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Securing Key Employees in Health Care M&A Transactions with Restrictive Covenants

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Like the vastness and diversity of the industry itself (and ostensibly because of it), mergers and acquisitions (M&A transactions) in the health care industry take many forms and vary widely in size and complexity. From multi-billion-dollar mergers of pharmaceutical giants to the acquisition of a physician group by a larger group or a private equity firm, there are myriad iterations. The most prudent buyer will focus on transfer of intellectual property, records, technology, equipment, real estate, and integrating workforces and benefit plans. But an important issue that is often overlooked is securing key employees post-closing. This is particularly true in a human capital-intensive industry like health care.

Specifically, an acquiring entity should determine who the key employees are that make the target entity valuable. Be they senior executives, scientists, engineers, salespeople, physicians, nurses, etc., these critical personnel must be either incentivized to stay or disincentivized from leaving such that they are not a flight risk post-closing, and not a threat post-employment (whenever their employment may terminate).[1] At the same time, the acquiring entity should also be sure to secure its own key employees. M&A transactions can create anxiety (in particular if internal communication is bad), which may cause those employees to seek out new opportunities. Competitors and independent recruiters will no doubt take advantage of any turmoil to aggressively recruit employees. If key employees of both the acquiring and target entities are not secured, or if done incorrectly, they may leave following the transaction, join a competitor, or worse, they may misappropriate trade secrets and/or poach customers and other employees on the way out the door.

One common method of securing key employees is the use of restrictive covenants. Restrictive covenants take many forms, including confidentiality or non-disclosure covenants, noncompetition covenants (often called “noncompetes”), and both customer and employee non-solicitation covenants (often called “non-solicits”). They also can be triggered by different events. For example, the seller of a business may agree to “post-closing restrictive covenants” that would, for example, restrict the seller from competing or soliciting the target company’s customers or employees for a period following *the closing of the transaction* (often for five to seven years). These covenants are designed to protect the goodwill purchased by the acquiring entity and its investment. Post-closing restrictive covenants are typical in M&A transactions because they protect the acquiring entity and allow the sellers of the target entity to realize a higher sale price. These types of restrictive covenants are permissible under every state’s laws.

If the seller of the business intends to remain employed by the target entity post-closing, then they may also sign “post-employment restrictive covenants” that would, for example, restrict the seller from competing or soliciting the target company’s customers or employees for a period following the *termination of their employment* (often for one to two years). Other key employees may sign these as well, regardless of whether they were a seller of the business. These covenants are designed to protect the acquiring entity’s legitimate business interests (i.e., confidential information, trade secrets, and customer goodwill or relationships)[2] from a departing employee with malign intentions or ignorance of their legal obligations. Post-employment restrictive covenants are regularly enforced in most states, but not all, and the inquiry is very fact- and jurisdictional-dependent as discussed below.

The departure of key employees, in particular from businesses—like many in the health care industry—that derive their value, in large part, from human capital, can have a dramatic impact on the value of a business. Likewise, any unfair competition or solicitation of customers or other employees can place the acquiring entity's legitimate business interests at risk. As such, it is critical that the issue be addressed before closing so that there are no surprises.

Securing Key Employees Requires a Carrot and Stick Approach

Although this article primarily focuses on the use of restrictive covenants to secure key employees in connection with an M&A transaction, it is important to consider restrictive covenants as just one tool in a toolbox that also includes incentives such as retention bonuses, equity grants, stock options, generous benefits plans, flexible work arrangements, and the like. Indeed, not only do such incentives engender loyalty, but as discussed below, they may strengthen the legal enforceability of any restrictive covenants.

