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INVOLUNTARY DISSOLUTION: THE NUCLEAR OPTION

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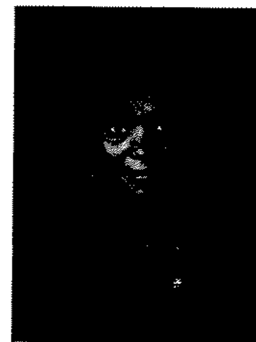

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Business lawyers frequently (and seemingly more frequently when times are tough) find themselves representing closely held business owners whose relationships with the other owners have soured to one degree or another. In some instances, the parties' exit strategy, or exit options, are laid out in the written agreement governing their relationship, whether it be a Shareholders' Agreement, Operating Agreement, or Limited Partnership Agreement. In other instances, however, a writing may not exist. Frequently, even when it does exist, it may not provide a clear path for the contending owners to resolve their differences.

Often, each contending faction of owners wants to keep the business. In many cases, however, there may be no mechanism for one owner or faction to buy out the interest of the other owner or faction. Tensions can be magnified when owners cannot agree on governance or business strategy. Sometimes, for example, a majority owner, although unable to force the departure of a minority owner, may hijack effective control of the entity by virtue of its superior voting power.

In a frustratingly large percentage of cases, the operative documents were entered into long before the client had engaged a lawyer to help solve the problem. At that point, there often seems nothing to do but negotiate, until one of the contending factions outlasts the other or gives up in exhaustion. In a situation where neither party is compelled to sell its interests by the terms of the governing document, it can seem as though there is no way out. In many instances, the governing document even provides that neither party nor faction will dissolve the entity.

Where the owners of a business entity are deadlocked or cannot agree on an exit strategy, the ultimate safety valve may be the involuntary dissolution statute (also called "judicial dissolution"). Importantly, contractual provisions prohibiting dissolution refer to voluntary dissolution. For example, limited liability company operating agreements frequently include an agreement by the majority member that it will not take any action to dissolve the limited liability company. This is necessary to protect the investment and expectations of the minority member. However, these provisions do not apply to bar a judicial dissolution, which always remains available as an option when the statutory grounds are met.

The chart below sets forth the involuntary dissolution statutes for corporations, limited liability companies, and limited partnerships in California and Delaware. For each business entity, the chart identifies the applicable involuntary dissolution statute, the party or parties authorized by the statute to initiate involuntary dissolution, the statutory grounds for involuntary dissolution and, finally, whether and upon what terms the other owners of the business entity can avoid dissolution by purchasing the interest of the moving party. As shown by the chart, California permits the non-moving owners of its business entities to avoid dissolution of the entity by buying out the moving party at an appraised value.

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Comedy Club, Inc. v. Improv West Associates: The Ninth Circuit Limits Franchisors' Use Of In-Term Non-Competition Covenants To Those Situations Where The Covenant is "Narrowly Tailored"

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In *Comedy Club, Inc. v. Improv West Associates*, 553 F.3d 1277 (9th Cir. 2009), the Ninth Circuit held that an in-term (during the term of the contract/relationship) covenant not to compete governed by California law was enforceable to the extent that it did not foreclose competition in a substantial share of a business, trade, or market. The court overturned an arbitrator's ruling that permitted a nationwide in-term covenant not to compete for "manifest disregard of the law." The court relied on an apparent variant of the Ninth Circuit's "narrow restraint" doctrine and older California state law authority to support a watered-down version of the covenant not to compete. Because arbitration decisions are notoriously difficult to overturn, the Ninth Circuit's ruling was somewhat unexpected in light of a 2008 U.S. Supreme Court decision that many believed disposed of the "manifest disregard of the law" standard entirely. Further, the case may have questioned longevity when examined in light of the California Supreme Court's recent decision in *Edwards v. Arthur Andersen*, 44 Cal. 4th 937 (2008) ("*Edwards*").

