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California Appellate Decision Applies a Limited Exception to California's General Rule Prohibiting Restrictive Covenants

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In a decision from California's Fourth Appellate District, Fillpoint, LLC v. Maas et al., 208 Cal. App. 4th 1170 (Aug. 24, 2012), the court confirmed California's general rule prohibiting restrictive covenants, as well as the limited "sale of a business" exception to that rule. Material Facts of the Case Defendant Michael.....

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Material Facts of the Case

Defendant Michael Maas was employed by Star Video Games, and he owned stock in Crave, the parent company of Star. In 2005, Maas and other Crave stockholders entered into a securities *purchase agreement* with the Handleman Company, dated October 18, 2005 (the purchase agreement). Handleman acquired Crave in the purchase. The purchase agreement included a covenant not to compete that prohibited Maas from engaging in Crave's business of distributing and publishing video games, for a period of 36 months after the closing date of the purchase. The purchase agreement also contained Crave's agreement to ensure that Maas would sign an employment agreement with Crave at the closing.

About a month after the purchase agreement was signed, on November 22, 2005, Maas entered into an employment agreement with Crave by which he agreed to work for Crave for three years (the employment agreement). The employment agreement also included a covenant not to compete or solicit for a period of one year *after* the expiration of Maas's employment agreement, or *after* the termination of his employment with Crave. Maas resigned from Crave on November 22, 2008, after satisfying the three-year term of his employment agreement. In February 2009, another company (Fillpoint) acquired Crave's assets from

Handleman. About four months later, in June 2009, Maas became the president, chief executive officer, and a shareholder of Solutions 2 Go, a competitor of Crave. In other words, Maas started his employment with a Crave competitor prior to a full year after he left Crave. Fillpoint, which had acquired Crave from Handleman, sued Maas for breaching the restrictive covenant provision in his employment agreement. The trial court granted Maas's nonsuit motion, alleging that the plaintiff could not prove its case, which the appellate court affirmed.

The Court's Analysis and Decision

The court's analysis was based on the following principles of California law: (1) the general rule is that Section 16600 of the Business and Professions Code prohibits covenants not to compete, except under limited exceptions; (2) the exception contained in Section 16601 of the Business and Professions Code protects covenants not to compete entered into in connection with the sale of the goodwill of a business; and (3) the covenant not to compete in the employment agreement, standing alone, is unenforceable under section 16600.

Pursuant to Section 16601 of the Business and Professions Code, the court approved of the three-year covenant not to compete in the purchase agreement as properly designed to protect the goodwill of the business being sold. Section 16601's exception to California's rule prohibiting restrictive covenants is based on the purpose of protecting the value of a business acquired by the buyer. When there is the sale of a business for its fair market value and goodwill, it is then unfair for the seller to compete against the buyer, which would diminish the value of the business just sold. Accordingly, section 16601 protects the buyer's interest in preserving the goodwill of the acquired company.

However, Fillpoint sought to enforce the noncompetition and nonsolicitation covenant in Maas's employment agreement (not the purchase agreement) with Crave. The court noted that the employment agreement's covenant not to compete improperly prevented Maas, for one year after the termination of his employment, from (1) making sales contacts or sales to anyone who was Crave's customer or potential customer during the two years preceding the termination of Maas's employment, or assisting others in doing so; (2) working for or owning an interest in any business that competed with Crave; or (3) employing or soliciting for employment any of Crave's employees or consultants.

The court recognized that these provisions improperly limited Maas's rights to be employed in the future and even barred him from selling to or soliciting potential Crave customers. The court also noted 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 sold. The court concluded that such provisions would do far more than simply protect the buyer's purchased asset, but they would also improperly give the buyer broad protection against competition wherever the buyer's company happens to have employees or customers—at the expense of the seller's fundamental right to compete for employees and customers in the marketplace.

Conclusion:

Employers with operations and employees in California should regularly review their employment agreements and offer letters to ensure that they do not contain non-compete or non-solicitation provisions that impermissibly prohibit employee mobility. Instead, employers should consider including confidentiality provisions in employment agreements that properly obligate departing employees from using or disclosing the company's confidential, proprietary, or trade secret information. Moreover, potential buyers of companies in California cannot assume that the exceptions to Section 16600 will enable them to require restrictive covenants in the employment agreements of employees who are retained with the acquired company.

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