 64 Cal. App. 4th 402 (1998).

(16) *See, e.g., Artec Grp., Inc. v. Klimov*, 2016 U.S. Dist. LEXIS 170194 (N.D. Cal. Dec. 8, 2016).

(17) *Hendrickson*, 225 F. Supp. 3d 1013.

(18) *See, e.g., General Commercial Packaging v. TPS Package Eng'g*, 126 F.3d 1131 (9th Cir. 1997).

(19) *See, e.g., In re Cipro Cases I & II*, 61 Cal. 4th 116, 135-36 (2015).

(20) *See* Steven M. Perry & Sean F. Howell, *A Tale of Two Statutes: Cipro, Edwards, and the Rule of Reason*, Munger, Tolles & Olson LLP, available at <https://m.mto.com/Templates/media/files/Reprints/A%20Tale%20of%20Two%20Statutes%20by%20Steven%20Perry%20and%20Sean%20Howell.pdf> (last visited Mar. 14, 2018).



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