

What Issues should Business Buyers Consider when Drafting Non-Compete Agreements with their Sellers to Comply with California Law?

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Buyers of all or parts of another business often seek to protect the value of their investments by entering into non-compete agreements with their sellers. Courts typically favor enforcement of such sale-of-business non-compete agreements in order to protect buyers from unfair competition from sellers, and to protect the business's goodwill for which the seller has paid as part of the purchase price. Courts regularly enforce sale-of-business non-compete agreements, either as an exception to a general legal prohibition on agreements restraining trade or by applying a more lenient standard for enforceability. The public policy favoring enforcement of sale-of-business non-compete agreements stands in stark contrast to non-competes between employers and their employees triggered by termination of employment. Courts in most states generally will enforce narrowly drafted and reasonable post-employment non-competes in accordance with a patchwork of state laws. However, courts in several states, notably California, North Dakota and Oklahoma, broadly refuse to enforce post-employment non-competes.

Although California law prohibits post-employment non-compete agreements, California law allows parties to enter into non-compete agreements in the context of a sale of business in accordance with certain detailed statutory requirements. Because of the size of the California economy, and the willingness of California courts to enforce appropriate sale-of-business non-compete agreements, buyers of businesses both inside and outside of California frequently seek to maximize compliance with California law. One of the key issues such buyers need to consider in drafting sale-of-business non-compete agreements is whether the ownership interest being sold will suffice to trigger California's sale-of-business exception. In this article, we discuss California law governing sale-of-business non-competes and the case law addressing the nature of the ownership interest that the seller must transfer for the sale-of-business rules to apply. We also analyze the Federal Trade Commission's (FTC) recently published proposed rule banning post-employment non-competes. Like the California prohibition on employment non-compete agreements, the FTC's proposed rule also includes a sale-of-business exception which buyers should consider in structuring their transactions.

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California's Sale-of-Business Exception

California generally invalidates non-compete agreements by making “void” “every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind.” Cal. Bus. & Prof. Code § 16600. However, Section 16601 of the Business and Professions Code carves out a limited exception for buyers and sellers of businesses.^[1] Under Section 16601, any of the following persons “may agree with the buyer to refrain from carrying on a similar business within a specified geographical area in which the business is sold, or that of the business entity, division, or subsidiary has been carried on, 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”: (1) “any person who sells the goodwill of a business”; (2) “any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity”; or (3) “any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary.” Cal. Bus. & Prof. Code § 16601.

Courts construe Section 16601 to protect the buyer’s purchase of the intangible goodwill from actions by the seller that would undermine the value of the goodwill acquired. “Goodwill” is defined as the “expectation of continued public patronage.” Cal. Bus. & Prof. Code § 14100; see *also* *Alliant Ins. Services, Inc. v. Gaddy*, 72 Cal. Rptr. 3d 259, 277 (2008). In determining whether a party has transferred goodwill, “there must be a clear indication that in the sales transaction, the parties valued or considered goodwill as a component of the sales price.” *Hill Medical Corp. v. Wycoff*, 103 Cal. Rptr. 2d 779, 785 (2021). In the context of selling shares of company stock, the Court in *Hill Medical Corp.* recognized that “[s]imply selling shares to an individual vendee or back to the corporation does not necessarily demonstrate that goodwill is part of the agreement.” *Id.* All aspects of the sales arrangement must be evaluated, including the shares transferred and the fractional interest involved, the entire structure of the transaction and the sales price, such as whether fair market value is paid for the shares. *Id.*

In *Vacco Industries v. Van Den Berg*, 6 Cal. Rptr. 2d 602, 609 (1992), a California court enforced a sale-of-business non-compete agreement against a shareholder who sold all of his stock in the company, which amounted to less than 3% of the company’s stock. Vacco, a machinery manufacturing company, entered into an agreement with Emerson Electric Co. in which Emerson agreed to purchase all of Vacco’s stock. In conjunction with the sale, Vacco entered into employment contracts and separate non-competition agreements with 12 major shareholders. Van Den Berg, an operations manager and officer of Vacco, was one of them. The non-compete agreement specified that he “would not carry on any business competitive with the business of Vacco for the lesser of (1) five years from the date of the agreement or (2) so long as Vacco conducts the Business within the territory.” *Id.* The court enforced the noncompete agreement because Van Den Berg was the 9th largest shareholder and held a substantial interest in the company.

