SEYFARTH SHAW LLP
ATTORNEYS

Management Alert

California Court Rules That Non-Competition Agreement Contained In Employment Agreement Is Unenforceable Against Former Seller Even Though It Was Executed In Connection With The Sale Of A Business

Non-competition agreements executed in connection with the sale of a business are typically enforceable as a limited exception under Business and Professions Code section 16601 and applicable case authority to California's general prohibition against non-competition agreements. A recent California Court of Appeal decision, however, further narrows this limited exception.

In *Fillpoint v. Maas, 2012 WL 3631266 (Aug. 24, 2012)*, the California Court of Appeal, Fourth District, found that two separate agreements–a stock purchase agreement and employment agreement–executed pursuant to the sale of a business, must be read together when analyzing the restrictive covenants contained in each agreement. The Court then held that the non-competition covenant in the employment agreement, whose terms differed from the non-competition covenant in the purchase agreement, did not fall under the "sale of business" exception, and thus was unenforceable. The Court reasoned that the covenant was not focused on protecting the acquired company's goodwill. Rather, it impermissibly "targeted an employee's fundamental right to pursue his or her profession" in violation of Business and Professions Code section 16600, California's statute prohibiting non-competition agreements.

Background Facts

Defendant Michael Maas was an employee of specialty video game publisher Crave Entertainment Group. When Handleman Company acquired Crave, Maas sold his company stock and signed a stock purchase agreement. The purchase agreement contained a three-year covenant not to compete, which restricted Maas from engaging in the business he sold, with the exception of working on behalf of Crave. Business was defined as "distribut[ion] and publish[ing] of interactive entertainment (videogames), software, hardware and accessories and provid[ing] videogame software, hardware and accessories category management services for certain game retailers."

In the purchase agreement, Crave also agreed to ensure that Maas would execute an employment agreement at closing. In fact, the purchase agreement contained an integration clause that made a blank form employment agreement part of the purchase agreement.

A month after the purchase agreement was signed, Maas entered into an employment agreement with Crave by which he agreed to work for Crave for three years. The employment agreement contained a covenant not to compete or solicit paragraph. The non-compete provision contained therein was different than the covenant not to compete in the purchase agreement. It prevented Maas from participating, engaging or having an interest in any competitive business in any county

in which Crave does business. In addition to the covenant not to compete provision, the paragraph contained a covenant not to sell competitive products to customers and prospective customers of Crave, and a covenant not to employ or solicit employees or consultants of Crave –hereinafter this is referred to as the non-solicitation provision. Both the non-competition and the non-solicitation provisions lasted for one year after the expiration of the employment agreement or after the earlier termination of his employment. The employment agreement contained an integration clause specifying that the employment agreement and purchase agreement constituted the sole and entire agreements between the parties, that any prior agreements were of no force and effect, and that to the extent that there was any conflict between the two agreements, the purchase agreement shall prevail.

Maas resigned exactly three years after executing the purchase agreement, purportedly satisfying the three-year non-competition covenant contained within the purchase agreement. Shortly thereafter, Maas became the President and CEO of competitor Solutions 2 Go.

Plaintiff Fillpoint LLC is a videogame distributor that acquired Crave's assets from Handleman, including the rights to Maas' employment agreement. Because of Maas' employment with competitor Solutions 2 Go, Fillpoint filed suit against Maas for breach of the employment agreement and against Solutions 2 Go for tortious interference with the employment agreement. The defendants asserted, among other defenses, that the covenant not to compete or solicit paragraph in the employment agreement was unenforceable under California Business and Professions Code section 16600.

Trial Court's Decision

After Fillpoint's opening statement at trial, the defendants moved for nonsuit (i.e. as a matter of law, the evidence presented by plaintiff was insufficient to permit a jury to find in its favor). The trial court granted the defendants' nonsuit motion and found the following: (1) Maas' non-competition covenants were assignable to Fillpoint, (2) the covenants were contained in separate agreements and should not be read together, and (3) the covenant not to compete or solicit in the employment agreement was unenforceable under section 16600. The court later decided to dismiss the tortious interference claim because it was based upon the covenant not to compete or solicit in the employment agreement, which the court found to be unenforceable.

Court of Appeal's Holding

The Court of Appeal reversed the trial court's decision and held that the purchase agreement and employment agreement must be read together, adopting Fillpoint's argument. (*See* Cal. Civ. Code § 1642: "Several contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, are to be taken together."). The Court, however, affirmed the trial court's judgment and found that the covenant not to compete or solicit in the employment agreement was void and unenforceable under California law. The Court reasoned that the covenant not to compete or solicit did not fall under the "sale of business" exception (Business and Professions Code section 16601) because it was overly broad and not designed to protect the acquired company's goodwill.