The Ninth Circuit's decision has several important implications for franchisors with a California presence. First, the court's decision has the potential to limit franchisors' use of non-competition covenants during the term of the franchise agreement. Under the decision, in-term covenants not to compete governed by California law must be "narrowly tailored" (i.e., not foreclose competition in a substantial share of a business, trade, or market). In contrast, existing California authority holds that post-term covenants not to compete in franchise agreements are void and unenforceable regardless of how "narrowly tailored" the covenant may be. *See Scott v. Snelling*, 732 F. Supp. 1034, 1040-41 (N.D. Cal. 1990).

The court also modified the arbitrator's injunction to permit the injunction only against the enjoined company and those persons in active concert or participation with the company. By contrast, the arbitrator's injunction had enjoined tangential family members, e.g., ex-spouses of the principals of the enjoined company, from competing in the industry during the term of the non-compete covenant. This is significant because franchisors often include broad definitions of affiliates in franchise agreements. Now, an in-term covenant not to compete will not be enforceable against family members based on a family relationship alone.

Next, the long-term vitality of the Ninth Circuit's decision is arguably questionable in light of the California Supreme Court's decision in *Edwards*, a case which rejected the very "narrow restraint" doctrine used by federal courts to justify certain restrictive covenants such as the in-term covenant in *Comedy Club*. In *Edwards*, the Supreme Court held that covenants not to compete are void in California under Business and Professions Code section 16600 (Cal. Bus. & Prof. Code § 16600) unless permitted by a *statutory exception*. Section 16600 provides that "[e]xcept 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." Whether *Edwards* also applies to in-term covenants not to compete in franchise agreements is unclear.

A. Background and Procedure

Comedy Club Inc. ("CCI") owned and operated restaurants and comedy clubs nationwide. Improv West founded the Improv Comedy Club and owned the "Improv" and "Improvisation" trademarks. In June 1999, the parties executed a trademark licensing agreement (the "Agreement") where CCI, as licensee, would have exclusive use of Improv West's trademarks nationwide as it opened new nightclubs. In exchange, CCI was to open four clubs a year and was prohibited from opening any non-Improv comedy clubs during the term of the Agreement. *Comedy Club*, 553 F.3d at 1281.

After CCI failed to open clubs in a timely manner, Improv West revoked CCI's license and threatened to start opening Improv clubs itself. CCI filed suit in the Central District of California seeking a declaration that the covenant prohibiting CCI from opening any non-Improv comedy clubs was void under CAL. BUS. & PROF. CODE § 16600. Improv then filed a demand for arbitration under the Agreement's arbitration clause and the district court ordered the parties to arbitration. *Id.* at 1282.

At the heart of the dispute was section 9(j) of the Agreement, which stated:

> Licensee shall not own or operate, and Licensee shall ensure that none of its Affiliates shall own or operate any bar, restaurant, nightclub, or other facility which presents live stand-up or sketch comedy performances or live improvisational performances, other than the Melrose Improv or a Club, or Second City. *Id.* at 1281.

The arbitrator's award was sweeping and held that section 9(j) of the Agreement was valid and enforceable for the remainder of the Agreement, which, by its terms, lasted until 2019. The arbitrator issued a nationwide permanent injunction enjoining CCI and its affiliates (which included tangential relatives of CCI principals) from opening or operating any new comedy clubs until 2019 and from changing the name on any of its current clubs. *Id.* at 1283.

After the district court confirmed the arbitration award, CCI appealed the district court's decision to the Ninth Circuit. *Id.* at 1283. The Ninth Circuit reversed the district court and upon writ petition, the U.S. Supreme Court vacated the Ninth Circuit's opinion and remanded the case for the Ninth Circuit to reconsider its decision in light of the Supreme Court's decision in *Hall Street Associates LLC v. Mattel Inc.*, 128 S. Ct. 1396 (2008), which addressed the "manifest disregard for the law" standard for vacating arbitral decisions.

