The Enforceability of Covenants Not to Compete in Limited Liability Company Operating Agreements

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It is quite common for limited liability companies to include covenants not to compete ("non-competes") in their operating agreements. These non-competes are generally triggered upon the company's repurchase of a member's ownership interest when one of its members withdraws from the company. Such non-competes do not present a problem when the repurchase price represents the fair value of the membership interest, including the departing member's interest in the company's goodwill. However, where a limited liability company seeks to punish voluntarily departing members by forcing them to sell their interests back to the company at a penalty price (i.e., one that does not take goodwill into account) and simultaneously seeks to enforce a non-compete, it runs afoul of California law. This article concludes that in the context of a limited liability company, a repurchase price that does not take goodwill into account cannot form the basis for the valid non-compete in California.

Covenants not to compete generally are void as a matter of public policy in California. *Kelton v. Stravinski,* 138 Cal. App. 4th 941, 949 (2006). California Business and Professions Code section 16600 sets out the rule and provides, "[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." Any agreement by an employee or independent contractor not to compete with his or her employer after leaving that employment is void under this standard. *Bosley Medical Group v. Abramson*, 161 Cal. App. 3d 284, 288 (1984).[1] Nonetheless, there are a few limited exceptions to this general rule. Business and Professions Code section 16601 provides in part that "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" may agree with the buyer to refrain from carrying on a similar business within a specified geographic area. The term "business entity" is defined in section 16601 to mean a partnership, limited liability company, or corporation. A related section, Business and Professions Code section 16602.5, permits a member of a limited liability company to agree not to compete "upon or in anticipation of a dissolution of, or the termination of his or her interest in" the limited liability company.

One important distinction between sections 16601 and 16602.5 is that the former requires that the selling party receive compensation for the goodwill of the business entity (including if it is a limited liability company) as a component of the purchase price. *See, Hill Medical Group v. Wycoff*, 86 Cal. App. 4th 895, 903 (2001). In *Hill*, the plaintiff Dr. Wycoff was an employee and shareholder of a corporation comprised of radiologists. The operative stock redemption agreement required Dr. Wycoff to sell his shares back to the corporation upon the termination of his employment, and also contained a three-year covenant not to compete within a specified geographic area. When Dr. Wycoff resigned and sold his shares back to the corporation, he received a purchase price that *did not* include any component of goodwill. *Id.* at 899. The corporation thereafter sued Dr. Wycoff to enforce the non-compete agreement. The trial court denied the corporation's request for an injunction, and the appellate court affirmed. Specifically, the court of appeals found that the stock repurchase transaction did not bring the non-compete within the exception created by section 16601. As the court explained, "[i]n order to restrain the seller's profession, trade, or business, there must be a clear indication that in the sales transaction, the parties valued or considered goodwill as a component of the sales price, and thus, the share purchasers were entitled to protect themselves" from competition by the selling shareholder. *Id.* at 903. In short, *Hill* instructs that without proof that the purchase price took into account corporate goodwill, the purchaser of a business cannot protect itself against competition from the seller, as the transaction will not fall within the exception against non-competes covered by section 16601. *Id*. at 604.

Section 16602.5, on the other hand, does not impose a similar requirement upon the transactions falling within its scope. *See South Bay Radiology Med. Ass'n v. W.M. Asher, Inc.*, 200 Cal. App. 3d 1074, 1083 (1990) (refusing to read the goodwill requirement of section 16601 into section 16602, which is substantively identical to section 16602.5 but addresses partnerships). Like *Hill*, the *South Bay Radiology* case involved a group of radiologists; however, the group was organized as a professional partnership, not a corporation. The operative partnership agreement provided that a "dissolving partner" would be prohibited from competing with the part-

nership for five years in a certain area, and also specified that in valuing the dissolving partner's interest, "no allowance" would be made for goodwill. *Id.* at 1077. When the partners attempted to enforce the covenant not to compete against the plaintiff, Dr. Asher (through an arbitration proceeding), argued that the non-compete was invalid because the value he received for his partnership interest did not include a component of goodwill. The court of appeals rejected the argument. "Given their express terms and the foregoing history, we cannot accept Asher's argument the goodwill requirement of section 16601 should be read into section 16602. For almost 120 years versions of each statute have stood together…[t]hough given the opportunity through the recodification and amendment of both provisions, the Legislature has never expressly made compensation for goodwill a predicate to application of section 16602." *Id.* at 1083.

Presumably, limited liability company operating agreements that include provisions requiring departing members to sell their interests back to the company for something less than fair market value (i.e. without paying for goodwill), yet still impose a covenant not to compete, are premised upon the theory that such a transaction is covered and permitted by section 16602.5. Specifically, those drafting operating agreements with clauses of this sort appear to assume that a transaction in which a member voluntarily withdraws and sells his or her interests back to the company falls within the exception allowing non-competes "upon or in anticipation of…the termination of his or her interests in" in the limited liability company.

This interpretation, however, cannot be maintained in the face of several well-established rules of statutory construction, and is inconsistent with the legislative history of sections 16601 and 16602.5.

It is a core principle of statutory interpretation that the plain language of statute governs its meaning. Cal. Civ. Proc. Code § 1858. Thus, courts first look to the words of statute, giving effect to the usual, ordinary import of the language. "When the legislature uses materially different language in statutory provisions addressing the same subject or related subjects, the normal inference is that the legislature intended a difference in meaning." *Kleffman v. Vonage Holdings Corp.*, -- Cal. 4th -- (2010), 2010 WL 2471753, *5 (Cal. June 21, 2010), *citing People v. Trevino*, 26 Cal. 4th 237, 242 (2001). A corollary to this rule teaches that statutory construction requires ascertainment of the Legislature's intent "so as to effectuate the purpose of the statute as a whole." *Playboy Enters., Inc. v. Super. Ct.*, 154 Cal. App. 3d 14, 20 (1984). "[Thus] that every word and phrase employed is presumed to be intended to have meaning and perform a useful function; [and] a construction rendering some words in the statute useless or redundant is to be avoided." *Id.* at 20-21. A review of the statutes at issue here shows that there is a material difference between the broad language utilized by section 16601, which addresses any transaction in which a member is "selling or otherwise disposing of" his or her ownership interests in the limited liability company, and the more specific language of section 16602.5, which addresses "the termination of [the member's] interests in" the company.

