WSGR ALERT

Chancery Court Refuses to Enforce Non-Competition Agreement Against a California-Based Employee Despite Delaware Choice-of-Law Provision

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In non-competition agreement disputes involving California employees, it is common to encounter an agreement stating that the law of another state governs the non-compete. Since non-competes in California are generally unenforceable under California law, non-compete disputes involving California employees typically involve employees moving to California from another state, those working in California for a company with its principal operations in another state, or California-based employees that have signed a non-compete as part of an M&A transaction. Common to each of these situations (although not always the case) is the use of a non-compete agreement providing that its interpretation is governed by the law of a state other than California.

In *Ascension Insurance Holdings, LLC v. Underwood et al.* (January 28, 2015), the Delaware Court of Chancery addressed whether a non-compete agreement entered into in connection with an acquisition, and governed by Delaware law, could be enforced against a California-based employee competing against his employer in California. The court, concluding that California law (and not Delaware law) must be applied despite a Delaware choice-of-law provision, refused to enforce the non-compete agreement, and denied the former employer's request for an injunction prohibiting the employee from competing.

Background

In *Ascension*, a limited liability company (Ascension) incorporated in Delaware, but with its principal place of business in California, acquired the assets of another company. As part of the transaction, Ascension entered into an asset purchase agreement (APA) with the seller, as well as an employment agreement with Underwood, a California employee. The APA and the employment agreement each contained a non-compete restricting Underwood from competing against Ascension (and its subsidiaries) for five years after the acquisition. Underwood apparently lived up to the obligations of those agreements, and they were not at issue in the case.

At issue in *Ascension*, however, was a *third* agreement—an employee investment agreement (EIA), that contained a non-compete provision purporting to restrict Underwood from competing against it for a two-year period following the termination of his employment with Ascension's subsidiary. At the time Ascension entered into the APA with the seller of the assets, as well as the employment agreement with Underwood, it was anticipated that Underwood and Ascension would subsequently enter into an investment agreement permitting Underwood to invest in the parent company. They indeed did so, but did not enter into the EIA until approximately five months after the acquisition. In the EIA, the parties contractually agreed to both a Delaware venue (for any disputes) and Delaware choice of law. When Underwood began competing allegedly in violation of the EIA's non-compete, Ascension sought an injunction seeking to enforce the non-compete against Underwood and his new employer.

Court Concludes that California Law— Not Delaware's—Applies to the Non-Compete

The *Ascension* court readily noted that Delaware, unlike California, has no public policy disallowing contractual non-competition agreements, and similarly recognized that upholding freedom of contract is a fundamental policy of the state. Furthermore, the court acknowledged that where parties to a contract have chosen the law that will govern the contract, a court will generally respect that selection. Notwithstanding, the *Ascension* court rejected the idea that it must automatically defer to the parties' choice of law selection, and instead concluded that before it could apply Delaware law to the non-compete, it first had to determine whether enforcement of the non-compete would conflict with a "fundamental policy" of California. If such a conflict existed, the court could only apply Delaware law if Delaware's interest in the question of whether or not the non-compete at issue was enforceable was materially greater than that of California's interest in upholding its policy against the enforcement of non-competes. The court resolved both questions in favor of applying California law, not Delaware's.

Enforcing the Non-Compete Would Contravene California Public Policy Favoring Competition

With little discussion, the court acknowledged California's strong public policy disallowing contractual agreements not to compete, underscoring that in California "a contracting party's right to freely be employed (and to compete thereby with the parties with whom he has contracted) trumps his freedom to contract," and that this public policy is "enshrined in statute," Business & Professions Code §16600. It noted as well that, absent the parties' agreement "to import Delaware law," California law would apply to the question of whether the non-compete could be enforced. As a result, the court had no trouble concluding that the EIA's non-compete provision violated a California fundamental public policy.

While recognizing the "narrow exception" to B&P Code §16600 found in §16601 (sometimes referred to as the "sale of business" exception), the court concluded that while it was true that the asset acquisition transaction resulting in the APA and the employment agreement with Underwood contemplated an

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investment agreement, there was no contemporaneous agreement between the parties as to the EIA's non-compete restrictions. As a result, the evidence did not support a finding that the non-compete was a negotiated part of the asset purchase, and it could not have been relied upon by the parties at the time of the acquisition—especially in light of the fact that a non-compete had already been secured in the APA and the employment agreement. To support its view that the court had to examine each of the agreements separately, even though related to the same asset acquisition transaction, the court cited the California Court of Appeals decision in *Fillpoint, LLC v. Maas,* which is discussed online at: https://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-fillpoint-llc-maas.htm.

California Had the Materially Greater Interest in Protecting its Public Policy Disallowing Non-Competes

In considering whether California's interest in vindicating its public policy regarding non-competition agreements is greater than Delaware's interest in respecting the parties' contract as written and enforcing the non-compete agreement, the court rejected Ascension's assertion "that Delaware's broad interest in the freedom of contract will always, or even routinely trump the default state's [here, California's] public policy." Instead, given the facts of this case (including the facts that Underwood resided and worked in California and the agreement was entered into in California, and the alleged unlawful competition was taking place in California), the court concluded Delaware had no compelling interest in enforcing the non-compete, and that "California's specific interest in enforcement is materially greater than Delaware's general interest in the sanctity of a contract that has no relationship to this state."

Lessons Learned

- California's public policy disallowing non-competition agreements is a strong one and is recognized as such not just by California's state and federal courts, but by the courts of other states as well. Unless the non-compete is otherwise permissible under a statutory exception to §16600 (such as §16601), it likely will fail.
- While the §16601 sale or acquisition of a business exception to §16600 remains available in M&A transactions, those drafting agreements must take care to ensure that the non-compete sought as part of the transaction falls within the parameters of the exception, and should make clear in the transaction documents the purposes and rationale for the non-compete. A party desiring to secure an enforceable non-compete should properly address the non-compete in the underlying deal documents and should avoid attempting to do so at the last minute. The relevant documents should reference each other expressly and contain proper integration clauses. Without such tethering of a non-compete (or any other restrictive covenant potentially unlawful under §16600) 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.
- Those drafting non-compete agreements should consider carefully whether to include a choice of law provision specifying that the agreement will be governed by the law of another state, as well as selecting the venue desired for any dispute relating to the non-compete. Notwithstanding the result in *Ascension*, a case with different facts or equities might have been adjudicated differently in Delaware. Indeed, the *Ascension* court appeared prepared to consider factors that a California court might reject out of hand in analyzing a non-compete under California law. It is possible that another state's courts might have reached a different result based on the same facts.
- Lawsuits involving non-compete agreements can prove time consuming, expensive, and uncertain. While the particulars of *Ascension* are not known precisely, the decision makes clear that there were two hearings and a few rounds of briefing over at least a three-month period. Assessing the enforceability of a non-compete governed by the law of another state when considering the hiring of a candidate is essential to avoiding unnecessary legal disputes. Similarly, properly assessing the strengths and weaknesses of a non-compete enforcement action early on is critical to determining the correct litigation and/or settlement strategy.

Wilson Sonsini Goodrich & Rosati actively is following developments around the country with respect to non-competition agreements and other 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 Rico Rosales (urosales@wsgr.com), Marina Tsatalis (mtsatalis@wsgr.com), Laura Merritt (lmerritt@wsgr.com), or any member of the firm's employment and trade secrets litigation practice.

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650 Page Mill Road | Palo Alto, CA 94304-1050 | Tel: (650) 493-9300 | Fax: (650) 493-6811 | email: wsgr_resource@wsgr.com | www.wsgr.com