B. Reversal of the Arbitrator's Decision

In *Hall Street*, the Supreme Court held that the Federal Arbitration Act ("FAA") provided the exclusive grounds for vacating an arbitrator's award. *Id.* Many believed that *Hall Street* disposed of the "manifest disregard of the law" standard, which had long been applied in evaluating whether an arbitration award could be judicially vacated. The doctrine allows reviewing courts to vacate an arbitration award where an established and controlling legal authority applies to the dispute, but the arbitrator fails to apply it.

The Ninth Circuit reconciled *Hall Street* with the FAA by stating the "manifest disregard of the law" doctrine was consistent with the court's previous interpretation of the statutory language of the FAA, namely the FAA's language stating that courts may vacate arbitration awards where the arbitrators exceeded their powers. 553 F.3d at 1290 ("We have already determined that the manifest disregard ground for vacatur is shorthand for a statutory ground under the FAA...stat[ing] that the court may vacate "where the arbitrators exceeded their powers," quoting *Kyocera Corp. v. Prudential-Bache T Servs.*, 341 F.3d 987, 997 (9th Cir. 2003).). The Ninth Circuit ultimately held that because *Hall Street* is not "clearly irreconcilable" with *Kyocera*, the "manifest disregard of the law" standard remained a valid ground for vacatur. *Id.* at 1290.

C. The Court Found the In-Term Covenant not to Compete Was Unlawful and Significantly Narrowed Its Scope

The court found that the arbitrator's injunction violated CAL. BUS. & PROF. CODE § 16600 and limited the scope of who was enjoined and its geographical reach as explained below.

1. The Court Significantly Narrowed the Scope of Individuals Bound By the Injunction

First, as to the restrictive covenant's use and definition of "Affiliates," the court found that affiliates included third parties who were not in privity with the parties to the Agreement. *Id.* at 1287-1288. Further, because arbitration clauses generally do not bind non-parties other than third-party beneficiaries, agents or assigns, the court held that the arbitrator did not have the authority to bind non-parties to an injunction. *Id.* The court also found that "[p]recluding non-party relatives or ex-spouses from opening or operating improv-comedy-related businesses or restaurants violates CAL. BUS. & PROF. CODE § 16600. . . . and that [b]y restricting non-party relatives and ex-spouses from engaging in a lawful business, the injunctions, with respect to those persons, exceed the arbitrator's authority." *Id.* The court stated that the injunction should be vacated in so far as it "as it enjoins any of CCI's Affiliates who are not connected to the principals of CCI as, by analogy to Rule 65(d), 'their officers, agents, servants, employees, and attorneys, and [upon] those persons in active concert or participation with them.'" *Id.* at 1288. The court concluded that a narrowing of the restrictive covenant on affiliates is required by CAL. BUS. & PROF. CODE § 16600 and the principle that non-parties generally are not bound in arbitration as such non-parties can only be restrained to the extent permitted by Rule 65(d). *Id.*

2. The Court Narrowed the Geographical Scope of the Injunction

In its analysis concerning the validity of the geographical scope of the in-term covenant, the court remarked that it had not located any Ninth Circuit or California cases holding that in-term

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the loss of significant value for your client. *See In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 648 (7th Cir. 2008) (finding secured creditor's interests can be "dealt with" by modification, impairment, exchange, or elimination; a due on sale clause is not a component of a lien). Thus, it is essential that you and your client pay careful attention to exact terms by which the debtor proposes to make the payments mandated by the Bankruptcy Code.

The import of the "due on sale" clause illustrates the concern. If your client were to make the 1111(b)(2) election, the debtor would be compelled to make $4 million in deferred payments with a net present value of $3 million. Without the due on sale clause, however, the debtor could then sell the property a week later. If the sale price of the property was $4 million in cash, the debtor could (at least in theory) take the $4 million, purchase an annuity that mirrored its payment obligations to your client for $3 million, assign the annuity payments to your client, and then pocket the $1 million difference; alternatively, it could sell the property to the buyer for $1 million, subject to your client's lien and payment terms which, by hypothesis, would have a value of $3 million.[3] In either case, the debtor would get a $1 million windfall while your client would take a loss. Of course, such an outcome flies against the very logic of section 1111(b)(2), but such a transaction is technically compliant with the minimum requirements of the statute. Freely assignable notes carry with them the same hazard. The absence of other traditional protective covenants may not have the same immediate impact but will similarly impact the value of the lender's security.