The best-case scenario, of course, is a happy and productive workforce that has no reason to move to a competitor, misappropriate trade secrets, or poach clients and other employees, and thus no need ever to enforce the restrictive covenants. But hoping for the best-case scenario is not a strategy, so implementing protective measures such as restrictive covenants proactively at the time of the acquisition is critically important.[3]

Determining What Protections Already Exist

As a first step, the acquiring entity should determine during due diligence what, if any, restrictive covenants already exist at the target entity, and whether (and to what extent) they are enforceable. Assuming the transaction is a stock deal, the acquiring entity will step into the shoes of the target entity, and there is no need for formal assignments of any restrictive covenant agreements and no risk that any such agreements will be wiped out as a result of the acquisition.[4]

If it is an asset deal, however, consideration must be given to the assignability of any existing agreements containing restrictive covenants, and any assignments must be done properly. This may require providing notice to the employee or obtaining the employee's consent, depending on how the assignment provision is drafted and state law. Indeed, some states do not permit assignment of restrictive covenant agreements absent a valid assignability provision and/or the employee's express consent.[5] And it is important to keep in mind that restrictive covenants are not only found in employment agreements; often they are contained in equity grants, stock option plans, or other agreements that may be eliminated or replaced as a result of the transaction.

Regardless of the form the transaction takes, the acquiring entity must ensure that any existing protections that the target entity has in place are sufficient to protect its investment and ongoing legitimate business interests. At a bare minimum, *all* employees who have access to confidential information and trade secrets must be subject to confidentiality or non-disclosure agreements. If they are not, that should be a major red flag. Not only are the target entity's trade secrets and confidential information unprotected—and may have already been disclosed, thereby ostensibly diminishing the value of the target entity—but it is a sign that the target entity either does not understand the importance of protecting its sensitive information or does not care. That lack of comprehension or concern could carry over to other aspects of the transaction.

Next, the acquiring entity should determine the existence and analyze the enforceability of any noncompete or non-solicitation covenants that the target entity's employees have executed. As discussed below, state law governing restrictive covenants has evolved substantially over the past decade and continues to do so at a rapid pace. This is particularly true in the health care industry, which has seen a lot of change over the past several years, some resulting from the pandemic.[6] As a result, the target entity may not have up-to-date agreements in place, or may not comply with all necessary technical requirements, and may not, therefore, be protected. Thus, it is critically important that attorneys who regularly practice in this area review and advise on this seemingly small but often significant aspect of the transaction.

Moreover, this is likewise a good time for an acquiring entity to make sure its own house is in order. There need to be incentives and/or protections in place securing all the employees it expects and/or hopes to remain following the transaction. These employees are just as critical as the target entity's key employees (if not more so) and should be treated accordingly.

Implementing New Protections If Necessary

To the extent the acquiring entity determines that there are insufficient protections in place to secure the target entity's key employees (or its own), it should work with counsel to create a strategy to update existing protections and/or implement new ones. Just as when analyzing existing protections, acquiring entities must understand the legal landscape when seeking to impose new restrictive covenants on employees. The acquiring company must implement a strategy that is not only compliant with current state laws, but adaptable to future changes in state (and potentially federal[7]) law.

Indeed, the legal landscape for restrictive covenants—especially noncompetes—differs from state to state. And these laws are not necessarily static. To the contrary, the legal landscape is rapidly changing nationwide. In the first half of 2022 alone, no fewer than 98 noncompete bills were introduced in 29 state legislatures.[8]

While most states will enforce reasonable, narrowly tailored restrictive covenants in most circumstances, California, North Dakota, and Oklahoma prohibit most post-employment restrictive covenants across the board.[9] Several other states have set wage floors and/or limit permissible restrictions in other ways. In certain states, continued employment alone is insufficient consideration, but in other states it is. And if the target entity is a physician group or practice, or otherwise employs health care workers, acquiring entities must be aware that several states either prohibit or limit the enforceability of post-employment restrictive covenants against certain health care workers, typically patient-facing practitioners like physicians and nurses (hereinafter, "health care noncompetes").[10]

Fortunately, employers are not necessarily out of luck in states that do not permit post-employment restrictive covenants, either generally or in the health care setting. Because the restrictive covenants are being implemented in connection with an M&A transaction, there are other possible avenues to achieve the desired result, some more creative and risky than others. For example, virtually all states—no matter how restrictive their laws may be—permit restrictive covenants that are ancillary to the sale of a business. This is true even in California, North Dakota, and Oklahoma, which otherwise generally prohibit restrictive covenants.[11] The issue then becomes how risk-tolerant and creative the acquiring entity is or is willing to be.