(1) The Non-Competition Covenants in the Purchase Agreement and Employment Agreement Must Be Read Together

The Court stated that neither party cited any case with the same facts presented by the instant case–a purchase agreement and employment agreement entered at roughly the same time and as part of a single transaction, but containing different non-competition covenants. The Court proceeded to discuss several California cases that addressed non-competition covenants located in different and/or multiple documents.

The Court referenced the Court of Appeal decision in *Hilb, Rogal & Hamilton Ins. Services v. Robb* (1995) 33 Cal.App.4th 1812, which held that the placement of a three-year post-termination non-compete in an employment contract, rather than a merger agreement, did not affect the covenant's enforceability under section 16601 when both agreements were executed pursuant to the same business acquisition.

The Court also referenced the Court of Appeal decision in *Alliant Ins. Services, Inc. v. Gaddy* (2008) 159 Cal.App.4th 1292, which held that a non-compete contained in a purchase agreement executed pursuant to the sale of a business was enforceable under section 16601 in the context of a motion for preliminary injunction. The *Fillpoint* Court noted that the language in the purchase agreement was identical to the covenant contained in the related employment agreement. The identical covenants applied to the entire state of California, for a period of five years after the stock purchase closing date or two years after the termination of Gaddy's employment with the new company, whichever was later.

The *Fillpoint* Court distinguished the two cases from the instant case because they essentially involved a single non-competition covenant, where the instant non-competition covenants were different–three years after the purchase of Maas stock (purchase agreement) vs. one year after the termination of Maas' employment (employment agreement), with differing language.

The Court ultimately agreed with Fillpoint's argument that the purchase agreement and employment agreements should be read together because both agreements were part of the same single business transaction, referenced each other, were between the same parties, and contained an integration clause, but the Court did not reach the result that Fillpoint expected would result from that conclusion.

(2) The Non-Competition Covenant in the Employment Agreement is Unenforceable Under Business and Professions Code Section 16600

The Court recognized that section 16601 permits the enforcement of non-competition covenants, executed in connection with the sale of a business, to protect an acquired company's goodwill and guard the value of the property right that was acquired. *The Court noted that the burden is on the buyer to prove that this exception applies.*

The Court rejected Fillpoint's argument that the fact the purchase agreement and employment agreement should be read together automatically meant the non-competition covenant in the employment agreement was enforceable under section 16601.

The Court found that the non-competition covenants in the two agreements were different by their very nature. The Court explained that "the purchase agreement's covenant was focused on protecting the acquired goodwill of Crave for a limited time" and "[t]he employment agreement's covenant targeted an employee's fundamental right to pursue his or her profession."

In fact, the Court reiterated that the non-competition covenant in the purchase agreement was fully satisfied and expired when Maas resigned three years later. The Court found that Fillpoint conceded in its briefing that the two non-competition covenants were intended to "deal with the different damage Maas might do wearing the separate hats of major shareholder and key employee." Thus, the Court concluded that the non-competition covenant in the employment agreement was unenforceable under section 16600 and failed to fit within the limited exception under section 16601.

The Court also found the non-solicitation provision in the employment agreement too broad and inconsistent with the purposes and terms of section 16600 and 16601 because it gave overly broad protection to the seller and extended beyond the business sold by barring Mass from selling to or soliciting the buyer's potential customers. The Court cited with approval *Strategix, Ltd. v. Infocrossing West, Inc.* (2006) 142 Cal.App.4th 1068, which found that "nonsolicitation covenants barring the seller from soliciting all employees and customers of the buyer, even those who were not former employees or customers of the sold business, extend their anticompetitive reach beyond the business so sold" and that such "covenants would give the buyer broad protection against competition wherever it happens to have employees or customers, at the expense of the seller's fundamental right to compete for employees and customers in the marketplace."

The Court concluded that Maas satisfied his covenant not to compete for three years under the purchase agreement. The employment agreement's covenant not to compete for an additional year, including its broad non-solicitation provision, cannot be reconciled with California's strong public policy permitting employees the right to pursue a lawful occupation of their own choice.

What *Fillpoint* Means: The Takeaways

(1) **Current agreements.** *Fillpoint* may have a significant impact on companies who currently have different non-competition covenants contained within separate agreements that were executed pursuant to the sale of a business with sellers/key employees. While *Fillpoint* does not foreclose the ability to enforce non-competition covenants under section 16601, California courts may not enforce these covenants under this statute if the language of the agreement does not reflect a clear purpose to protect business goodwill. Companies should evaluate their non-competition agreements and recognize the risk that covenants within employment agreements may not be enforceable to the extent that they conflict with or have a broader scope than the terms of the covenants in the purchase or merger agreements and are not clearly and expressly calculated to protect the business goodwill of the selling company. Companies should also recognize that, while not at issue in this case, they may still attempt to argue that such covenants are enforceable because they are necessary to protect trade secrets under the so called "trade secrets exception" to Business and Professions Code section 16600. There remains a dispute as to whether such an exception exists and if so, what it means.

