BY JEFFREY HURON

Statutory Constraints on Partnership Agreements

IT IS COMMON KNOWLEDGE that business partners have fiduciary duties to each other and the partnership, which fundamentally include a duty not to compete with the partnership.[1] Similarly, managers and members in a member-managed limited liability company owe a fiduciary duty not to compete with the company.[2] Disputes between partners and members typically involve claims that a partner breached his fiduciary duty by wrongfully competing with the company. The duty not to compete in the partnership context is so well established and ingrained that California's strong public policy in favor of free competition is counter-intuitive and thus often overlooked in partnership litigation.[3] This is a mistake.

California Business and Professions Code Section 16600 "embodies the original, strict common law antipathy towards restraints of trade," and establishes a "prohibition against restraints on trade as follows: 'Every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.'"[4] If "a contract creates an illegal restraint on trade, there is nothing that the parties can do that will in any way add to its validity," and "it cannot be ratified."[5] Section 16600 permits noncompete agreements only "in two narrow situations: when a person sells the goodwill of a business, and when a partner agrees not to compete in anticipation of dissolution of a partnership."[6]

A partner's duty not to compete therefore can conflict with California's settled policy in favor of open competition, and, when it does, Section 16600 will invalidate any restriction on a partner's right to compete. Regarding Section 16600's application to ongoing partnerships, *Kelton v. Stravinksi* is the law.[7] In *Kelton,* the court found that a noncompete letter entered into in connection with a partnership constituted an illegal restraint on trade, and was, therefore, void.[8] There was nothing about the partnership relationship that warranted an exemption from Section 16600. The court expressly held that "[i]n the partnership context, an ongoing business relationship does not validate the covenant."[9] Therefore, even between partners, "covenants not to compete in contracts other than for either the sale of goodwill or dissolution of a partnership are void."[10]

The plaintiff partner in *Kelton* did argue the noncompete letter was enforceable because it is consistent with a partner's duty under Corporations Code Section 16404 not to compete. The court rejected this argument because the partners had inconsistently agreed to limit their fiduciary duties in other agreements that explicitly allowed them to engage in competitive real estate activities.[11] The rights to compete were consistent with Section 16600's prohibition of restraint on trade, and there was no basis for the plaintiffís claim that his partner's pursuit of a competing venture violated Corporations Code Section 16404 because the parties had expressly agreed in other agreements to permit competition.[12]

The *Kelton* Court's refusal to enforce a noncompete agreement even between partners is consistent with the U.S. Supreme Court's instruction against judicially created common law exceptions that undermine Section 16600's broad applicability. "California courts have repeatedly held that Section 16600 should be interpreted as broadly as its language reads."[13] Accordingly, *Kelton* is widely cited for its holding that covenants not to compete between partners are void.[14]

Partnership agreements (and similarly operating agreements)[15] often contain language limiting the duties or obligations of partners with regard to the right to compete or entitling the partners to compete with each other and the partnership consistent with Section 16600's prohibition against restraint of trade. To circumvent such language, however, complaining partners and their attorneys resort to alleging broad partnership terms and even oral or umbrella (parent) type partnership agreements that purport to supersede free-to-compete language. For example, they may allege the partners agreed to do all business together as in *Kelton,* or that one partner cannot pursue an investment without the consent of the other. However, as *Kelton* makes clear, partnership agreements that create an illegal restraint of trade are invalid and unenforceable pursuant to section 16600. ■

---

[1] A partner's duty of loyalty includes to "refrain from competing with the partnership in the conduct of partnership business before the dissolution of the partnership." Corp. Code §16404(b)(3).
[2] Corp. Code §17704.09.
[3] Hill Med. Corp. v. Wycoff, 86 Cal. App. 4th 897 (2001).
[4] Edwards v. Arthur Anderson LLP, 44 Cal. 4th 937, 947-48 (2008).
[5] Kelton v. Stravinksi, 138 Cal. App. 4th 941, 946-47 (2006).
[6] Kolani v. Gluska, 64 Cal. App. 4th 402, 407 (1998) (citing Bus. & Prof. Code §§1601, 1602).
[7] Kelton, 138 Cal. App. 4th 941.
[8] *Id.* at 950.
[9] *Id.* at 944, 947.
[10] *Id.* At 946.
[11] *Id.* at 944, 948. *See* Corp. Code §16103(b)(3)(A).
[12] *Id.* at 948.
[13] Scott v. Snelling & Snelling, Inc., 732 F. Supp. 1034, 1042 (N.D. Cal. 1990).
[14] *See, e.g.*, Holtzman, et al., California Antitrust and Unfair Competition Law §12.06 (Matthew Bender, 2015) (citing *Kelton* (138 Cal. App. 4th at 947), stating that a noncompete provision made "in anticipation of a partnership" rather than during the partnership's dissolution constitutes an illegal restraint of trade); 17A C.J.S. Contracts §327 (2016) (citing *Kelton* that "a covenant not to compete as between two partners will be unenforceable as a matter of law where it is not executed as part of the sale of the good will of a business or the dissolution of the partnership.").
[15] Operating agreements may reasonably reduce the duties of care owed by a manager and a member in a member-managed limited liability companies. Corp. Code §17701.10(14).

Jeffrey Huron is the managing member of Dykema Gossett's Los Angeles office. He specializes in business and real estate litigation often involving partnership disputes.