Sellers Should Receive Post-Closing Restrictive Covenants and (If Permissible) Post-Employment Restrictive Covenants

For any shareholders, members, partners, or other owners of the target entity that could be considered "sellers" of it, the transaction documents should include *post-closing* restrictive covenants. In addition, where the sellers will remain employed by the acquiring entity indefinitely, *post-employment* restrictive covenants should also be required in states that permit them.

For example, if a physician group owned by the physicians is selling its practice to a private equity firm in a state that permits health care noncompetes, and the physicians intend to remain employed by the new owners post-closing, the purchase and sale agreement should include covenants that prohibit the physicians from competing and soliciting patients and other employees (e.g., nurses) for some amount of time *following the closing of the transaction*. In addition, because they will remain employed (and could remain far longer than the term of the post-closing restrictive covenants), the physicians should also be required to sign agreements that contain covenants prohibiting unfair competition and solicitation of patients and other employees for some amount of time *following the termination of their employment*. The post-closing and post-employment covenants can be "stacked" in this manner—with one triggered by the transaction closing and the other, possibly at a later date, by termination of employment—and both should be utilized so as to protect the acquiring entity's investment and its ongoing legitimate business interests.

Unfortunately, the second prong of this approach (the *post-employment* restrictive covenants) would not work in our hypothetical in states that either do not permit noncompetes at all or prohibit health care noncompetes. So, for those situations—or any other situation in which the sale of a business exception would not apply, i.e., to non-seller employees—more creativity is necessary, which may also require an increased risk tolerance.

Non-Seller Employees Require More Creativity

In most states, assuming compliance with state law, employees of the acquired entity can be required to sign post-employment restrictive covenants as a condition of initial or continued employment. But there are outlier states that will require more creativity to secure these employees, whether the state prohibits noncompetes generally or health care noncompetes specifically. The example below will illustrate this point.

Assume that the transaction is a merger of two small biotechnology companies that will result in a new entity (Newco), and that certain key employees of both companies live and work in California, which generally does not permit post-employment restrictive covenants under Cal. Bus. & Prof. Code, § 16600 (Section 16600). In addition, assume these key employees have equity in their respective companies that will roll over into equity in Newco, and/or that they will receive new equity grants in Newco, and that they will remain employed by Newco post-closing. Finally, assume that these employees are expected to stay with the acquiring entity for longer than any post-closing restrictive covenants they may be subject to, and that Newco wants to ensure that they do not compete or solicit customer or other employees for a period following their termination of employment. Although Section 16600 would prohibit any *post-employment* restrictive covenants, there are a few options available, depending on whether the employee is represented by counsel, the amount and nature of the equity the employee will hold in Newco, how any equity buy-back provisions are drafted, and the acquiring entity's risk tolerance.

Out-of-State Choice-of-Law and Forum Selection Clauses May Be a Viable Option

One option is to include choice-of-law and forum selection clauses in restrictive covenant agreements that identify another state (e.g., the state in which Newco is incorporated or has its principal place of business) as the applicable law and venue for any disputes. While the chosen state's courts may enforce such a provision,[12] there are risks attendant with this approach because some states have laws that prohibit the use out-of-state choice-of-law and forum selection clauses that would result in a resident of that state being deprived of his or her rights under that state's laws. One example is California Labor Code § 925 (Section 925), which not only voids out-of-state choice-of-law and forum selection clauses that would deprive a California employee of the substantive protection of California law, including the employee's rights under Section 16600, but it permits impacted employees to obtain injunctive relief to prevent enforcement of such provisions, and if successful the employees would be entitled to recover attorneys' fees. Colorado and Washington have enacted similar laws.[13]

For any California employees who have retained their own counsel, however, Newco can attempt to take advantage of language in Section 925 that says that the prohibition on out-of-state choice-of-law and forum selection clauses "shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement." In other words, if an employee is represented by counsel, the parties may choose to include out-of-state choice-of-law and forum selection provisions and they will not automatically be void under Section 925. This approach does not guarantee success, but it is certainly worth trying in certain circumstances.[14]

Accordingly, for employees in states other than California, Colorado, and Washington—and potentially for represented employees in California—acquiring entities should consider including choice-of-law and forum selection clauses identifying a more business-friendly state's law as applicable to any dispute arising out of or in connection with any restrictive covenants. While this may not be foolproof, it can be a viable option in most states.

