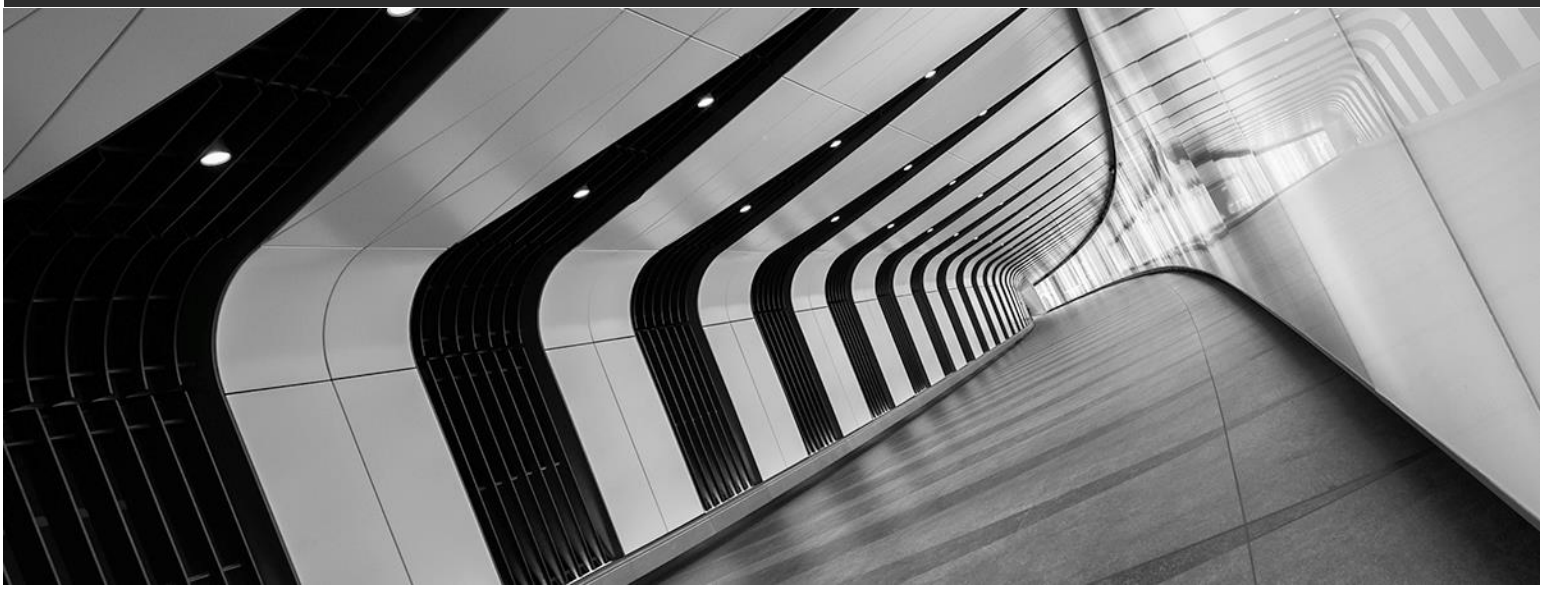
Calif. Supreme Court Clarifies Reach of Business and Professions Code §16600 and Terminable At-Will Business Contracts



By Todd A. Pickles and Kurt A. Kappes | Aug. 21, 2020 | The Recorder

The California Supreme Court in *Ixchel Pharma LLC v. Biogen*, (Aug. 3, 2020, No. S256927), issued an important opinion with far-reaching application to litigation challenging business agreements.

California Business and Profession Code Section 16600 provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." The court, having previously held that employee noncompete agreements are void (subject to statutory exceptions), held that a rule of reason analysis applies in determining whether a business contract implicates Section 16600. In so holding, the court rejected an argument that any agreement that restrains trade is per se illegal under Section 16600. Instead, where an agreement, outside the employment context, limits other business transactions, the agreement is unlawful when the "agreement harms competition more than it helps" after considering various factors.

The court also held that, when alleging a claim for tortious interference with a business contract that is terminable at will, a plaintiff must allege an independent wrongful action beyond termination of the agreement. The *Ixchel* decision will create a higher bar for challenging legitimate business transactions.

The Background

The case involved three actors—Ixchel Pharma, Forward Pharma, Biogen—and two agreements—a collaboration agreement between Ixchel and Forward, and a subsequent settlement agreement between Forward and Biogen.

