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It Is Tough To Beat Calif. On Noncompetes

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On Jan. 28, 2015, the Delaware Chancery Court declined to follow an explicit Delaware choice of law provision, denying a Delaware limited liability company's request for preliminary injunctive relief to enforce a noncompete provision against a California resident and former employee. See Ascension Insurance Holdings LLC v. Underwood. This case serves as a reminder that a non-California choice of law provision is not a guarantee that a noncompetition covenant that would be void under California law will be enforced, even by non-California courts, and has particular implications for employers seeking noncompete agreements against California employees.

Background

In 2008, Roberts Underwood, a California employee, participated a sale of assets (including goodwill) of Paula Financial to Ascension Ins. Holdings, a transaction that was governed by an asset purchase agreement. At the time, the parties expressly contemplated that Underwood would subsequently invest in the plaintiff but, notably, the parties did not discuss whether a restriction on competition would be a part of that contemplated investment agreement. Several months after the APA was entered into, the parties entered into an employee investment agreement under which the defendant purchased an interest in the plaintiff and agreed, among other things, to refrain from competing with the plaintiff or its subsidiary for two years after leaving employment with the plaintiff's subsidiary. In the EIA the parties also agreed to both Delaware venue and Delaware choice of law.

The plaintiff sought injunctive relief in the Court of Chancery to enforce the noncompete.

Noncompetition Covenants

Delaware public policy generally permits reasonable contractual agreements not to compete. In California, Section 16600 of the Business and Professions Code prohibits noncompetition covenants (…"every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void"). Such prohibition is subject to narrow statutory exceptions such as Section 16601, which permits a person who sells the assets and goodwill of a business to be subject to a noncompetition covenant.

Delaware Choice of Law

In Ascension, the plaintiff argued that the noncompete should be enforced under Delaware law, as the parties had agreed under the EIA choice of law provision. Delaware follows the Restatement (Second) of Conflict of Laws. Section 187 of the Restatement provides that, while the parties' choice of law will generally control, a choice of law provision should not be enforced in a way that circumvents the fundamental public policy of the state that would otherwise control the contract if that state has a materially greater interest in the matter than the state elected in the choice of law provision. Vice Chancellor Sam Glasscock III sought to determine whether: (1) enforcement of the covenant would conflict with a fundamental policy of California and (2) if so, whether California had a materially greater interest in the issue than Delaware.

Court Analysis

The vice chancellor found that California law applied notwithstanding the choice of law provision in the EIA. First, the vice chancellor determined that California was the state with the strongest contacts to the contract and that absent the choice of law provision, California law would apply. Next, he noted that California's public policy against noncompete provisions is stated unequivocally by statute. Finally, while he considered the fact that Delaware strongly favors parties' right to freedom of contract, the vice chancellor found that California had a materially greater interest in the question of whether the contract at issue should be enforced or not.

In determining that California's specific interest was materially greater than Delaware's, he noted that: (1) the APA and EIA were entered into in California, (2) the APA and EIA were negotiated in California, (3) the noncompete provision was limited almost exclusively to California by virtue of the geographic scope of the plaintiff's business and (4) the defendant's state of residence and the plaintiff's principal place of business were both in California. The vice chancellor stated that "[t]he entire purpose of the Restatement [choice of law] analysis is to prevent parties from contracting around the law of the default state by importing the law of a more contractarian state, unless that second state also has a compelling interest in enforcement."

The plaintiff argued that, even if California law applied, the exception set forth in Section 16601 permitted enforcement of the noncompete. The vice chancellor, applying California law, determined that the exception did not apply because there was no evidence that at the time the parties entered the APA they had contemplated a noncompete would be included in the EIA, and therefore the noncompete in the EIA was not a negotiated part of the asset purchase transaction. Bolstering this finding was the fact that Underwood had entered into a noncompete at the time of the APA — set forth in an employment agreement — but that covenant had expired in 2013. Failing to find that the plaintiff had relied on the EIA additional restriction not to compete because there was no agreement contemporaneous to the APA under which those restrictions were set forth, the vice chancellor noted that the purpose of the Section 16601 exception is to enforce a "post-acquisition" noncompete in order to protect a purchaser's interest in capitalizing on acquired goodwill for a limited period, as distinguished from a "post-employment" noncompete such as the one in the EIA, which is targeted at an employee's fundamental right to pursue a profession.

Conclusion

Employers seeking noncompetes against California employees (or where other California contacts are

present) should not rely on choice of law provisions to render an unenforceable noncompete enforceable. Ascension confirms that it is extremely difficult to obtain an enforceable noncompetition covenant against a California employee or resident. Where the employee, business and/or geographic scope of the noncompete are all closely tied to California, parties will want to be very certain that any noncompetition covenant fits squarely within one of the statutory exceptions to Section 16600 and that any agreement with respect to such a noncompetition covenant is documented contemporaneous with the underlying transaction giving rise to the exception.

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