
STATE CORNER

California Court Clarifies California's Non-Competition and Non-Solicitation Doctrines

by Thomas C. Klein

The California Court of Appeal for the Fourth Appellate District¹ in the recent case of *Strategix v. Infocrossing*² nullified a non-competition and non-solicitation agreement entered into between the buyer and seller of a California business. Although California has a statutory bar prohibiting non-competition arrangements,³ there is a statutory exception to this bar that allows certain narrow non-competition arrangements entered into in connection with the sale of a business.⁴ The *Strategix* decision not only reaffirmed California's statutory bar on agreements that restrain engaging in a trade or business, but also clarified just how constrained a non-competition arrangement must be drawn under the statutory exception to survive judicial scrutiny. Furthermore, the Court of Appeal refused to "blue-pencil" the offending agreement to save some enforceable portion of the parties' arrangement; rather, the court nullified the agreement, holding that the court would not create for the parties a new agreement out of an illegal contract.

Permissible Exceptions to California Statute

California Business and Professions Code § 16600 provides:

Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.

The exceptions to this prohibition are contained in Business and Professions Code §§ 16601–16602.5,

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which permit the seller of the goodwill of a business disposing of all of his or her ownership, or selling all or substantially all of the assets of a business, to agree to a non-competition agreement within a specified geographic area in which the business sold has been carried on for so long as the buyer carries on a like business in such area. In contrast to many other states, the California courts do not apply a "rule of reason" to analyze non-competition arrangements.⁵

Strategix Non-Competition Arrangement

Strategix, its parent company ePassage, and its principal owner Matthew Aarsvold (the Strategix Parties) entered into an agreement to sell Strategix's goodwill and substantially all of Strategix's assets to the predecessor entity of Infocrossing. In a consulting agreement entered into in connection with the acquisition, ePassage agreed not to solicit Infocrossing's employees and customers for one year after the termination of such consulting agreement. ePassage and Strategix subsequently sued Infocrossing alleging Infocrossing breached the consulting agreement causing a failure of consideration for both the acquisition and the consulting agreement. Infocrossing then cross-complained against the Strategix Parties alleging breach of the non-competition covenants, and sought a permanent injunction. The Superior Court issued a temporary restraining order to enforce the non-competition covenants, and after a hearing, issued a preliminary injunction enforcing the non-competition covenants.

Appellate Courts Nullifies the Non-Competition Covenants

The Appellate Court recognized that Section 16601 of the Business and Professions Code permits the purchaser of a business to preserve the goodwill of the business purchased by a valid non-competition agreement. However, the Court noted that any non-competition agreement must be limited to the area where the sold business was carried on.⁶ By extension, the Court concluded, "...non-solicitation covenants may only bar the seller of a business from

soliciting *the sold business's* employees and customers."⁷ (emphasis in the original.)

The Court reasoned that under Section 16600's strong public policy against restraints on engaging in trades or businesses, any extension of a covenant not to solicit employees or customers beyond the "business so sold"⁸ constituted an impermissible restraint under Section 16600. The Court said that such covenants "would give the buyer broad protection against competition wherever it happened to have employees or customers, at the expense of the seller's fundamental right to compete for employees and customers in the marketplace."⁹

In 1985, the California Court of Appeal, Sixth District,¹⁰ in *Loral Corp. v. Moyes*¹¹ upheld an employment-based non-solicitation agreement against an individual accused of "raiding" his former employer's workforce. The Court in *Loral* held that such a contract intended by Loral to maintain a stable workforce was not void on its face under Section 16600.¹² However, in a sale-of-a-business case, an Indiana court applying California law in *Cap Gemini America, Inc. v. Judd*¹³ distinguished *Loral* and held a non-solicitation agreement unenforceable because it attempted to cover employees beyond those in California where the defendant had worked. The *Strategix* decision extends the reasoning in *Cap Gemini* to further limit non-solicitation covenants to employees of just the business sold.