Ixchel is a biotechnology company that develops small-molecule drugs to treat mitochondrial disease. Ixchel has been developing an experimental therapeutic drug to treat Friedreich's ataxia, a rare neurological disease. The active pharmaceutical ingredient in Ixchel's drug is dimethyl fumarate (DMF). In January 2016, Ixchel entered into an agreement with Forward, a Danish biotech company that develops drugs containing DMF to treat neurological disease.

Under the terms of the agreement, Ixchel and Forward agreed to jointly develop a new DMF drug. For its part, Forward, with Ixchel's assistance, would be responsible for the clinical trials and managing the manufacturing and commercialization of the drug with FDA approval. Ixchel would be entitled to a percentage royalty on sales of the approved drug. Forward could terminate the agreement.

Meanwhile, Forward was also trying to resolve an intellectual property dispute with Biogen. Biogen is a pharmaceutical company that sells a DMF drug to treat multiple sclerosis. As part of the settlement that was executed in January 2017, Forward agreed to "terminate" its agreement with Ixchel to develop a DMF drug.

As the settlement required, Forward provided written notice to Ixchel that it was terminating the agreement, including ceasing all of Forward's work to develop a new DMF drug and the planned clinical trials. Ixchel alleged that, without Forward's participation, or the participation of another partner, it could not develop its new drug.

The Federal Court Litigation

Ixchel filed suit against Biogen in the U.S. District Court of the Eastern District of California, alleging claims for relief, including that Biogen tortiously interfered with Ixchel's agreement with Forward. The district court granted Biogen's motion to dismiss the complaint. Relevant to the California Supreme Court's decision, the district court held that Ixchel was required to allege "independently wrongful conduct" for its claim of tortious interference with contract. The district court noted this was an unsettled area of California law beyond the employment context but found the weight of California authority supported application of the rule to all at-will contracts. The court found that the agreement, as alleged, was at will, and that Ixchel did not allege any independently wrongful conduct other than Forward's mere termination of the agreement itself. Ixchel was given leave to amend.

In its second amended complaint, Ixchel alleged that an independent wrongful act was the settlement between Biogen and Forward. Ixchel argued that under the California Supreme Court's decision in *Edwards v. Arthur Andersen LLP*, (2008), 44 Cal.4th 937, any restraint on competition—here the settlement—is barred under California's Business and Professions Code Section 16600, which states that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." The district court disagreed. It held that *Edwards* was confined to the employment context and that the rule of reason instead applied under Section 16600. Applying that text to the settlement, the district court found that Ixchel alleged a speculative harm to competition that was not sufficient to state a claim and dismissed the complaint without further leave to amend.

Ixchel appealed to the Ninth Circuit, which recognized that its decision turned on two unsettled areas of California law and, therefore, certified the matter to the California Supreme Court on two related questions. The first issue was whether Section 16600 of the California Business and Professions Code voids a "contract by which a business is restrained from engaging in a lawful trade or business with another business?" The second question was whether "a plaintiff [is] required to plead an independently wrongful act in order to state a claim for intentional interference with a contract that can be terminated by a party at any time, or does that requirement apply only to at-will employment contracts?"

The California Supreme Court

The California Supreme Court addressed both of the certified questions, in reverse order, in its written opinion issued Aug. 3, 2020.

Must an independently wrongful act be pleaded for tortious interference with contracts that are terminable at will?

The court held that a plaintiff must plead some independent wrongful conduct for tortious interference with an agreement that is terminable at will. The court started by reaffirming that claims for tortious interference with contract have been treated differently than for tortious interference with prospective economic advantage. Where there is only a prospective economic relationship, "the expectation of future relations is weaker and the interest in maintaining open competition is stronger, [such that] the law usually takes care to draw lines of legal liability in a way that maximizes areas of competition free of legal penalties."

The court then noted that in *Della Penna v. Toyota Motor Sales U.S.A.*, (1995), it held that a cause of action for intentional interference with prospective economic advantage requires allegation of an act "wrongful by some legal measure other than the fact of interference itself." The court reasoned that this requirement "struck a balance between providing a remedy for predatory economic behavior and keeping legitimate business competition outside litigative bounds." In *Ixchel*, the court extended the same reasoning to claims for intentional interference with contracts that are terminable at will.