Conclusion

Now that you've explained the intricacies of section 1111(b) to your client, it understands why it could fare better under the debtor's plan than outside of the Chapter 11: the Bankruptcy Code takes away its right to credit bid on its collateral in the absence of a sale and instead gives the lender the right to a deficiency claim or a secured claim in excess of the current value of its collateral. Without a crystal ball, there is no way to determine whether the lender should make the 1111(b)(2) election. With competent counsel's advice, however, at least it should be able to make an informed bet on how to proceed. ■

Endnotes

1 References herein are to the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*, unless otherwise indicated.

2 See discussion of the "due on sale" clause and related protections below.

3 This example illustrates the difference between receiving nominal payments worth $4 million and receiving *value* of $4 million. An annuity that would provide for nominal payments of $4 million, but over an extended period of time, could be purchased at a price of substantially less than $4 million. This $1 million difference in the foregoing example is value that should be recoverable by your client, but without the "due on sale" clause, may not be accelerated when the debtor sells the underlying real property.

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covenants not to compete of any scope are necessarily valid. *See id.* at 1291. Turning to a franchise case for guidance, the court analyzed *Dayton Time Lock Service, Inc. v. Silent Watchman Corp.*, 52 Cal. App. 3d 1 (1975). *Dayton Time Lock* concerned an in-term exclusive dealing clause in a franchise agreement that prohibited Dayton Time Lock Service, Inc. from selling or leasing any locks or other devices or providing service of any kind in competition with the business of Silent Watchman Corp. *Comedy Club, Inc.*, 553 F. 3d at 1291. In *Dayton Time Lock*, the court upheld the exclusive dealing provision of the contract. 52 Cal. App. 3d at 7. The *Dayton Time Lock* court stated that, while exclusive-dealing contracts are not "necessarily invalid," they "are proscribed when it is probable that performance of the contract will foreclose competition in a substantial share of the affected line of commerce." *Id.* at 7 (citing *Standard Oil Co. v. United States*, 337 U.S. 293, 314 (1949)). The *Dayton Time Lock* court stated that a determination of illegality requires knowledge and analysis of the line of c ommerce, the market area, and the affected share of the relevant market. *Id.*

The Court stated that the *Dayton Time Lock* court imposed "the standards analogous unto federal anti-trust law when interpreting § 16600." *Id.* at 1291. The court then cited *Great Frame Up Systems, Inc. v. Jazayeri Enterprises*, 789 F. Supp. 253 (N.D. Ill. 1992), which it indicated was similar to *Dayton Time Lock*. The court indicated that the Illinois federal court found that California courts support the position that in-term covenants not to compete in franchise agreements would not violate section 16600 but that they still cannot prevent a "party from engaging in an entire profession, business or trade" under California law. *Id.* at 1291, n.15 (citing *Great Frame Up Systems, Inc.*, 789 F. Supp. at 256). The court also cited in the same footnote the Ninth Circuit's opinion in *General Commercial Packaging, Inc. v. TPS Package Engineering, Inc.*, 126 F.3d 1131 (9th Cir. 1997) (per curiam), which addressed a covenant not to compete in a general contractor-subcontractor context and where the Ninth Circuit upheld the covenant not to compete because it only limited the sub-contractor's "access to a narrow segment of the packing and shipping market." *Id.* at 1291, n.15 (citing *General Commercial Packaging, Inc.*, 126 F.3d at 1134).

