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Goodwill Hunting: Enforcing Non-Competes in California M&A Transactions

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In late August, a California appellate decision provided a useful primer on drafting non-competition covenants in California merger and acquisition transactions. In *Fillpoint LLC v. Maas*, the California Court of Appeals affirmed a judgment of the Orange County Superior Court holding unenforceable a non-compete in an employment agreement entered into as part of a business sale. The decision provides useful guidance for buyers in drafting non-competes to properly protect the goodwill of the acquired business in a manner that will withstand court scrutiny.

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Non-competes in California

California has a strong public policy protecting each person's right to pursue his or her chosen lawful occupation. This public policy is codified in California Business and Professions Code Section 16600 and provides that generally "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 California Legislature has provided an exception to permit non-competes entered into in connection with business sales. Business and Professions Code Section 16601 allows that any person who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business within a specified geographical area in which the business has been carried on for so long as the buyer carries on a like business. This exception is available in transactions structured as a sale of substantially all of the operating assets of a company or its division or subsidiary, or the sale by a shareholder of his or her stock in a company. As part of an enforceable non-compete, courts will also enforce non-solicitation covenants barring the seller from soliciting the sold business's employees and customers.

In allowing this exception, California has recognized the important commercial purpose in protecting the value of an acquired business, recognizing that, when a seller is paid for the goodwill of a business, it is unfair for the seller to engage in competition which diminishes the value of the sold business.

However, courts have emphasized that this exception is limited and have declared that, in order to uphold a non-compete pursuant to Section 16601, the contract may not circumvent California's deeply rooted public policy favoring open competition and must clearly fall within this limited exception.

The Issues Presented in *Fillpoint*

In 2005, Handleman Co. acquired Michael Maas's stock in Crave Entertainment Group. In the Stock Purchase Agreement, Maas agreed not to compete with the sold business for a period of 36 months following the closing. As part of the acquisition, Maas entered into an Employment Agreement containing a non-compete covenant for one year following the termination of his employment with Crave. Maas resigned from Crave about three years after its sale and after the expiration of the non-compete in the Stock Purchase Agreement; however, approximately six months later, he began working for a competitor of Crave during the period that the non-compete in the Employment Agreement remained operative. Fillpoint, which had acquired Crave from Handleman, then sued Maas for breaching his Employment Agreement and also sued his new employer and its principal for interference with contract.

In its decision, the Court was willing to read the Purchase Agreement and the Employment Agreement together as an integrated agreement as the agreements were signed by the parties around the same time and referenced each other. This was helpful to the buyer since a non-compete in an employment agreement, standing alone without integration with a purchase agreement, would be unenforceable. This is also consistent with other California court decisions which have generally held that the location of a non-compete in a document separate from the purchase agreement, such as an employment or non-competition agreement, is not fatal, in and of itself, to its enforcement provided that the covenant otherwise meets the statutory requirements.

However, the Court declared that the fact that the two Agreements should be read together does not mean that the non-compete in the Employment Agreement is enforceable automatically. In striking down the non-compete in the Employment Agreement, the Court distinguished that covenant from the non-compete in the Purchase Agreement Maas had complied with, which the Court considered appropriate to protect the goodwill of the acquired business for a specified period and to serve the purposes of the statutory exception. The Court viewed the non-compete in the Employment Agreement differently, finding that that covenant was much broader and prevented Maas for one year after employment termination from making sales contacts or making actual sales to anyone who was a Crave customer or potential customer, working for or owning any interest in a business which would compete with Crave, or employing or soliciting for employment any of Crave's employees or consultants.

The Court concluded that the non-compete in the Employment Agreement was directed towards affecting Maas' rights to be employed in the future – in this case, for a year after the end of the three-year non-compete period in the Purchase Agreement. In doing so, the Court cited a "concession" in the buyer's appellate brief that the two covenants were intended to deal with different damages the employee might do wearing his separate hats of majority shareholder and key employee. Accordingly, the Court held that the Purchase Agreement covenant was properly focused on protecting the acquired goodwill for a limited period of time, but the Employment Agreement's covenant improperly targeted Maas' fundamental right to pursue his profession.

In addition, the Court also found that the non-solicitation provisions were too broad. It noted that the provision barred solicitation of even potential customers. It also cited its prior decision in *Strategix Ltd. v. Infocrossing West Inc.* which considered non-solicitation provisions prohibiting the solicitation of all employee and customers of the buyer as being impermissibly broader in scope than non-solicitation provisions which barred solicitations of customers and employees of the sold business only.

Key Considerations for Buyers

A review of this decision and other cases leads to a conclusion that had the non-competition covenant in the purchase documentation been drafted differently, the buyer may have achieved its aims by keeping the employee from competing during the one year after his employment ended. For example, the *Fillpoint* decision distinguished an earlier decision in *Alliant Ins. Services v. Gaddy* which upheld identical covenants in a purchase agreement and an employment agreement which applied for the later of five years following the purchase or two years after termination of the employee's employment with the new company.

When drafting non-competes, buyers and their counsel should consider the following:

Integrate, Integrate, Integrate. It is critically important that the various transactional documents appropriately reference each other, particularly if non-compete covenants are contained in documents outside of the Purchase Agreement. The covenants in different deal documents should also be consistent with each other. One of the factors which may have influenced the decision in *Fillpoint* was the fact that Maas had already satisfied his non-compete in his purchase agreement. Accordingly, the buyer had to justify separate and different non-compete provisions in the employment agreement. Had the provisions been consistent with each other, it would not have faced this battle.

Make Your Case for Enforcement in the Deal Documents. The non-compete provisions should be drafted with an eye towards subsequent legal challenge and should make the case themselves as to their absolute necessity to protect the acquired business's goodwill. This can be done through a number of means including, recitals confirming that the purpose of the non-compete is to protect the goodwill and the reasonableness of the provisions in doing so, closing conditions and other provisions which make clear the buyer would not have closed on the purchase without these essential protections, and allocating part of the deal consideration to goodwill.

Don't be Greedy. Buyers should not overreach by barring sellers from activities beyond the scope of the statutory exception. The courts will take umbrage at covenants which not only bar solicitation of the customers and employees of the acquired business but which cast a broader net to all of the buyer's employees and customers. Practitioners sometimes take illusive comfort that courts will "blue pencil" non-competes with overbroad or omitted restrictions and make them enforceable by providing reasonable limitations. However, California courts will not go so far as striking a new bargain for the purposes of saving an illegal contract. As stated by the Court in *Strategix,* "had the parties intended to reach such limited – and enforceable – covenants, they could have negotiated for them. We will not do so for the parties now."

Conclusion

The law governing non-competes in California mergers and acquisitions serves as another example that careful thought and analysis is requisite to accomplish the parties' objectives and to implement their bargained agreements. Parties who proceed without understanding what courts will permit and who overreach do so at their peril.

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