Court Refuses to "Blue-Pencil" Covenant

Infocrossing requested that the Court modify the preliminary injunction granted by the lower court to apply only to Strategix's former customers and employees. The Court acknowledged that courts have "blue penciled" non-competition covenants in certain instances to include reasonable time or geographic limitations when such limitations were overbroad or omitted; however, the Court was unwilling to "strike a new bargain for the parties for the purposes of saving an illegal contract."¹⁴ The Court did not state whether the covenants contained severability or savings clauses, but even so, it is not clear the Court could have limited the covenants to an enforceable portion absent mistake by the parties.¹⁵ Accordingly, the Court declined to narrow the

illegal contract to constitute just a bar on soliciting Strategix's employees and customers.

Conclusion

The *Strategix* decision makes clear that California Courts will strictly apply the provisions of the California Business and Professions Code when determining the enforceability of non-competition and non-solicitation agreements. In view of this decision, it is recommended that practitioners limit the scope of sale-of-the-business non-competition and non-solicitation agreements governed under California law to the narrow enforceable boundaries permitted by Section 16601-16602.5. Doing otherwise for California law governed agreements could result in an acquiring party not being able to enforce any non-competition or non-solicitation covenants against the seller of the business.¹⁶

NOTES

1. The Fourth Appellate District covers the following counties: Imperial, Inyo, Orange, Riverside, San Bernadino, and San Diego.
2. *Strategix v. Infocrossing*, 142 Cal. App. 4th 1068, 48 Cal. Rptr. 3d 614 (Cal. App. 4 Dist., 2006).
3. California Business & Professions Code, Section 16600.
4. *Id.* at § 16601.
5. *Bosley Med. Group v. Abramson*, 161 Cal. App. 3d 284, 207 Cal. Rptr. 477 (Cal. App. 2 Dist., 1984) ("... the so-called rule of reasonableness was rejected by this state in 1872." At least since 1872, a non-competition agreement has been void unless specifically authorized by sections 16601 and 16602.)
6. *Strategix*, at 1073.
7. *Id.* at 1073.
8. *Id.* at 1073, quoting the language of Bus. & Prof. Code, § 16601.
9. *Id.* at 1073.
10. The Sixth Appellate District covers the following counties: Monterey, San Benito, Santa Clara (covering a large portion of Silicon Valley from Palo Alto south to San Jose), and Santa Cruz.
11. *Loral Corp. v. Moyes*, 174 Cal. App. 3d 268, 219 Cal. Rptr. 836 (Cal. App. 6 Dist., 1985).
12. *Distinguished in: Thompson v. Impaxx, Inc.*, 113 Cal. App. 4th 1425, 7 Cal. Rptr. 3d 427 (Cal. App. 2 Dist., 2003) (holding anti-solicitation covenant void and reading *Loral* as upholding the anti-solicitation covenant in order to protect trade secrets).
13. *Cap Gemini Am., Inc. v. Judd*, 597 N.E.2d 1272 (Ind. App. 1 Dist. 1992).
14. *Strategix* at 1074, quoting *Kolani v. Gluska*, 64 Cal. App. 4th 402, 75 Cal. Rptr. 2d 257 (Cal. App. 2 Dist, 1998).

15. See *Kolani v. Gluska* 64 Cal. App. 4th 402, 75 Cal. Rptr. 2d 257 (Cal. App. 2 Dist, 1998).

16. For those contemplating the parties' agreeing to the governing law of another state coupled with a forum selection clause moving any dispute to another state (or even arbitration in another state), that may be a viable

strategy in certain instances. See Wu, Christina L, "Noncompete Agreements in California: Should California Uphold Choice of Law Provisions Specifying Another State's Law," 51 *UCLA L.Rev.* 593 (December 2003), *Advanced Bionics v. Medtronic*, 29 Cal. 4th 697, 128 Cal. Rptr. 2d 172 (2003), *Medtronic v. Advanced Bionics*, 630 N.W.2d 438 (Ct. App. Minn. 2001).