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The court then examined another California Court of Appeal decision, *Kelton v. Stravinski*, 38 Cal. App. 4th 941 (2006), which held that even though a covenant not to compete was during a business relationship (partnership), it still violated Cal. Bus. & Prof. Code § 16600. *Comedy Club, Inc.*, 553 F. 3d at 1291-1292. According to the Court, *Kelton* reaffirmed that in the franchise context, "[section] 16600 prohibits an in-term covenant not to compete that 'will foreclose competition in a substantial share of the affected line of commerce.'" *Id.* at 1292 (citing *Kelton*, 138 Cal. App. 4th at 947-48).

The court concluded that *Dayton Time Lock* and *Kelton* "make evident that under CBPC § 16600 an in-term covenant not to compete in a franchise-like agreement will be void if it 'foreclose[s] competition in a substantial share' of a business, trade, or market." *Id.* at 1292 (citing *Dayton Time Lock*, 52 Cal. App. 3d at 6 and *Kelton*, 138 Cal. App. 4th at 948). The court further opined that, "California courts are less willing to approve in-term covenants not to compete outside a franchise context because there is not a need 'to protect and maintain the franchisor's trademark, trade name and goodwill.'" *Id.* at 1292 (citing *Kelton*, 138 Cal. App. 4th at 948).

Relying on this analysis and authorities, the court found that CCI's relationship with Improv was in essence a franchise agreement because CCI contracted with Improv to use Improv's trademarks and open comedy clubs modeled on Improv's clubs. *Id.* at 1293.

After weighing CCI's right to operate its business against Improv's interest "to protect and maintain its trademark, trade name, and goodwill," the court concluded that "this balance tilts in favor of Improv West with regard to counties where CCI is operating an Improv club, but under the restraint of Cal. Bus. & Prof. Code § 16600, California law does not permit an arbitrator to foreclose CCI's competition in opening comedy clubs throughout the United States." *Id.* at 1293. The court stated:

> We hold that the arbitrator's ruling that § 9.j. is a valid covenant not to compete ignores CBPC § 16600 and thus is in manifest disregard of the law. To comply with § 16600, the covenant not to compete must be ***more narrowly tailored*** to relate to the areas in which CCI is operating Improv clubs under the license agreement (empasis added). *Id.*

Accordingly, the court upheld a more limited injunction that restricted competition by CCI and those persons in active concert or participation with CCI, but only in counties where CCI continued to operate comedy clubs using the licensed "Improv" name. *Id.* at 1293-1294.

The court's holding that the in-term covenant must be more "narrowly tailored" is significant. First, in the context of franchise and other exclusive dealing agreements, it may actually serve to diminish a franchisor's/licensor's ability to protect its licensed intellectual property and goodwill (at least under a breach of restrictive covenant theory)—unless it can show the scope of the restrictive covenant should be broader because it is necessary to protect and maintain the franchisor's trademark, trade name, and goodwill—because the court equated "narrowly tailored" with restricting the covenant not to compete to "counties" in which CCI was operating an Improv club under the trademark licensing agreement. *See also* 2 Callman, Unfair Competition, Trademarks & Monopolies § 16:16 (4th Ed.) (covenant not to compete with licensor cannot extend beyond the territory in which the licensee operates under the license under *Comedy Club* decision); 34(A) Cal. Jur 3d *Franchises From Private Parties* § 9 (an in-term covenant not to compete in a franchise-like agreement will be void if it forecloses competition in a substantial share of a business, trade, or market).)

Taken on its face, this standard could allow a franchisee to open a competing enterprise in relatively close proximity to an operation subject to the franchise agreement. From the franchisor's perspective, such competition may not be tolerable because the franchisor may presume (and perhaps justifiably so) that the franchisee is necessarily using its intellectual property to maintain a competing business. But as with many things legal, the devil will be in the details as it may be hard for the franchisee to defensibly assert that in operating its competing enterprise it has not made use of the franchisor's intellectual property or otherwise breached the franchise agreement; however, enforcing the in-term covenant not to compete will not be a sure thing as the franchisee may assert that the covenant forecloses competition in a substantial share of a business, trade, or market and violates Cal. Bus. & Prof. Code § 16600.