Tying Restrictive Covenants to the Sale of Equity at Termination of Employment May Be Feasible

Another option can arise where a departing employee can be considered a "seller" of goodwill in the business at the time the employee's employment with Newco terminates and is thus subject to the "sale of a business" exception to Section 16600 found in Section 16601 (or another state's equivalent).[15] For example, if the employee has a sufficient amount of equity, and Newco has a right (or obligation) to it buy back in the event the employee leaves the company, provided that Newco exercises that right and buys back all of the employee's equity for fair market value such that the employee can be said to be selling the employee's goodwill in the company, then the sale of a business exception may apply. In other words, when the employee resigns or is terminated—one, five, or even ten years down the road—Newco would buy back all the employee's equity and thereby trigger "post-closing" restrictive covenants beginning on the date such equity was sold that are covered by the sale of a business exception in Section 16601.

That said, employees should not be provided with equity solely to avoid the strictures of Section 16600 (or another state's laws), as it makes neither legal nor business sense to do so, and the courts may see right through it. California courts that have addressed this issue have held that an agreement of this nature cannot be a "transparent sham designed to get around the statutory proscription in section 16600."[16] However, not every case of an employee owning and selling seemingly small amounts of equity constitutes a "sham," especially when an employee's equity is obtained in the normal course of the employee's employment.

For example, in one seminal decision on this issue, the California Court of Appeal rejected an argument by an employee that he was not a "substantial shareholder" even though "he owned less than 3 percent of [his employer's] stock and received only $500,000 of the $23,000,000 purchase price" when his employer was sold.[17] In that case, the employee had, during his more than 20-year employment, "periodically purchased [his employer's] common stock and ultimately acquired approximately three percent (3%) of the outstanding shares."[18] Other decisions have come down on both sides of the issue, depending on the facts of the case. Ultimately, the upshot of this line of cases is that, "[i]n order to restrain the seller's profession, trade, or business, there must be a clear indication that in the sales transaction, *the parties valued or considered goodwill as a component of the sales price*, and thus the share purchasers were entitled to protect themselves from competition from the seller which competition would have the effect of reducing the value of the property right that was acquired."[19]

This approach is certainly not without risk (and cost, as the employer will have to buy back all the employee's equity at fair market value), and there is no bright line rule in the caselaw as to how much equity (in dollars or percentage) is sufficient to trigger the sale of a business exception versus being deemed a "sham." That said, it is a defensible approach in certain circumstances and something that companies with higher risk tolerances (and/or no other options) may consider, provided they can make it work practically. Any such provision, however, should be contained in an equity grant agreement or the like, not an employment agreement, to avoid the perception that it is really nothing more than a sham designed to get around the prohibition on post-employment restrictive covenants in Section 16600 or another state's equivalent.[20]

Conclusion

At the end of the day, it may not be possible to secure all key employees of a target entity, either with carrots (incentives) or sticks (restrictive covenants), following an M&A transaction. But that does not mean that the acquiring entity should not try, within the bounds of the law of course, to protect its investment, as well as the trade secrets, customer relationships, and workforce that it is acquiring. A little creativity can go a long way.

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1 It is often the case that a new entity will be created for purposes of a merger or acquisition. Likewise, in a merger of equals, there may not be a "target entity" per se. Moreover, different companies will value employees differently. Nevertheless, the terms "acquiring entity," "target entity," and "key employees" are used liberally herein to include all potential situations.

2 In most states, restrictive covenants are permissible provided they are intended to protect legitimate business interests, which typically include trade secrets, confidential information, and customer goodwill or relationships. In some states, it can include specialized training. Any reference to "legitimate business interests" in this article is intended to include these things and anything else state law may permit.