By contrast, in *Bosley Medical Group v. Abramson*, 207 Cal. Rptr. 477, 481 (1984), another California court refused to enforce a non-compete agreement contained in a stock purchase agreement based on a finding that the transaction was a “sham” to circumvent state policy prohibiting non-competes. In *Bosley*, a medical group engaged a doctor in its practice of hair transplantation and male pattern reduction surgery. As a condition to engaging the doctor in the practice, the medical group required the doctor to sign both an independent contractor agreement and a stock purchase agreement. The stock purchase agreement required the doctor to purchase nine shares of the medical corporation for \$10,000, which shares represented 9% of the shares of the corporation. The agreement also allowed the medical group to repurchase the shares upon termination of the doctor’s engagement as an independent contractor by either party at an agreed upon amount equal to the purchase price plus 10% of such purchase price per year of the doctor’s ownership of the shares. The doctor purchased the shares with the proceeds of a promissory note. The purchase agreement contained a provision which prohibited him from engaging in a similar medical practice within certain counties for three years after leaving the medical group.

The court concluded that the non-compete agreement was “a sham” because the doctor was required, not permitted, to purchase the shares and because he did not benefit from the value of the stock he purchased. The court further observed that the doctor could not benefit from the payment of dividends or a capital gain on the value of the stock, because the interest he paid on the promissory note exceeded the dividend that was paid. The court also referred to the small amount represented by the purchase price plus only 10% of the purchase price per year that he received under the stock purchase agreement when he left the group. The court concluded based on these facts that the real purpose of the stock purchase agreement was to prevent the doctor from leaving the medical group and opening a competitive practice. The court also stated that Section 16601 applied “only in situations in which the transfer of ‘all’ of the owner’s shares involves a *substantial interest* in the corporation so that the owner, in transferring ‘all’ of his shares, can be said to transfer the goodwill of the corporation.” *Id.* at 481.

The FTC’s Proposed Rule

The Federal Trade Commission recently proposed to ban most non-compete clauses for American workers based on its view that such clauses are an “unfair method of competition” and, therefore, prohibited under Section 5 of the Federal Trade Commission Act. See FTC Proposed Rule, 88 Fed. Reg. 3482 (Jan. 19, 2023). The proposed rule carves out from this prohibition “a non-compete clause that is entered into by a person who is selling a business entity or otherwise disposing of all of the person’s ownership interest in the business entity, or by a person who is selling all or substantially all of a business entity’s operating assets, when the person restricted by the non-compete clause is a substantial owner of, or substantial member or substantial partner in, the business entity at the time the person enters into the non-compete clause.” *Id.* § 910.3. The proposed rule defines “*substantial owner*, *substantial member*, and *substantial partner*” as “an owner, member, or partner holding at least a 25 percent ownership interest in a business entity.” *Id.* § 910.1(e). Therefore, if the person is an owner,

member or a partner owning less than 25 percent of a business entity, the proposed rule would prohibit that person from entering into a non-compete agreement with a buyer.

Takeaways

Business buyers seeking to enter into non-compete covenants with their sellers that satisfy California's sale-of-business exception should consider taking the following precautions:

First, buyers should confirm that the purchase involves the seller's transfer of a *substantial interest* in the business, and not appear to be a sham to avoid compliance with public policy prohibiting employment non-competes.

Second, buyers should keep in mind that the business owner must sell "all of his or her ownership interest in the business entity."

Third, buyers should ensure that goodwill is a part of the consideration for the sale of business.

Finally, buyers should be aware that the FTC is seeking to make sweeping changes to override the non-compete laws in all fifty states. Accordingly, buyers should keep in mind the possibility that the sale-of-business non-competes previously viewed as lawful under state law may in the future be significantly restricted, and take these new realities into account in negotiating their purchase agreements.

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[1] This article does not address two other exceptions to California's prohibition of non-compete agreements. Section 16602 of the Business and Professions Code allows partnerships to enforce non-compete provisions against a partner upon dissolution of the partnership or the partner's dissociation from the partnership. Further, Section 16602.5 provides that any member in an LLC may agree in anticipation of the termination of his or her interest in the LLC that he or she will not carry on a similar business within a specified geographic area where the LLC business has been transacted, so long as any member or any person deriving title to the business or its goodwill from any other member carries on a like business. Unlike the sale-of-business exception, there is no requirement under Sections 16602 or 16602.5 that the partnership or LLC repurchase the interest in the partnership or LLC upon termination for a price that includes a payment for goodwill.