Second, given the California Supreme Court's rejection in *Edwards* of the Ninth Circuit's "narrow restraint" exception to Cal. Bus. & Prof. Code § 16600 in the context of post-term covenants not to compete, one is left to wonder whether the Ninth Circuit's "narrowly tailored" standard for in-term "franchise-like" agreements will be long-lived. In *Edwards*, the California Supreme Court decided that Cal. Bus. & Prof. Code § 16600 prohibits all employee non-competition agreements unless the agreement falls within limited statutory exceptions. The Court held "[u]nder the statute's plain meaning . . . an employer cannot by contract restrain

a former employee from engaging in his or her profession, trade, or business unless the agreement falls within one of the exceptions to the rule." *Edwards*, 44 Cal. 4th at 946-947. In doing so, the Court provided a bright-line rule, expressly rejecting the federal "narrow restraint exception" used by some courts to construe CAL. BUS. & PROF. CODE § 16600 as permitting non-competition agreements where one is barred from pursuing only a small or limited part of a business, trade, or profession.

Notably, in the Court's decision, there is negative treatment of the Ninth Circuit's decision in *General Commercial Packaging, Inc. v. TPS Package Engineering, Inc.*, 126 F.3d 1131 (9th Cir. 1997), which was cited by the *Comedy Club* court in its analysis. The Court noted that *General Commercial Packaging, Inc.* is one of the cases that follows the Ninth Circuit narrow restraint exception and goes on to state that "no reported California state court decision has endorsed the Ninth Circuit's reasoning, and we are of the view that California courts have been clear in their expression that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat." *Edwards*, 44 Cal. 4th at 949-950.

D. Lessons From the Case

Notwithstanding the lack of precise clarity in California law concerning non-competition covenants in the franchise setting, franchisors should review their franchise agreements, employment agreements, and operating manuals to ensure that they at least comport with the minimum requirements of California law. Apart from copyright, patent, trademark, and potential contract remedies, another avenue to help franchisors protect their intellectual property assets from unlawful in-term and post-term competition by franchisees is California's Uniform Trade Secrets Act, CIV. CODE § 3426, *et seq.* ("CUTSA"). Franchisors should ensure that they have adequate trade secret protections in place so that they can attempt to avail themselves of CUTSA remedies. The following lessons may be gleaned from *Comedy Club* by counsel for franchisors:

1. In-term covenants not to compete may be enforceable in the franchise context in California "to protect trademarks, trade names, and goodwill of a licensor" if they are narrowly tailored and do not foreclose a party from engaging in its business or trade in a substantial section of the market—the geographic scope should be the territory where the company or companies are doing business during the agreement. Franchisors' counsel should review their client's agreements to ensure that they comport with the court's decision and bear in mind that a California court may find that the covenant still violates CAL. BUS. & PROF. CODE § 16600 in light of the *Edwards* decision.

2. Businesses should use caution before utilizing any covenants not to compete in California and should assess whether the restriction on competition can be tied to one of the statutory exceptions to CAL. BUS. & PROF. CODE § 16600. Businesses cannot assume that CAL. BUS. & PROF. CODE § 16600 does not have potential applicability to in-term covenants not to compete. Further, existing California authority holds that post-term covenants not to compete in franchise agreements are void and unenforceable. *See Scott v. Snelling*, 732 F.Supp. 1034, 1040-41 (N.D. Cal. 1990).

3. Franchisors should not include overly broad definitions of "affiliates" in their franchise agreements in California. Courts will not enforce overly broad covenants that restrict non-party relatives from engaging in a lawful business because such covenants violate CAL. BUS. & PROF. CODE § 16600.

4. The court's decision may be seen by some franchisees/licensees/employees as allowing greater mobility, even where proprietary information is taken. Franchisors should consider auditing their intellectual property protections, including trade secret protections, to protect against this risk and ensure that their intellectual capital is adequately protected. Such an audit will assist franchisors to protect their trade secrets from unlawful competition under the CUTSA. ■

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regarding the payment of patronage dividends to their members, have a tax advantage over C Corporations under Subchapter T of the Internal Revenue Code. Dividends paid to the patrons of the cooperative (such as employees or customers) in proportion to the amount of their patronage are not subject to the double tax.