3 In addition to contractually limiting a former employee's ability to compete unfairly and/or solicit customers and other employees, restrictive covenants are also an important tool for protecting confidential information and trade secrets. Indeed, the federal Defend Trade Secrets Act and the Uniform Trade Secrets Act (which has been adopted in one form or another in 49

states, the only holdout being New York) require that "reasonable measures" or "reasonable efforts" be taken to protect any trade secrets. 18 U.S.C. § 1839(3)(A); Uniform Trade Secrets Act, § 1(4)(ii). One such measure (among others) is the use of restrictive covenants.

4 *Acordia of Ohio, LLC v. Fishel*, 133 Ohio St. 3d. 356, 357-58 (2012) ("employee noncompete agreements transfer to the surviving company after a merger has been completed").

5 *See, e.g.*, Fla. Stat. § 542.335(1)(f)(2) ("The court shall not refuse enforcement of a restrictive covenant on the ground that the person seeking enforcement is . . . an assignee or successor to a party to such contract, provided . . . [i]n the case of an assignee or successor, the restrictive covenant expressly authorized enforcement by a party's assignee or successor."); *Hess v. Gebhard & Co., Inc.*, 570 Pa. 148, 166-67 (2002) ("a restrictive covenant not to compete, contained in an employment agreement, is not assignable to the purchasing business entity, in the absence of a specific assignability provision, where the covenant is included in a sale of assets").

6 Erik Weibust and Katherine Rigby, *How to Protect Health Care Trade Secrets with Covenants*, Law360 (May 25, 2022), https://www.law360.com/articles/1496647/how-to-protect-health-care-trade-secrets-with-covenants.

7 Erik Weibust, *FTC Signals New Action on Noncompetes—But Is That the Will of the People?* Trade Secrets & Employee Mobility (June 13, 2022), https://www.tradesecretsandemployeemobility.com/2022/06/articles/non-compete-agreements/ftc-signals-new-action-on-noncompetes-but-is-that-the-will-of-the-people/.

8 Russell Beck, *Eight States with 39 Pending Noncompete Bills: Colorado is changing its noncompete law—again*, Fair Competition Law (July 6, 2022), https://faircompetitionlaw.com/2022/07/06/8-states-with-39-pending-noncompete-bills-colorado-is-changing-its-noncompete-law-again/.

9 *See, e.g.*, Cal. Bus. & Prof. Code § 16600; N.D. Cent. Code § 9-08-06; Okla. Stat. tit. 15, § 217.

10 *See, e.g.*, Colo. Rev. Stat. Ann. § 8-2-113(3) (physicians); Conn. Gen. Stat. Ann. § 20-14p (physicians); Conn. Gen. Stat. Ann. § 20-681 (home health care providers); 6 Del. Code § 2707 (physicians); Fla. Stat. § 542.336 (physicians); Ind. Code § 25-22.5-5.5-1, *et seq.* (physicians); N.H. Rev. Stat. Ann. § 329:31-a (physicians); N.H. Rev. Stat. Ann. § 315:18 (podiatrists); N.M. Stat. Ann. 1978, § 24-1i-1, *et seq.* (dentists, osteopathic physicians, physicians, podiatrists, certified registered nurse anesthetists, certified nurse practitioners, certified nurse-midwives); R.I. Gen. Laws § 5-37-33 (physicians); S.D. Codified Laws § 53-9-11.1 (physicians, physician assistants, certified nurse practitioners, nurse-midwifes, certified registered nurse anesthetist, registered nurses, and licensed practical nurses); Tenn. Code Ann. § 63-1-148 (physicians (except emergency medical specialists), podiatrists, chiropractors, dentists, optometrists, osteopathic physicians, and psychologists); Tex. Bus. & Com. Code Ann. §§ 15.50(b)-(c) (physicians); W. Va. Code §§ 47-11E-1, *et seq.* (physicians).

11 *See, e.g.*, Cal. Bus. & Prof. Code §16601; N.D. Cent. Code § 9-08-06; Okla. Stat. tit. 15, § 218.