(2) **Future agreements.** Going forward, at a minimum, companies should include all non-competition covenants within the terms of the purchase agreements with sellers/key employees. As seen in the *Gaddy* case, a non-competition agreement that contains a latent tail (i.e. additional post-termination covenant triggered at an undetermined future date) may possibly be enforceable if contained within the terms of the purchase agreement. Some legal commentators, however, *believe* that latent tails that become effective many years after the sale may now be unenforceable. Companies should consider maxing out the duration of a permissible non-competition covenants in the purchase agreement with sellers/key employees. To the extent that companies include the non-competition covenants in employment agreements or other agreements, the non-competition provision should be identical to the non-competition provision in the purchase agreement and should contain clear language indicating that the purpose of the provision is to protect the business goodwill in connection with the sale of business. Any non-solicitation covenants in connection with the underlying transaction should be limited to customers and employees of the seller under the *Strategix* decision. The purchaser/new employer should also be able to prohibit the solicitation of employees that the key employee has contact with after joining the company under *Loral v. Moyes* (1985) 174 Cal.App.3d 268, for up to one year post-termination.

(3) **This is only one Court of Appeal decision and other decisions may support a different result.** This case's holding that the non-competition covenant in the employment agreement did not fall under section 16601 because it focused on the "right to pursue a profession" appears to conflict with the Idaho Supreme Court in *T.J.T., Inc. v. Mori* (Id. 2011) 266 P.3d 476 (applying California law) and other California decisions. The Idaho Supreme Court in *T.J.T.* found that a two-year non-compete agreement executed in connection with the sale of a business was enforceable under California law, despite the fact that the seller also became an employee of the purchasing company as a result of the sale. Even though the non-compete agreement referred to the employee/seller's employment with the new employer/buyer to determine its duration and enforceability, the court found that such an "incidental" link does not necessarily mean the provision is unenforceable. Instead, the court reasoned that the employee's employment only came about as part of the larger transaction–the sale of the business to a competitor–and was therefore enforceable. Interestingly, *T.J.T.* examined the same cases (*Hilb, Rogal & Hamilton Ins. Services v. Robb* (1995) 33 Cal.App.4th 1812 (containing a three year post-termination non-compete in employment agreement) and *Alliant Ins. Services, Inc. v. Gaddy* (2008) 159 Cal.App.4th 1292 (2008) (containing a five year non-compete and two year post-termination non-compete in asset purchase agreement and employment agreement) as *Fillpoint* but came to a different conclusion.

Also, the *Fillpoint* Court did not address two existing California Court of Appeal decisions that may also be instructive and lead to a different result. In *Newlife Sciences v. Weinstock* (2011) 197 Cal.App.4th 676, the California Court of Appeal, Second District, upheld a preliminary injunction based upon discovery issue sanctions entered against an employee who breached his non-competition agreement contained in an employment agreement with his new employer. The non-competition agreement was operative during his new employment and for five years after termination of that employment. The trial court determined that it was enforceable because it was part of the transfer of business and its goodwill by the selling employee.

Additionally, in *Monogram Industries, Inc. v. SAR Industries, Inc.* (1976) 64 Cal.App.3d 692, the California Court of Appeal, Second District, affirmed the entry of a preliminary injunction against an employee on a breach of a covenant not to

compete. The five year covenant not to compete was contained in a consultant agreement executed in a connection with a purchase agreement. The court upheld the provision under a previous version of section 16601 reasoning that the purpose of section 16601 is to permit the purchaser to protect himself or itself against competition from the seller which competition would have the effect of reducing the value of the property right that was acquired. Some may consider this interest as the same side of the coin compared to the *Fillpoint* Court's concern for the "employee's fundamental right to pursue his or her profession." The court also reasoned that there was an inference that business had a "goodwill" and that it was transferred where the covenant was executed as an *adjunct* of a sale of a business.

(4) **California is unique regarding the enforcement of non-competes.** This case reminds us that California is different from other states in its general prohibition and strong public policy against non-competes. In most states, the one-year non-competition covenant at issue in this case would likely be enforceable in whole or part. Companies may want to consider including out-of-state forum selection and choice of law provisions, coupled with consent to jurisdiction provisions, to attempt to increase the likelihood of successfully enforcing their non-competition agreements against business sellers/key employees provided the parties to the transaction have a sufficient connection to the outside forum state.

By: *Robert Milligan* and *Joshua Salinas*

Robert Milligan is a partner in Seyfarth's Los Angeles office and *Joshua Salinas* is an attorney in Seyfarth's Los Angeles office. If you would like further information, please contact your Seyfarth attorney, Robert Milligan at *rmilligan@seyfarth.com* or Joshua Salinas at *jsalinas@seyfarth.com*. You may also visit our blog, Trading Secrets, at *www.tradesecretslaw.com*.