Wisconsin's relatively new cooperative statute is particularly interesting. The statute is a "hybrid" cooperative statute that includes many features from the limited liability company model. This new model was created in response to the fact that under the traditional cooperative statute (including the California cooperative statute), it is virtually impossible to attract outside investment from non-patrons due to severe limits on voting rights for such investors.

Wisconsin's Chapter 193 authorizes the creation of membership interests for investors who are not patrons of the cooperative. Such investor-members' voting rights may not exceed a total of 49%, but the bylaws may provide such members with the power to

veto certain unusual decisions such as merger or dissolution. And, the investors' may not receive more than 70% of the profit allocations and distributions of the cooperative.

A cooperative formed under Chapter 193 may elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code or as a cooperative under Subchapter T.

Proposed Legislation

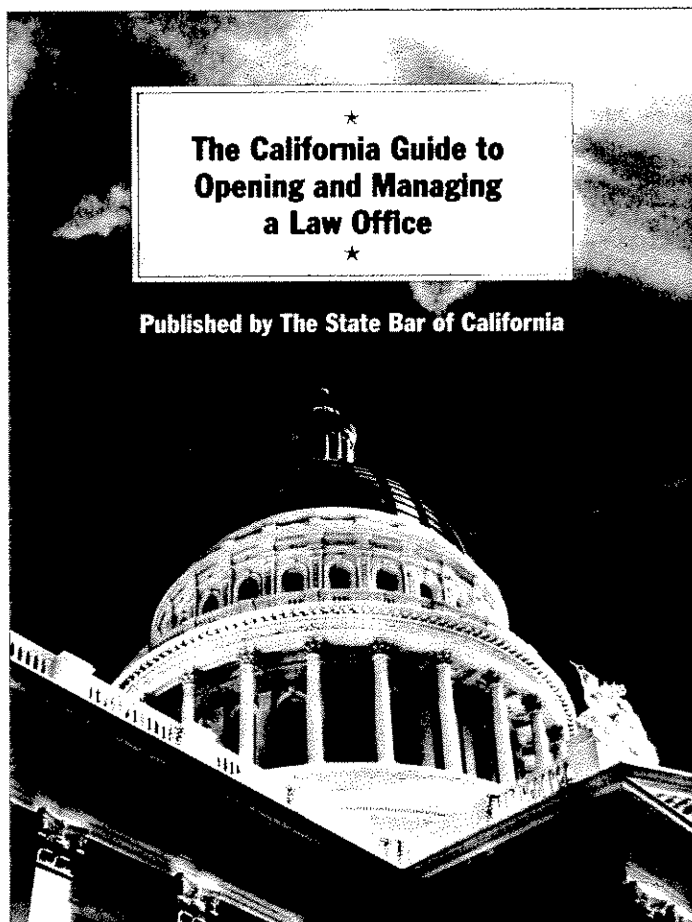
In addition to the three models described above, there is proposed and pending legislation in several states to provide even more alternatives for social businesses. For example, a group of California attorneys and advocates for socially responsible business is drafting legislation to create a new corporate form that would include provisions in the articles of incorporation that explicitly identify one or more social or environmental purposes of the corporation. A group called Citizens for Corporate Redesign in Minnesota has introduced a bill to create a new corporate form called Socially Responsible (SR) Corporation (see the proposed legislation at https://www.revisor.leg.state.mn.us/bin/bldbill.php?bill=S0510.0.html&session=ls86).

Conclusion

Recent events have caused many to question whether business entities should be required to behave more responsibly. For entrepreneurs who want to clearly demonstrate their commitment to socially responsible behavior and practices, there are several structuring options from which to choose. ■

Endnote

1 However, California LLCs may incorporate B Corporation language into their operating agreements.



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