

Non-Compete Covenants in M&A: Structuring to Bind Sellers and Key Employees

Navigating State Laws and Recent Court Cases Regarding Enforceability

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Non-Compete Covenants in M&A: Structuring to Bind the Target Company, Founders, and Key Employees

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OUTLINE OF MAIN TOPICS

1. *Enforceability*

- *Delaware*
- *New York*
- *California*

2. *Drafting Considerations*

- *Restricted Activities*
- *Restricted Parties*
- *Length of Restrictions*
- *Restricted Territories*

ENFORCEABILITY

Enforceability (NY) – General

- New York courts distinguish covenants not-to-compete incident to the sale of a business from those made in the employment context.
 - Covenants not-to-compete made in the context of the sale of a business are more liberally enforced.
 - The idea being that a Seller may not recapture through its competition the goodwill it just sold.
- New York Court of Appeals, *Purchasing Associates, Inc. v. Weitz*, 13 N.Y.2d 267 (N.Y. 1963)

Enforceability (NY) – Reasonableness Standard

- A covenant-not-to-compete incident to the sale of a business in New York must be reasonable, in that it is “not more extensive, in terms of time and space, than is reasonably necessary to the buyer for the protection of his legitimate interest in the enjoyment of the assets bought.” *Purchasing Associates, Inc. v. Weitz*, 13 N.Y.2d 267 (N.Y. 1963)
- Examples of reasonableness (3-5 years):
 - A 3-year, nationwide restriction found reasonable for the sale of particular “business recovery services unit.” *FTI Consulting, Inc. v. PriceWaterhouseCoopers, LLC*, 779 N.Y.S.2d 56 (N.Y. App. Div. 1st Dep’t 2004).
 - A 5-year, NYC-wide restriction found enforceable for the sale of intercom installation business. *Hadari v. Leshchinsky*, 662 N.Y.S.2d 85 (N.Y. App. Div.2d Dep’t 1997)
 - A 5-year, world-wide restriction found reasonable for the sale of a circuit board business. *Brintec Corp. v. Azko N.V.*, 514 N.Y.S.2d 18, 19 (N.Y. App. Div. 1st Dep’t 1987)
 - A 5-year, nationwide restriction found reasonable for the sale of internet-based business. *Hakakian v. Think Bronze, LLC*, 2010 WL 5559030 (N.Y. Sup. Ct. Nassau Cnty. Dec. 22, 2010) (unpublished)

Enforceability – Diversified Shareholding

- Often times in an M&A transaction, the Target may have a diverse, unequal shareholding
- The Appellate Division, First Department has addressed the conceptual difference between a non-compete for a minority shareholder who receives relatively little consideration in a sale and a non-compete for a principal shareholder in *Shearson Lehman Bros. Holdings, Inc. v. Schmertzler*, 116 A.D.2d 216 (1986).
 - “[T]here is a clear, realistic difference between the problem presented by the application of a non-competition agreement to someone with a minimal ownership interest, and its application in the more familiar situation to the principal of a company being sold, or one of several principals of the company being sold, *where their identification with the company sold is so significant and pronounced that subsequent competition would inevitably impair the value of that which was bought.*” *Shearson Lehman Bros.*, 116 A.D.2d at 224 (emphasis added).
 - In *Shearson*, the court refused to enjoin a Managing Director of Lehman Brothers from accepting employment with Morgan Stanley’s investment banking group, when the Managing Director was a small, 0.49% minority shareholder and was participating in administrative functions at the time of the sale. *Shearson Lehman Bros.*, 116 A.D.2d at 229.

Enforceability (DE) – General

- Delaware courts distinguish covenants not-to-compete incident to the sale of a business from those made in the employment context.
- Covenants not-to-compete made in the context of the sale of a business are subject to a “less searching” inquiry.
- Covenants not-to-compete are subjected to a four-part test:
 - They must meet general contract law requirements;
 - They must be reasonable in scope and duration;
 - They must advance a legitimate economic interest of the party enforcing the covenant; and
 - They must survive a balancing of the equities.

