To Penalize or Not to Penalize: When are Covenants Not To Compete Enforceable in California?

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Owners of businesses, whether the businesses are organized as corporations, LLCs or partnerships, frequently agree that they will not compete with the business while they are owners and for a specified period after they cease to be owners. It is also common for the business's governing agreement, whetherit be a shareholders' agreement, an operating agreement or a partnership agreement, to permit the forced repurchase of an owner's interest in the event that the covenant not to compete is violated. When the repurchase price represents the fair value of the membership interest, non-competes of this sort do not present a problem. However, where a business seeks to punish an owner by forcing him to sell the interest back 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.

Non-compete agreements are void as a matter of public policy in California, but there are a few limited exceptions to the general rule. Generally, under §16601 of the Business and Professions Code, "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 to include a partnership, a limited liability company or a corporation.

In order for the covenant to be enforceable following repurchase of the interest, both the ownership and the sale must be bona fide. In Hill Medical Corporation v. Wycoff (2001) 86 Cal.App.4th 895, the Court of Appeal held that a covenant not to compete was unenforceable against a selling shareholder if the shareholder does not receive value for the goodwill that is attached to his shares. In Hill v. Wycoff, Dr. Wycoff was a shareholder in a radiology group in Pasadena that had fourteen shareholders. The shareholders were all party to a redemption agreement that required them to sell their shares back to the corporation at a price measured by tangible book value of the corporation (without goodwill). Dr. Wycoff left the group and sold his shares for book value. The group sought to enjoin him from competing within the 7.5 mile noncompete radius. The trial court held the restriction unenforceable. The Court of Appeal affirmed, holding that a sale that did not pay an owner the fair market value of the interest, including the value of the goodwill of the business, did not satisfy the exception in §16601, and was unenforceable.

The Wycoff case involved a corporation, but the principle is equally applicable to LLCs and partnerships because they are included in the definition of the term "business entity." Similarly, its reach is not limited to medical practices. Most ambulatory surgery center governing documents, for example, require an owner to redeem his interest if he violates the covenant not to compete. Often, the price paid for interests purchased as a result of competition or other "adverse" events represents a discount from the price that would otherwise be payable, whether determined by an appraisal or the application of a formula. Under the rule of Hill v. Wycoff, there is significant question regarding whether such a transaction could support a noncompete under California law. For example, an ASC operating agreement may provide that upon termination of a membership interest, the interest is repurchased at a price equal to three times the ASC's trailing 12 month EBITDA, a price intended to represent the fair market value of the interest and to obviate a need for appraisal. The same operating agreement may prohibit ownership of another facility within 10 miles of the ASC, and may make such ownership an adverse terminating event. However, for members who compete, the price is fifty percent (50%) of the formula price. If four times EBITDA represents fair market value, then two times EBITDA cannot represent fair market value. Does the exception in §16601 apply in this instance? It should not. The analysis is even starker if the penalty price is based on book value (as it was in the Wycoff case) or on capital account balance, which is frequently nominal in mature surgery businesses.

These issues should be considered at the outset of a business, when the governing agreements are put into place. The question is which is more important: punishing a "rogue" owner or being able to enforce a covenant? Most remaining owners find it galling to pay a breaching owner the full fair market value of his interest, but if the covenant is important they must do so.

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