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Franchise Alert: It May Be a New Day for Enforcement of Franchise Covenants Against Competition in California

08/11/2020 | 3 minute read

Section 16600 of the California Business and Professions Code states:

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.

Thirty years ago, in *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Cal. 1990), a federal district court in California held that Section 16600 voided any post-termination covenant against competition contained in a franchise agreement relating to a franchised unit operating in California. Since then, that decision has been viewed by the franchise bar as reflecting established California law.

On August 3, 2020, the California Supreme Court, in *Ixchel Pharma, LLC v. Biogen, Inc.*, 2020 WL 4432623 (Cal. Aug. 3, 2020), held that agreements covered by Section 16600 that are between businesses, rather than between an employer and its employee, are subject to case-by-case review under the "rule of reason." Although *Ixchel* did not arise out of a franchise relationship, it is likely to dramatically change franchisors' ability to enforce covenants against competition in California.

In *Ixchel*, the plaintiff Ixchel Phama entered into an agreement with Forward Pharma to develop a drug treatment for a neurological condition. While it was working with Ixchel, Forward was also negotiating with the defendant Biogen, Inc. to resolve a patent dispute. In settling that dispute, Forward agreed with Biogen that Forward would withdraw from its relationship with Ixchel. Ixchel then sued Biogen in federal court in California alleging, among other things, violation of Section 16600.

The United States District Court for the Eastern District of California granted Biogen's motion to dismiss, holding, in part, that Section 16600 did not apply outside of the employment context. Ixchel appealed to the Ninth Circuit, and the Ninth Circuit certified two questions to the California Supreme Court. One was:

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Does section 16600 of the California Business and Professions Code void a contract by which a business is restrained from engaging in a lawful trade or business with another business?

Id. at *3.

Not surprisingly, the California Supreme Court responded that Section 16600 did, in fact, apply in the business context. But the court went on to provide guidance as to the appropriate standard to be applied under the statute. When they appear in contracts between businesses, the court instructed, restrictive covenants should be reviewed under a "rule of reason" that considers the various interests in question based upon the facts of the case. Id. at *10. In doing so the court distinguished the policy considerations underlying enforcement of covenants not to compete in the employment setting from those at issue in assessing similar provisions in commercial agreements. Id.

A specific example offered by the court of a potentially enforceable restrictive provision in the commercial setting is an exclusive dealing provision in a franchise agreement. Recognizing the possible procompetitive effects of such a provision the court expressly refused to "call such arrangements into question simply because they restrain trade in some way." Id. at *17. In the end, the California Supreme Court instructed the Ninth Circuit to apply a "rule of reason" analysis to determine whether the restrictive covenant in the Biogen-Forward agreement was a reasonable restraint on trade. Id. at *18.

The California Supreme Court's holding in *Ixchel* that in cases under Section 16600 the "rule of reason" is to be applied to competitive restraints in contracts between businesses does not directly answer all of the questions that may be raised about the enforcement under Section 16600 of covenants against competition contained in franchise agreements. For example, it does not specifically address whether a distinction might be drawn between in-term and post-term covenants against competition in the franchise setting. However, in that regard, it should be noted that appropriately limited post-termination covenants against competition in franchise agreements have been found to be supported by legitimate commercial interests and to be reasonable and enforceable under the laws of virtually every other state. See generally Covenants Against Competition In Franchise Agreements, 3d ed. (ABA Forum on Franchising 2012). A strong argument can be made that California law has now joined that camp.

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