WSGR ALERT

California Court Strikes Down Post-Employment Non-Compete Agreement, Raising Questions about the Validity of Employee Non-Solicits

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A recent California Court of Appeals decision, *Fillpoint, LLC v. Maas* (August 24, 2012), once again highlights California's strong fundamental public policy favoring open competition and disfavoring restrictive covenants.

Following the California Supreme Court's 2008 decision in *Edwards v. Arthur Andersen LLP*, California law is clear that, unless they fit within one of three narrow statutory exceptions, employee post-employment non-compete and customer non-solicitation agreements are void and unenforceable under Business and Professions Code §16600. *Fillpoint* does not deviate from that result. However, the decision does consider the conditions under which perhaps the most common exception to §16600—the §16601 exception—applies to an employee non-compete, a customer non-solicit, and an employee non-solicit. Such restrictions are found in many, if not most, merger and acquisition (M&A) transaction documents. Thus, *Fillpoint* provides useful guidance as to the parameters of §16601, as well as practical tips on the use of restrictive covenants in the M&A context. Perhaps most importantly, however, *Fillpoint* creates considerable uncertainty as to the continuing validity of post-employment covenants not to solicit employees where no statutory exception applies—an issue left unresolved by *Arthur Andersen*.

Facts

Michael Maas was a "key" employee and "Major Shareholder" of Crave Entertainment Group, Inc., which was acquired by Handleman Company. After the acquisition, the acquired company continued to go by the name Crave. As part of the transaction, and as consideration for the sale of his stock in the seller, Maas signed a stock purchase agreement containing a covenant not to compete. The non-compete prohibited Maas from engaging in a business competitive to Crave for 36 months following the closing date of the transaction. The stock purchase agreement also contained a provision requiring certain key employees of the seller, including Maas, to execute employment agreements with Crave following the acquisition.

After the closing of the acquisition, Maas entered into an employment agreement with Crave. The employment agreement contained not only a covenant not to compete, but also certain non-solicitation restrictions. Specifically, for a period of one year following Maas's termination of employment from Crave, he generally was prohibited from: (1) making sales contacts or actual sales to any Crave customer or potential customer; (2) working for or owning any business that competes with Crave; or (3) employing or soliciting for employment any of Crave's employees or consultants.

After satisfying the three-year non-compete provision in the stock purchase agreement, Maas resigned his employment with Crave. Shortly thereafter, Maas began working for a Crave competitor as its president and CEO. Crave (through its successor, Fillpoint) then sued Maas for breaching the employment agreement's one-year non-compete that was triggered as soon as Maas's employment with Crave ended. Crave also sued the company Maas joined for interference with contractual relations (i.e., the non-compete Crave enjoyed with Maas).

Analysis and Holding

The *Fillpoint* court first addressed whether the employment agreement and the stock purchase agreement should be read together as one integrated document. If the employment agreement was viewed as a stand-alone document unrelated to the stock sale, the court said it would run afoul of California's general prohibition on non-compete agreements found in §16600. However, if the two agreements are viewed as one integrated document, the post-employment non-competition and non-solicitation covenants contained in the employment agreement might survive under the §16601 "sale of business" exception to §16600's general prohibition of restraints against those engaging in a lawful profession, trade, or business.

In concluding that the two agreements constituted one integrated agreement, the court noted that nothing in the sale-of-business exception required that the covenant be contained in any particular type of document. Instead, 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." In this case, the two agreements were between the same parties, both agreements referenced each other, and the employment agreement contained an integration clause providing that in the event of any conflicts between the two documents, the purchase agreement would prevail.

The *Fillpoint* court then addressed whether the non-competition and non-solicitation covenant contained in the employment agreement was void and unenforceable under California law. The court noted that the covenant contained in the purchase agreement (which was not the subject of dispute, as the parties admitted it had been satisfied because the three-year non-competition period had passed without being violated) was created to

protect the goodwill acquired by the buyer. In contrast, the non-competition and non-solicitation covenant in the employment agreement served a different purpose and affected Maas's right to be employed in the future. As such, the non-competition and non-solicitation covenant was broader and "targeted an employee's fundamental right to pursue his or her profession." The court further noted that the non-solicitation provisions were overbroad in that they limited the solicitation of and sales to *potential* Crave customers (as opposed to just its actual customers). In light of these factors, the court held that the non-competition and non-solicitation covenant found in the employment agreement was void and unenforceable under California law.

