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California High Court: Interference With 'At Will' Contract Requires 'Separate Wrong' to be Actionable

The sky is not falling. Opinion limited to 'at will' contracts.

By Dan Mogin and Jennifer M. Oliver

When a third party craters a contract, you and the other contracting party almost certainly will suffer demonstrable financial ramifications. But if your contract can by its own terms be terminated at-will, the California Supreme Court has now commented, any financial rewards and expenses associated with the agreement fall more into the "prospective" category. Therefore, the court determined, if a third party, a competitor for example, interferes with your at-will agreement they must have committed a separate wrong — beyond the mere interference — for purposes of assessing damages.

That is the result of the court's decision in *Ixchel Pharma LLC v. Biogen Inc*. (No. S256927, Calif. Sup. Ct.; No. 18-15258, 9th Cir.), which held that under Business and Professions Code 16600, tortious interference with at-will contracts between businesses requires "independent wrongfulness," and that when Section 16600 is applied in such circumstances the "rule of reason" applies.

This decision will likely be twisted by some to have broader application. But a fair reading shows that its reach is expressly limited to the context of business-to-business contracts that are terminable at will. In that same limited context, the opinion also now tethers Section 16600 to the restraints on trade prohibitions in Section 16720 and adopts the standard characterizations of *per se* and rule of reason treatments, finding in this particular case that a settlement agreement fell within the rule of reason. Here, the alleged violation of section 16600 was the alleged independently wrongful act accompanying the contractual interference claim.

Yawn. The sky is not falling. Business-to-business covenants not to compete are not per se legal or even per se subject to rule-of-reason treatment. California has not abandoned its strict abhorrence of covenants not to compete, particularly in the employment context, and the antitrust earth is not shaking. One could easily conclude that there are now two statutes under which plaintiffs can bring an action in cases of agreements not to compete.

The court was asked to answer these questions by the Ninth Circuit U.S. Court of Appeals. Before the appellate court is a case in which biotech company Ixchel Pharma LLC claims a competing biotech company, Biogen Inc., interfered with a joint drug-development agreement between Ixchel and Forward Pharma, resulting in the termination of the agreement. The facts of the case are:

- The agreement authorized Forward to terminate "at any time" provided it gave 60 days' notice.
- Ixchel could terminate if Forward informed Ixchel that it would not conduct clinical trials or if it would not submit a timely application with the FDA.
- Forward informed Ixchel that it was proceeding with clinical trials, and the two began planning for the study.
- Separately, while this was happening, Forward and Biogen were working to settle a patent dispute.
- Part of the ultimate patent settlement required Forward to terminate all existing contracts and barred it from entering into any new ones with Ixchel involving development of products containing a specific active ingredient, one that was used in the product Forward and Ixchel were developing.

The court re-worked the questions posed by the Ninth Circuit this way:

- "Is a plaintiff required to plead an independently wrongful act in order to state a claim for tortious interference with a contract that is terminable at will?"

- "What is the proper standard to determine whether section 16600 voids a contract by which a business is restrained from engaging in a lawful trade or business with another business? The questions are related; the alleged violation of section 16600 is the independently wrongful act in Ixchel's contractual interference claim."

The court reviewed the state's "related but distinct" economic torts of interference of a contract and interference with a prospective partnership.

"Tortious interference with prospective economic advantage … does not depend on the existence of a legally binding contract," the court explained, saying a plaintiff asserting this tort must show that the defendant knowingly interfered with an economic relationship between the plaintiff and a third party, a relationship with the probability of economic benefit to the plaintiff.

Prior to its 1995 ruling in *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* (1995) 11 Cal.4th 376, the court said it treated the two torts – a) interference with a contract and b) interference with a prospective advantage — as "two species of the same tort." The biggest difference, the court said, is that affirmative defenses are broader when a defendant interferes with an unconsummated prospective economic relationship.

In *Della Penna* the court held that to recover damages for interfering with a prospective economic advantage a plaintiff must plead that the defendant's conduct was "wrongful by some legal measure other than the fact of interference itself." The court reasoned that damages are awarded when a contract is interfered with "precisely because the exchange of promises resulting in such a formally cemented economic relationship is deemed worthy of protection from interference by a stranger to the agreement." Economic relationships not yet memorialized in a contract need to stand on "different legal footing."

"Because ours is a culture firmly wedded to the social rewards of commercial contests, 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 held in Della Penna.

"Imposing an independent wrongfulness requirement at the pleading stage thus struck a 'balance between providing a remedy for predatory economic behavior and keeping legitimate business competition outside litigative bounds.'"

The court moved next to address whether the same is true for an at-will contract. While interference in this case is actionable as an economic tort, the court said it had yet to determine in previous business-vs-business cases whether the "at will" aspect of a contract makes it more like a contract or more like a prospective economic advantage. The question was never consequential until this case came along, the court said.

In the employment context, however, the court held in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140 that a plaintiff employee must plead "independent wrongfulness" when an employment contract is interfered with. The court said California's public policy favoring employment competition supports the rule. More importantly in this context, the court held that the economic relationship involved in binding contracts and "at will" contracts "is distinguishable," citing *Della Penna*. "[A]t-will contracts do not involve the same 'cemented economic relationship[s]' as contracts of a definite term." The court expressly rejected Ixchel's argument that this approach should be restricted to the employment context.

Again citing *Della Penna*, the court wrote: "Because the expectation of future relations is weaker and the interest in maintaining open competition is stronger, 'the law usually takes care to draw lines of legal liability in a way that maximizes areas of competition free of legal penalties.' In circumstances where parties have no legal assurance of future relations, 'the rewards and risks of competition are dominant.'"

The court noted that parties who enter these contracts are aware of their respective risks, and that with binding contracts not only do the parties make business decisions based on the terms, but so do other parties who may be enlisted to execute various provisions of the agreements.

The court dedicated several pages to explain the history and precedent behind the standard by which contractual restraints are judged, concluding:

"[W]e have long applied a reasonableness standard to contractual restraints on business operations and commercial dealings." The court said it was not disturbing its holdings in *Edwards v. Arthur Andersen LLP* (2008) 44 Cal.4th 937, or other decisions "strictly interpreting section 16600 to invalidate noncompetition agreements following the termination of employment or sale of interest in a business." The court said those decisions do not cast doubt on applying the reasonableness standard in the contractual restraints context.

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