- Delaware Court of Chancery, *Tristate Courier and Carriage, Inc. v. Berryman*, 2004 WL 835886 (Del. Chanc. Ct. Ch. April 15, 2004) (unpublished opinion)

Enforceability (DE) – Relevant Standards

- Legitimate Interest:
 - Courts have recognized protecting the goodwill of clients and protecting confidential information to be “legitimate interests.” *Tristate Courier and Carriage, Inc. v. Berryman*, 2004 WL 835886 (Del. Chanc. Ct. Ch. April 15, 2004) (unpublished opinion)
- Examples of reasonableness (3-5 years):
 - A 4-year, nationwide restriction was upheld for the sale of a telecommunications equipment testing, repair and engineering service business. *O’Leary v. Telecom Res. Serv., LLC*, 2011 WL 379399 (Del. Super. Ct. Jan. 14, 2011) (noting that courts in Delaware have upheld covenants-not-to-compete with a 10 year duration)
 - A 5-year restriction was upheld in the sale of a mobile diagnostic laboratory and x-ray service for skilled nursing facilities. *Kan-Di-Ki, LLC v. Suer*, 2015 BL 234124 (Del. Chanc. Ct. July 22, 2015)
 - A 2-year, covenant limited to the geographic area in which the Seller conducted business was upheld. *Tristate Courier and Carriage, Inc. v. Berryman*, 2004 WL 835886 (Del. Chanc. Ct. Ch. April 15, 2004) (unpublished opinion)
 - Generally, courts have invalidated geographic restrictions that include districts, counties or states where a company’s business is not conducted. *Caras v. America Original Corp.*, 2987 WL 15533 (Del. Chanc. Ct. 1987)

Enforceability (DE) – Cigna

- Even where reasonable, non-compete may be invalidated if nexus between covenant and consideration is not sufficiently clear
- *Cigna v. Audax Health Solutions*
 - Shareholders required to execute letter of transmittal in order to receive payment for their shares
 - Merger agreement contained only a cursory reference to this requirement
 - One shareholder refused to agree to the broad release language in the letter of transmittal
 - Chancery Court ruled the release was a new obligation imposed following the closing because no indication was given in the merger agreement that the release would be included in the letter of transmittal
 - Without new consideration to support this new obligation, the Court nullified the release

Avoiding a Cigna Problem

- Include the language of the non-compete in the language of the agreement
 - Directly in text
 - Attach form of letter of transmittal
- Include non-compete covenants in employment agreements with key employees who will continue following acquisition
- Include non-compete covenants in support agreements with large shareholders

Enforceability (CA) – General

- California law distinguishes covenants not-to-compete incident to the sale of a business from those made in the employment context.
 - Covenants not-to-compete made in the context of the sale of a business are allowable, whereas non-compete agreements in the context of an employment relationship are unenforceable.
 - The idea being that a Seller may not recapture through its competition the goodwill it just sold, whereas restrictions on employee mobility are barred absent sale of a company's goodwill.
- California Business and Professions Code (CBPC) Sections 16600, 16601.

Enforceability (CA) – Relevant Standards

- California law on restrictive covenants derives from statute. In sum and substance, CBPC 16601 states:
 - Any person who sells the goodwill of a business, or any owner of a business entity that sells his or her ownership interest in the business entity, may agree to refrain from competing within a specified geographic area in which the business is sold, so long as the buyer carries on a like business therein.
- In contrast, CBPC 16600 reads:
 - 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.
- Courts in CA will examine the enforceability of non-competition provisions in a purchase agreement separately from restrictive covenants in an employment agreement executed as part of the deal. *Fillpoint, LLC v. Maas*, 208 Cal. App. 4th 1170 (2012).

DRAFTING CONSIDERATIONS

Restricted Activities – The Business

- Can be based on:
 - Activities (e.g., prohibited from manufacturing, distributing, marketing, selling)
 - Opportunities (e.g., prohibited from responding to RFPs from X agency)
 - Customers (e.g., prohibited from selling products to X customer)
- Specific Description
 - Example: “...shall not engage in, own, manage or operate any business that manufactures, distributes, markets, or sells widgets to customers in the construction industry...”
 - Best Uses:
 - Narrowly-tailored restriction
 - Maximizing clarity

Restricted Activities – The Business

- General Description
 - Example: “...shall not engage in, own, manage or operate a business the same as, substantially similar to, or which competes with, the business of the target company...”
 - Best Uses:
 - Providing buyer with broad protection
 - Businesses that cannot be reduced to one-line descriptions
 - Additional Consideration – timing for determining what constitutes the business
 - Business as currently conducted
 - Business as currently conducted and presently proposed to be conducted
 - Business as currently conducted and as conducted at any time in the past [X] months

