

# THE HAGAN LAW FIRM

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### COVENANT NOT-TO-COMPETE IN CORPORATE REPURCHASE OF SHARES

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Covenants not to compete are void as a matter of law in the state of California. This issue usually arises in an employment scenario. The legislature has established a bright line public policy principle to ensure that every citizen shall retain the right to pursue lawful employment and enterprise of their choice. (See *Metro Traffic Control, Inc. v. Shadow Traffic Network* (1994) 22 Cal.App.4<sup>th</sup> 853). However, there is one exception to this bright line rule. That exception occurs in a situation where a shareholder sells the goodwill of a small business and is compensated in the purchase price for that goodwill. In such a case, a covenant not to compete may be upheld and enforceable.

#### THE RULE

Bus. & Prof. Code Section 16600 provides as follows:

*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.*

In many other states, there exists a "rule of reasonableness" that determines when restraints are allowed to be made on a person's ability to practice a profession, trade, or business. California long ago rejected this "rule of reasonableness" in 1872 when it enacted the Civil Code (now enacted as Bus. & Prof. Code, § 16600) in favor of open competition.

#### THE EXCEPTION TO THE RULE

Despite the unequivocal language of Bus. & Prof. Code Section 16600, there is one narrow exception set forth in Section 16601 Bus. & Prof. This exception presently reads:

*Any person who sells the goodwill of a business, or any shareholder of a corporation selling or otherwise disposing of all his shares in said corporation...may agree with the buyer to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of said corporation,...so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein.*

This exception is only applied to the sale of a business or in the situation where owners of small corporations are selling or disposing of their entire interest in the corporation. In all circumstances, the parties must consider the "goodwill" of the business in the sales price. When goodwill is valued and incorporated into the sale price, the share purchasers are allowed by the exception to protect their investment from "competition from the seller which competition would have the effect of reducing the value of the property right that was acquired." *Monogram Industries, Inc. v. Sar Industries, Inc.*, (1976) 64 Cal.App.3d at p. 701.

### **THE HILL MEDICAL V. WYCOFF CASE**

The matter of *Hill Medical Corporation v. Wycoff* 86 Cal.App.4th 895 (2001) is very instructive in understanding how determined and committed the state Courts remain to maintaining the firmly entrenched policy of open competition in commercial activities. In *Hill Medical v. Wycoff*, the Court found that a covenant not to compete, **not** located in an employment agreement but rather a stock repurchase agreement, was void.

The *Hill Medical v. Wycoff* case stands for the proposition that covenants not to compete will be found unenforceable against a selling shareholder if that shareholder does not receive value for the good will that is attached to his shares. In other words, unless a purchaser pays a selling shareholder for the value of the goodwill of a business, that shareholder has the unfettered right to conduct the exact same business activity in direct competition with the purchaser the very next day after selling his shares.

To understand this ruling better, it is important to know the following facts:

1. Dr. Wycoff was one of fourteen shareholders in a medical group called Hill Medical Corporation.
2. In 1996, Dr. Wycoff entered into an amended and restated employment agreement and stock redemption agreement which required him to sell his stock in the corporation back to the corporation in the event he was no longer employed by Hill Medical.
3. Hill Medical was required to repurchase Dr. Wycoff's stock at a price measured by the net book value (assets minus liabilities). Hill Medical did not carry goodwill as an asset on its books.

4. The stock redemption agreement that Dr. Wycoff signed contained a noncompetition provision which barred Dr. Wycoff from practicing radiology in a 7.5 miles radius from Hill Medical for a period of three years after repurchase of his shares by the corporation.

5. In 1999, Dr. Wycoff resigned his employment from Hill Medical and went to work for a competing medical facility which was within the 7.5 mile radius. Upon termination from Hill Medical, Dr. Wycoff tendered his shares to the corporation and was paid by Hill Medical the "book-value" of his shares. The redemption price did not include a component of goodwill.

6. In April, 1999, Hill Medical sued Dr. Wycoff seeking injunctive relief and enforcement of the covenant not to compete.

### **The Trial Court Findings**

The Trial Court determined that the employment contract and the redemption agreement were not two separate agreements, but in fact, a package deal. The Court further found that the covenant not to compete was invalid because the redemption agreement was devised to accomplish what the law would not allow under an employment agreement. Moreover, since the repurchase price of the shares was not fair market value, it did not include goodwill, therefore, the exception to the Bus. & Professions Code Section 16600 was not demonstrated.

### **The Appellate Court**

Hill Medical Corporation appealed the findings of the trial court. On January 30, 2001, the California Appellate Court upheld the trial court ruling in *Hill Medical Corporation v. Wycoff* 86 Cal.App.4th 895 (2001) that a covenant not to compete was void under Section 16600 Bus. & Prof. Code, and did **not** qualify under the limited exception provided for in Section 16601 Bus. & Prof.

After reviewing the repurchase price of Dr. Wycoff's shares, which is a primary indicator as to whether business goodwill was a factor in the purchase of the shares, the Appellate Court concluded that "there was no suggestion that goodwill was considered in arriving at the repurchase price." The Court further found that the final repurchase price was not fair market value, and did not reflect that Dr. Wycoff "significantly benefited from an appreciation in the value of the stock over the 21 years he held the shares." Perhaps most importantly, the Court found no evidence to suggest that Dr. Wycoff was adequately compensated in the repurchase price to relinquish his rights to compete in the future against Hill Medical Corporation.

In the Court's footnote 6 to *Hill Medical v. Wycoff*, it defined "good will" as follows:

*"Expectation of continued public patronage." (Section 14100 Bus. & Prof. Code. Baker v. Pratt (1986) 176 Cal. App. 3d. 370, 380. It is "property of an intangible nature and is a thing of value. When it is sold,*

*it is not the patronage of the general public that is sold, but that patronage which has become an asset of the business."*

## **CONCLUSION**

Just as goodwill must be valued in a sales transaction between corporations to qualify for exception against covenants not to compete under the Section 16601 of the Bus. & Prof, the repurchase of corporate shares must likewise involve a payment equal to the estimated value of "good will" associated with those shares to qualify for the exception and to give the purchaser the right to enforce a covenant not to compete against the selling shareholder.

In *Baker v. Pratt*, 176 Cal. App. 3d at p. 380, the court stated "A going business has a value over and above the aggregate value of the tangible property employed in it, and such goodwill is an indispensable element of the fair market value of such business."

If you are considering the purchase of a business or shares of a business from a shareholder disposing of all of his shares, and you wish to be able to enforce a covenant not to compete in order to protect the value of that which you are buying, you should consider paying at least fair market value for the business/shares. Over and above that, you should also make sure that the purchase agreement allocates the purchase price to reflect that a specific amount is paid as consideration for the purchase of "good will" and a reasonably worded covenant not to compete.

*The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.*

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