12 *See, e.g.*, *The Hilb Group of New England, LLC v. Susan LePage*, 2022 WL 1538583, at *4-5 (E.D. Va. May 16, 2022) (rejecting argument that "enforcing the forum selection clause will go against Massachusetts's strong public policy interest" as set forth in the Massachusetts Noncompetition Agreement Act (MNCA), and holding that "federal law preempts Massachusetts's procedural rules" and "to allow the MNCA to trump the parties' contractual choice of forum would allow provincial attitudes to dominate").

13 *See* Colo. Rev. Stat. § 8-2-113; Wash. Rev. Code § 49.62.080. Other states, including Massachusetts, have similar prohibitions on out-of-state choice-of-law and forum selection provisions, but only Colorado and Washington have enforcement mechanisms similar to California's. Thus, while a court in Massachusetts may not enforce an out-of-state choice-of-law or forum selection provision if an employee were to bring a declaratory judgment action there, an employer will not be liable for penalties or attorneys' fees should it lose the argument, and thus the risk of such is lower.

14 It is not guaranteed because Section 925 does not provide that if a California resident has counsel and signs a contract that would require them to adjudicate a claim outside of California, then the California resident has waived the protections afforded under California law. It merely states that if the California resident has counsel, then an out-of-state choice-of-law provision is not automatically void under Section 925. In other words, while Section 925 precludes an employee who is represented by counsel from invoking Section 925's protections to *automatically void* a choice-of-law provision, nothing in Section 925 renders out-of-state choice-of-law provisions *automatically enforceable* when an employee is represented by counsel. A traditional conflicts of law analysis would still need to be performed, and California law may very well end up applying to the dispute. Likewise, Section 925 does not preclude an employee who is represented by counsel from asserting a Section 16600 challenge to a choice-of-law provision that would deprive him or her of Section 16600's protections. Thus, while this approach is less risky in California for employees who are represented by counsel, it is not guaranteed. And neither Colorado nor Washington have similar exceptions for represented individuals.

15 *See* Cal. Bus. & Prof. Code §16601 ("Any person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold, or that of the business entity, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein. . . . For the purposes of this section, 'owner of a business entity' means any partner, in the case of a business entity that is a partnership (including a limited partnership or a limited liability partnership), or any member, in the case of a business entity that is a limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction that recognizes such a series), or any owner of capital stock, in the case of a business entity that is a corporation.").

16 *Vacco Indus., Inc. v. Van Den Berg*, 5 Cal. App. 4th 34, 48 (1992) (citing *Bosley Med. Grp. v. Abramson*, 161 Cal. App. 3d 284, 287-88 (1984) ("Literally applied, section 16601 would permit a major public corporation to require any employee to purchase one of several million shares and to enter into an agreement not to work for a competitor—an absurd result, and contrary to this state's policy prohibiting such agreements.")).

17 *Vacco Indus.*, 5 Cal. App. 4th at 48-49 ("First, there was nothing sham about the purchase of Van Den Berg's stock. The purchase was not a device to impose an otherwise illegal restraint upon his future commercial activities. Second, Van Den Berg was, in the context of this transaction, a substantial shareholder. He was the ninth largest shareholder in the corporation and was one of its principal officers. The purchase of his stock was essential to Emerson's stated goal of acquiring all of Vacco's stock.").

18 *Id.* at 41.

19 *Hill Med. Corp. v. Wycoff*, 86 Cal. App. 4th 895, 903, 103 Cal. Rptr. 2d 779, 786 (2001) (emphasis added) ("When sellers transfer all of their corporate shares, which constitutes only a fraction of the corporate shares, the concerns are the same—did the transaction take into account corporate goodwill? The sale of the corporate fractional interest must involve a substantial interest in the corporation so that the owner, in transferring 'all' of his [or her] shares, can be said to transfer the goodwill of the corporation. Simply selling shares to an individual vendee or back to the corporation does not necessarily demonstrate that goodwill is part of the agreement. To hold otherwise would result in the enforceability of all covenants not to compete involving the sale of all of the vendors' shares, in violation of the purposes behind sections 16600 and 16601.") (internal quotations and citations omitted).

20 In other words, any such arrangement should be set up in a manner so that *Vacco Industries* governs, not *Bosley Medical Group*, which may be easier said than done depending on the facts of the case but is certainly not impossible.

