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JUDGMENT CALL

Noncompete clauses in California

Using LLC membership interests to create enforceable provisions

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Most people know that noncompetes generally are not enforceable in California. Most people also know there is a limited exception for noncompetes in connection with the sale of a business where the purchase price includes a payment for the goodwill of the business.

Fewer people know that LLC memberships held by key employees can be the basis for an enforceable noncompete at termination of the interest.

So, how does this work? Section 16602.5 of the Business and Professions Code is the statutory basis for the LLC membership exception to the general bar against noncompetes. Section 16602.5 provides that any member in an LLC may agree in anticipation of the termination of his or her interest in an LLC that he or she will not carry on a similar business within a specified geographic area where the LLC business has been transacted, so long as any member or any person deriving title to the business or its goodwill from any other member carries on a like business.

This means that if an employer-LLC awards membership interests to employees, that employer-LLC may be able to enter into noncompetes with those employee-members that are enforceable under California law.

Of course, there is a caveat: The membership interests must be meaningful. In other words, they cannot be a “sham” designed solely to get around the bar against noncompetes. Indications of a sham interest may include having an insignificant interest, requiring the employee to give up existing compensation in return for the interest, having a pre-set and equivalent buy-in and buyout payment, unreasonably limiting the potential for economic gain from the interest, lack of distributions tied to the interest, and awarding interests to employees who have no role in management of the enterprise.

Unlike the sale of business exception, there is no requirement under Section 16602.5 that the LLC repurchase the interest upon termination for

a price that includes a payment for goodwill. In *South Bay Radiology Group* (1990), the court held that the goodwill requirement of Section 16601 should not be read into 16602 (that is, the partnership section). The factors the court relied on in reaching this holding were 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. The court then qualified the potentially broad implications of this holding by stating that partners may legitimately protect themselves from these risks under Section 16602 by not paying for goodwill so long as all partners are subject to the same limitations and so long as the person is a bona fide partner (the partnership interest is not a sham).

Because Section 16602.5 is nearly identical to Section 16602—the differences between these two sections are limited to the different terminology used to describe a member v. a partner—the *South Bay Radiology* holding should apply equally to the LLC context. The California Supreme Court in *Howard v. Babcock* (1993) cited *South Bay Radiology* with approval, thus underscoring the validity of the holding. A 2002 case, *Hill Medical*, reaffirmed that the goodwill requirements of Section 16601 have never been read into Section 16602 (and by extension, 16602.5).

Even so, the noncompete must still pass muster under the statute. Specifically, the duration may extend only so long as LLC (or any other member or any person deriving title to the business or

its goodwill from any such other member) carries on like business. The restricted geographic area cannot be broader than the geographic area where the LLC was doing business at the time of the termination of the LLC interest. Exactly what that may include should be discussed with counsel, but it is generally considered to include geographic areas where the company is demonstrably seeking business, not just those where it is actually conducting business. Finally,

the scope of the noncompete cannot exceed the business of the LLC at the time of the termination of the interest. ■

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