Lessons Learned

- Non-competition and non-solicitation covenants generally remain unenforceable under California law. *Fillpoint* and *Arthur Andersen* are but a few of the numerous state and federal court decisions making clear that restrictive covenants are disfavored in California. Unless the covenant is otherwise permissible under an exception such as §16601, it likely will fail.

- Section 16601 retains its vitality. *Fillpoint* makes clear that §16601 serves an important commercial purpose by protecting the value of the business acquired by the buyer. In the case of the sale of the goodwill of a business, courts consider it "unfair" for the seller to engage in competition that diminishes the value of the asset sold.

- The proper integration of non-competition and non-solicitation covenants in the M&A context is important. Without the protection of §16601, non-competition and non-solicitation covenants risk being void and unenforceable under §16600. A party desiring to secure an enforceable non-competition or non-solicitation covenant should take care to properly integrate such covenants with the underlying deal documents. The relevant documents should reference each other expressly and contain proper integration clauses. Without such tethering of the restrictive covenants to the transaction at issue (assuming it qualifies under §16601), parties risk having the standalone covenants viewed as separate from the underlying transaction and not entitled to the more favorable analysis available under the §16601 exception.

- Recitals matter. Similarly, recitals in transaction-related agreements help to establish the applicability of §16601 and may inform whether non-competition and non-solicitation covenants will be enforceable or not. Specifically, non-compete agreements should evidence that they are being executed in connection with, and as consideration for, an underlying M&A transaction. The documents should reflect any separate consideration that is being offered in exchange for the execution of the non-compete provision. Finally, the recitals should indicate that the parties believe the non-competition and non-solicitation covenants are reasonable and no broader than necessary to protect the goodwill transferred between the parties. While not dispositive, such recitals help make clear the intentions of the parties and avoid the risk of a court refusing to consider other evidence offered to establish such intentions.

- Section 16601 will not save restrictive covenants that do not advance the purposes of the exception. To qualify for the §16601 exception, the restrictive covenant actually must be necessary to protect the value of the business acquired or the goodwill transferred. *Fillpoint* makes clear that restrictions that are overbroad or that overreach will not survive §16601 scrutiny. Indeed, in *Fillpoint* the court disapproved of a customer non-solicitation provision that many practitioners might consider to be reasonable and one fostering the purposes of §16601.

What about Employee Non-Solicits?

As noted above, the non-competition and non-solicitation covenant at issue in the employment agreement contained three separate prohibitions: (1) an agreement not to work for any competing company; (2) an agreement not to solicit customers; and (3) an agreement not to solicit employees. The court expressly stated that the non-competition and non-solicitation covenant at issue in the employment agreement, standing alone, was not enforceable under §16600 and that it "depends entirely on section 16601 for its survival." The court did not analyze each covenant separately, nor did it consider whether any of the covenants could be severed and still be enforced. As a result, *Fillpoint's* conclusion as to the enforceability of the employee non-solicit covenant appears at odds with the seminal, but pre-*Arthur Andersen*, California case on employee non-solicit (non-interference) agreements, *Loral Corp. v. Moyes*. That case holds that employee non-solicits do not violate §16600 and therefore are enforceable under California law.

Fillpoint does not address *Loral*. It does not explain why the employee non-solicit at issue in the Crave employment agreement "depends entirely on section 16601 for its survival" if *Loral* permits employee non-solicits. Indeed, post-*Arthur Andersen*, many question the continuing viability of *Loral's* employee non-solicit analysis. Without addressing *Loral*, at least one federal court recently has found an employee nonsolicit to be in violation of §16600. In short, it remains to be seen whether *Loral's* days are numbered, and whether any employee non-solicit will fail under §16600 in the future unless it falls within the §16601 or other statutory exceptions.

Wilson Sonsini Goodrich & Rosati actively is following developments around the country with respect to restrictive covenants, and the firm is available to assist companies, employees, newly formed businesses, and investors with every aspect of employment and trade secret litigation and counseling. For more information, please contact Fred Alvarez, Rico Rosales, Marina Tsatalis, Laura Merritt, Charles Tait Graves, or another member of the firm's employment and trade secrets litigation practice.

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