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Silicon separations

By Jennifer Redmond

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California has a statutory exception for noncompetes entered into between buyers and sellers of a company. But nothing about noncompetes is easy in California. Even with this exception, there are lots of ways to get noncompetes wrong in California. Here is some guidance on how to do it right.

Under Section 16601, a noncompete will be enforced within a specified geographic area in which the business of the seller has been carried on. One way to get it wrong in California is to define the restricted geographic area based on where the buyer does business.

Doing it right means looking broadly at the scope of the business of the seller as of the close.

Another key issue is the definition of the competing business. Under Section 16601, a covenant not to compete may restrict the seller only from engaging in business activities that are "similar" to the business activities of the seller. A noncompete that broadly prohibits the seller from competing with all the businesses of the buyer or from soliciting customers of the buyer (not just those of the seller) will violate Section 16601.

Section 16601 not-to-compete covenants are valid for "so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein." A noncompete that extends its duration beyond this time frame is invalid. This can be fixed by tracking the language of Section 16601 instead of putting a defined time limit into the agreement. Of course, an indefinite time limit may not be acceptable to a selling shareholder. Thus, one possible approach to duration in California is to use a hybrid approach — the lesser of x years or as long as the buyer conducts a similar business within the applicable geographic area.

When a selling shareholder becomes an employee of the buyer following the close, noncompetes are often written to run from the termination of employment, for obvious reasons. A noncompete that runs from the closing date will not protect the buyer if the employees work for the buyer longer than the duration of the noncompete — but taking this approach will invalidate the noncompete under Section 16601.

Therefore, buyers can lengthen the period of the noncompete to cover the expected period of employment, running it from the date of close. Another possibility is to use the hybrid approach and identify the duration as the lesser of the statutory language as to duration or x years from the date the shareholder terminates employment with the buyer.

A common mistake in California is to assume that the courts will fix an overbroad noncompete through blue penciling. Although California courts may blue-pencil noncompete agreements that seem to them unreasonable, they are not required to do so.

And the trend has been to move away from rewriting the terms. In a key case from 2006, Strategix Ltd. v. Infocrossing West Inc., the court invalidated the entire noncompete because it barred the former

shareholders of the seller from soliciting employees or customers of the buyer and defined the geographic scope as greater than the area where the seller carried on its business at the close.

Another frequent misconception in California is to assume that all shareholders of the seller can be bound by noncompetes, no matter how small their ownership. Although Section 16601 expressly covers all shareholders, some courts have nonetheless read into Section 16601 a requirement of "substantial" ownership before a noncompete will be enforced, such that the shareholder can be said to transfer his interest in goodwill.

Finally, beware of entering into noncompetes with shareholders who do not sell their entire interest. Courts will enforce a noncompete only if a shareholder sells all of his or her shares of a corporation. Retention of any shares will invalidate the agreement. Nor will substitutes for ownership suffice to support a noncompete under Section 16601, such as bonus payments tied to the closing of the deal or payouts for phantom stock. n

Jennifer Redmond is partner-in-charge of the labor and employment practice group in the San Francisco office of Sheppard Mullin Richter & Hampton LLP and co-chair of the firm's national noncompete and trade secrets team.