What To Do When a Selling Shareholder Becomes Your Employee: Drafting Enforceable Noncompetes Under Business and Professions Code Section 16601

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In California, there is a strong public policy against the enforcement of covenants not to compete, with an exception in Business and Professions Code section 16601 for noncompetes entered into between acquiring companies (buyers) and the shareholders of the acquired company (sellers). When a selling shareholder becomes an employee of the buyer, the buyer is often interested in having the noncompete start at the termination of the employment of the employee/selling shareholder (typically relying on the fiduciary duty or duty of loyalty of the employees to ensure non-competitive activities during the term of employment). Thus, employment counsel are often asked whether an otherwise legitimate noncompete under Section 16601 can be triggered and begin to run at termination of the selling shareholder's employment, rather than at the closing date of the acquisition.

There are no reported decisions in California answering this question. A noncompete structured in this manner was at issue in *Hilb, Rogal, Hamilton Insurance Services Inc. v. Robb*,[1] but the timing of the trigger (close of transaction versus termination of employment) was not addressed by the parties or analyzed by the court. In *Hilb*, the seller entered into two agreements with the buyer; a merger agreement and an employment agreement which contained a noncompetition agreement.[2] The noncompetition agreement ran for three years from the date of termination of employment.[3] The court addressed the issue of whether the covenant was enforceable even though it appeared in the selling shareholder's employment agreement and not in the merger agreement.[4] The court held that under Section 16601 of the Business and Professions Code, the validity of the covenant is not affected by its location in an employment contract.[5] As the court noted, the "purpose of the statute is served as long as the covenant is executed in connection with the sale or disposition of all of the shareholder's stock in the acquired corporation."[6] The two agreements at issue referenced each other, and the merger agreement referred to the noncompete as a "key requirement" of the transaction.[7] Further, the seller was paid consideration as part of the merger process solely for the noncompete.[8] Accordingly, the court held that there was "no doubt that the covenant was a necessary condition of the merger."[9] For whatever reason, the selling shareholder did not argue that using termination of employment as the trigger made the covenant unenforceable and, thus, the court did not analyze or decide this question. Nonetheless, it is not unreasonable to interpret the decision as impliedly condoning this practice.

More recent California law, however, raises the strong possibility that having the noncompete triggered by the termination of employment will be problematic. The California Supreme Court in *Edwards v. Arthur Andersen LLP*[10] held that there are no common law exceptions to California's statutory prohibition against restraints on trade such as noncompetition agreements. The court stated that covenants not to compete are void, subject only to the express statutory exceptions.[11] There is no "rule of reasonableness" under California, nor any common law exception for a restraint on trade that is narrowly tailored.[12] One exception, as laid out in Section 16601, is where "the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein." Under *Edwards*, either the noncompete falls squarely within a statutory exception or it will be void.

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1 33 Cal. App. 4th 1812 (1995).

2 *Id.* at 1817.

3 *Id.*

4 *Id.* at 1823–24.

5 *Id.* at 1825–26.

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 4 Cal. 4th 937 (2008).

11 *Id.* at 945.

12 *Id.* at 950.

The case of *Strategix v. Infocrossing*[13] further illustrates California's unwillingness to broadly read the statutory exceptions to Section 16600's bar on noncompetes. In that case, the court refused to enforce a broad nonsolicitation clause that prohibited the seller from not only soliciting customers of the sold business, but also those of the buyer more generally.[14] The court based its decision on the statutory language of Section 16601.[15] As noted, Section 16601 specifically provides that a noncompete can be entered into where the seller sells the goodwill of his or her business, provided that the noncompete is limited to "carrying on a similar business within a specific geographic area in which the business" was sold and "so long as the buyer ... carries on a like business." The court noted that the nonsolicit prohibited the seller not only from competing over the business sold, but also the buyer's business more generally. The court reasoned that the nonsolicit covenant was unenforceable because it did more than protect the goodwill of the sold business but, instead, provided the buyer with a broad protection against all competition.[16] Likewise, a noncompetition agreement running from the end of employment may be seen as too broad and generally curtailing competition, rather than attempting to narrowly protect the goodwill of the business sold.

The case of *Alliance Payment Systems, Inc. v. Walczer*[17] illustrates the issue in the context of the 16602 statutory exception. In that case, the court of appeal invalidated a revenue forfeiture provision in a partnership dissolution agreement as a restraint of trade because it could have required the payment of revenue on clients during a period of time when the other former partner was not carrying on a similar or "like business," which is a requirement for a valid noncompete under Section 16602, as it is under Section 16601.[18] In contrast, the court upheld a nonsolicitation clause pertaining to accounts, noting that an account of the partnership could not be solicited away unless the party was continuing to service the account and, thus, the provision complied with the "carries on a like business" requirement.[19] In the context of a selling shareholder who becomes an employee of the buyer, while it is very likely that a buyer would be continuing in the same or a like business when the selling shareholder leaves employment, this is not necessarily the case.

A final concern with having the noncompetition agreement run from the end of employment is that California courts are not likely to reform or blue-pencil the covenant at issue, with the possible end result of the entire restrictive covenant being found unenforceable. The circumstances under which California courts have blue-penciled noncompetition agreements are limited to cases where there is an otherwise valid noncompete, but there are overbroad or omitted geographic and time restrictions.[20] But where the agreement would require "striking a new bargain" for the parties, courts will not reform the language.[21] Indeed, this was the case in *Alliance*, where the court declined to read into the forfeiture provision a "like business" requirement.[22] Likewise, in *Strategix*, the court refused to rewrite the broad noncompete that prohibited the seller from soliciting any of the buyer's customers.[23] As noted, an agreement running from the end of employment looks more like a generic noncompete agreement, which is not enforceable and, more specifically, may be seen to run afoul of the "like business" requirement. Under these circumstances, courts (as in *Alliance* and *Strategix*) have been unwilling to blue-pencil the agreement because it would require them to rewrite the trigger, as opposed to merely shortening the length or lessening the breadth of the restriction (which they are willing to do).

In light of the cases since *Hilb*, the enforceability of a termination-of-employment trigger is in doubt. Yet, there may be one way to comply with Section 16601 and still achieve the same result. A buyer should consider language to the effect that the noncompete will run for the lesser of the period during which the buyer conducts a like business in a certain geographic area or "x" years following termination of employment. This type of provision would help to ensure that there is no possible scenario under which the covenant would be sought to be enforced in the absence of the buyer carrying on a like business, and ensure that the express statutory language is fully respected (as required by *Edwards* and *Strategix*).

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13 142 Cal. App. 4th 1068 (2006).

14 *Id.* at 1073.

15 *Id.* at 1074.

16 *Id.*

17 152 Cal. App. 4th 620 (2007), *review dismissed and remanded in light of Andersen*, 2008 Cal. LEXIS 12715 (Oct. 22, 2008).

18 *Id.* at 803.

19 *Id.*

20 *See, e.g., Strategix*, 142 Cal. App. 4th at 1074.

21 *Id.*

22 152 Cal. App. 4th at 637.

23 142 Cal. App. 4th at 1074.

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