Restricted Activities – Capacities

- Own
- Operate
- Manage
- Advise (e.g., serve as consultant or director)
- Act as agent (e.g., broker)
- Provide guarantees
- Finance Source
- Serve as vendor

Restricted Activities - Carveouts

- Passive Investments
 - Typically restricted to only publicly-traded companies
 - Range: 1-5%
 - Example:
 - “...except that the beneficial ownership (within the meaning of Section 13(d) of the Securities Exchange Act of 1934, as amended) of less than [X]% of the outstanding shares of common stock of a publicly-held corporation shall not be deemed to violate this covenant”

Restricted Activities - Carveouts

- Retained Businesses
 - Important issue in carveout transactions
 - Specific Description – list all businesses being retained
 - Example: “...provided that the Seller shall be permitted to continue to operate each of its businesses set forth on Exhibit A”
 - General Description – all businesses other than the business being sold
 - Example: “...provided that the Seller shall be permitted to continue to operate all of the businesses that it currently operates as of immediately following the closing”
 - Can be very difficult to draw the line in a way that prevents creep

Restricted Activities - Carveouts

- Future Acquisitions by Seller
 - Important issue when dealing with private equity sellers
 - Options for Addressing:
 - Provide for a de minimis exception
 - Example: “...provided that any future acquisition by Seller of a business that generates less than [X]% of its gross revenue from businesses that compete with the Business shall not be deemed to violate this covenant”
 - Provide for divestiture period
 - Example: “In the event that, following the closing, Seller acquires a business that competes with the Business, Seller shall divest such business within [X] months following such acquisition, and the interim operation of such business prior to such divestiture shall not be deemed to violate this covenant as long as such divestiture is consummated within such period”

Restricted Activities - Carveouts

- Future Acquisitions of Seller
 - Important issue in carveout transactions
 - Options for Addressing:
 - Require future acquirors to assume non-compete obligations
 - Provide carveout for future acquirors (perhaps with a time limitation)
 - Example: “Seller shall not, and shall cause its Affiliates not to....; provided that [from and after the date that is the eighteen (18) month anniversary of the Closing Date], solely for purposes of this Section, the term “Affiliates” shall not be deemed to include any Person who acquires a majority of the equity interests of Seller”

Restricted Parties

- Selling Parties
 - Significant shareholders
 - Founders
 - Key employees
 - Rank-and-file employees
- Affiliates of Selling Parties
 - All affiliates vs only controlled affiliates
- Other Related Parties
 - Successors and assigns
 - Family members
- Beware of “directly or indirectly”
 - For a period of [X] years from and after the Closing Date, the Shareholders shall not, **directly or indirectly**, engage in, own, have any financial interest in, manage or operate....”

Length of Restrictions

- Finite duration following the closing
 - Typically falls in the range of 3-7 years
 - “For a period of [X] years following the Closing...”
- Can be tied to the period in which certain parties remain associated with the target company following the closing
 - Example: “From and after the Closing until the [X]-year anniversary of the Restricted Party ceasing to serve as an employee, officer, director or consultant of, or adviser to, the target company....”

Restricted Territories

- Typically tailored to locations in which business operates at time of closing
 - Country-by-country
 - Regional
 - Global
- Consider including territories in which buyer hopes to expand
- Can be drafted to expand or contract as business grows into or withdraws from various markets but must address what happens to shareholder's existing business in event of expansion

Further Protections for Buyer-Employer

- Contractual Terms
 - Description of the confidential information or customer goodwill to which the employee will have access
 - Description of the geographic area in which the employee will work
 - Disgorgement of profits received due to breach
 - Acknowledgment of irreparable harm and the right to injunctive relief
 - Waiver of bond/security requirement
 - Re-starting the time period from most recent breach
 - Attorneys' fees to prevailing party
 - Arbitration of disputes (but carve out for injunctive relief)
 - Severability/equitable reformation
 - Obligation to notify new employer
 - Forfeiture for breach, e.g., equity grants, separation payments

Employment Agreement Pitfalls

- Overreaching
 - Is this a high level employee?
 - In which geographic regions does the employee work?
- Ignoring Choice of Law Issues
 - Where will the employee sign the agreement?
 - Where is the company's residence?
 - Where will the employee's services be directed?

QUESTIONS?

Thank You

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