The legislature chose to use differing terms. Thus, following the rules of statutory construction explained above, the presumption is that the Legislature used these different terms for a reason, and intended them to address separate and distinct types of events. Section 16601 addresses any transaction involving the *sale or disposition* of ownership interests, and section 16602.5 addresses the *termination* of those same interests. This interpretation is further supported by the legislature's use of the term "termination" in other statutory provisions addressing limited liability companies, allowing the statutes to be harmonized. It also makes sense from a logical perspective.

Section 17100(c) of the California Corporations Code provides that "the operating agreement [of a limited liability company] 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." The same section further provides that if a member's interest in the limited liability company is "terminated" in this manner, the member is entitled to receive a return of his or her initial contribution. In other words, as used by the legislature in the portions of the California Corporations Code governing limited liability companies, a "termination" of a member's interest is (1) an event defined in advance by the operating agreement, (e.g., an expulsion for cause); (2) in which the member's ownership may be involuntarily extinguished; and (3) in which the member is not entitled to receive anything more than his or her initial contribution to the company. Because sections 16601 and 16602.5 describe such radically different transactions, it makes sense that the legislature would address a "termination" of this sort (a pre-defined involuntary expulsion in which the seller is not legally entitled to receive compensation for goodwill) in a section separate from that addressing "sales" of ownership interests.

Practitioners asserting a contrary view would argue that "termination" should be given a broader interpretation to cover

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14. Do fundraising solicitations meet federal and state law requirements? Are solicitation materials accurate, truthful, and candid? Are fundraising costs reasonable? Does the organization provide information about fundraising costs and practices to donors and the public?

15. Enter the number of voting members of the governing body that are independent. Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee? (These questions are easy to state, but torturous to determine under the detailed pages of definitions and examples in the instructions to the Form 990. There are "reasonable efforts" examples for the questions that recommend the use of Questionnaires, sufficiently supplemented with definitions, to solicit the needed information from the officers, directors, trustees, and key employees to answer the questions. In the end, the answers will not help anyone determine if members who were not independent at the time removed themselves from the relevant discussion and vote. It is possible that each member at one time or another during the year had a conflict of interest in some matter affecting the organization, resulting in "0" on the 990—no members are "independent;" in which case an explanation on Schedule O of the implementation of the Conflict of Interest and Compensation Policies would be useful from a public relations standpoint.)

16. Did the organization make significant changes to its organizational documents since the prior Form 990 was filed?

17. Did the organization become aware during the year of a material diversion of the organization's assets? (What procedures are in place for checks and balances?) ■

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any transaction in which the relationship between a member and a limited liability company comes to an end, including those in which the member's interest is sold back to the company. But this interpretation is at odds with another, equally well-established principle of statutory construction: statutory schemes should be interpreted to produce internal harmony, and to avoid redundancies. *See Legacy Group v. City of Wasco*, 106 Cal. App. 4th 1305, 1313 (2003).[2] Interpreting the "termination" language of section 16602.5 to include even a narrow category of *sales* transactions would mean that two different statutory sections, with very different requirements regarding the calculation of a purchase price, both address the exact same type of transaction. In the case of a voluntarily withdrawing member who is selling his membership interest back to the company, it would be impossible—under this interpretation—to discern which of the two competing sections (16601 or 16602.5) should cover the transaction. This is precisely the sort of redundancy—and uncertainty—that this rule of statutory interpretation is intended to avoid.

Finally, interpreting the "termination of interest" language to exclude sales transactions is consistent with recent changes made to sections 16601 and 16602.5. In 2002, in response to complaints regarding the disparate treatment of limited liability companies and corporations under the non-compete provisions and exceptions of the Business and Professions code, the legislature scaled back the coverage of section 16602.5 by removing "or a sale of his or her interest in a limited liability company" from its text. The legislature simultaneously modified section 16601 to include limited liability companies within the definition of "business entity." These changes reveal the legislature's clear intent that section 16601 governs *all* sales of limited liability company membership interests, including voluntary withdrawals by members in which their ownership interests are repurchased by the company, and that section 16602.5 is *not* intended to cover those same transactions.

Operating agreements that punish a voluntarily withdrawing member with a non-compete obligation coupled with an artificially low repurchase price do not square with the plain meaning, legislative intent, or legislative history of sections 16601 and 16602.5. While a limited liability company is certainly entitled to enforce a non-compete agreement upon the termination of a member's interest, any effort to define such an event to include the repurchase of a member's interest upon his or her voluntary withdrawal is at risk of a successful legal challenge by the departing member. ■

Endnotes

1 This is distinguishable from contractual agreements pursuant to which an employee or contractor agrees not to use or disclose confidential and proprietary information learned during the course of employment in connection with new employment. There may be some circumstances where a confidentiality agreement might be drawn so broadly as to be interpreted as an impermissible non-compete, but that issue is not within the scope of this article.

2 See also, *Lexin v. Super. Ct.*, 47 Cal. 4th 1050, 1095 (2010) ("When interpreting a statute, we endeavor to harmonize it with other enactments to the extent possible."); *San Leandro Teach-*