The court recognized that in *Reeves v. Hanlon* (2004), it held that claims for tortious interference with at-will employment contracts require pleading an independently wrongful act. The court rejected Ixchel's argument that *Reeves* was or should be limited only to the employment context. Instead, the court explained that *Reeves* relied, in part, on the broader understanding that "the economic relationship between parties to contracts that are terminable at will is distinguishable from the relationship between parties to other legally binding contracts" and is actually more akin to a prospective economic relationship. "Like parties to a prospective economic relationship, parties to at-will contracts have no legal assurance of future economic relations."

The court also explained that "allowing interference with at-will contract claims without requiring independent wrongfulness risks chilling legitimate business competition." The court further noted the mischief that would befall business transactions if parties were not required to allege more than the termination of an at-will contract itself, including that parties could face liability for merely responding to solicitations from a party to a terminable at-will contract. "Allowing disappointed competitors to state claims for interference with at-will

contracts without alleging independently wrongful conduct may expose routine and legitimate business competition to litigation."

• Are all restraints on trade per se illegal under Section 16600?

The California Supreme Court next addressed whether all restraints on trade violate Section 16600, and thereby satisfy the independently wrongful act requirement. The court began by holding that Section 16600 applies to all business contracts, noting that this was not in dispute. Instead, the salient question was what standard applies under Section 16600 to business contracts. Ixchel argued that, based on the California Supreme Court's decision in *Edwards*, any restraint on trade under Section 16600 is per se illegal. The court rejected this argument. It explained that, "In context, Section 16600 is best read not to render void per se all contractual restraints on business dealings, but rather to subject such restraints to a rule of reason."

The court explained that in its prior decisions interpreting Section 16600 and its predecessor statute it made distinctions between the types of contract that potentially restrained trade. "Agreements not to compete after the termination of employment or the sale of interest in a business were invalid without regard to their reasonableness." In contrast, "agreements limiting commercial dealings and business operations were generally invalid if they were unreasonable." The court explained that *Edwards*, which involved a contract restraining employment, was a continuation of this "nuanced" distinction, and that "the rationale in *Edwards* focused on policy considerations specific to employment mobility and competition." The court stated that outside of the employment context it has "long applied a reasonableness standard to contractual restraints on business operations and commercial dealings." Under this rule of reason approach, the focus is whether "agreement harms competition more than it helps" by considering "the facts peculiar to the business in which the restraint is applied, the nature of the restraint and its effects, and the history of the restraint and the reasons for its adoption."

The court further explained that Section 16600 must be interpreted in the larger context of California's statutory scheme regulating trade. Specifically, the court noted that Cartwright Act was interpreted to apply only to unreasonable restraints on trade despite sweeping language similar to Section 16600. The court also noted that when the predecessor to Section 16600 was adopted, it was understood to codify the existing common law rules restricting unreasonable restraints on trade. Further, the court explained that to interpret Section 16600 to void all restraints on trade would have far-reaching negative consequences. The court noted that some restraints on trade promote competition, such as business partnerships or exclusive dealing agreements, including franchise agreements. "Such arrangements can help businesses leverage complementary capabilities, ensure stability in supply or demand, and protect their research, development, and marketing efforts from being exploited by contractual partners."

The court concluded by finding that the settlement must be reviewed under the rule of reason. The court did not decide whether, under the rule of reason, the settlement was an unreasonable restraint on trade. The case now returns to the Ninth Circuit.

The Impact of 'Ixchel'

The California Supreme Court in *Ixchel* charted a pragmatic course in interpreting Section 16600 and interference with contracts that are terminable at will. The court noted that such agreements are common in business and resisted a bright-line bar to all agreements that have some restraint on trade. After *Ixchel*, a party that alleges a claim of tortious interference with a

terminable-at-will-contract will need to assert some independent wrongful conduct beyond termination of the contract by a party. More broadly, *Ixchel* makes clear that outside of the employment context, business contracts such as franchise agreements, business partnerships and exclusivity agreements will be analyzed under the rule of reason, with a case-specific focus on whether the restraints harm competition more than they benefit it. To avoid challenges under Section 16600, businesses should be prepared to articulate pro-competitive benefits of agreements that might limit some transactions, including justifying the agreement within the context peculiar to the industry, and should be able to document the history of the agreement in question. However, the onus will be on the party challenging the restraint to allege facts that, if true, would show some non-speculative harm to competition. Businesses involved in legitimate transactions can breathe a sigh of relief after *Ixchel*.

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