6 Calif. Employment Laws To Know For M&A Deals

By **Sofia Chesnokova, Susan Eandi and Caroline Burnett** (June 8, 2021)

Sofia Chesnokova

Susan Eandi

Caroline Burnett

In April, California Gov. Gavin Newsom signed a statewide right-to-recall law — S.B. 93 — affecting certain employers. One of the key provisions of the new law, which has not been subject to much discussion, is how it affects corporate transactions.

In this article, we discuss this new statute that could present challenges for deals, as well as a few older laws that never fail to complicate things when doing deals in the Golden State.

1. New Right-to-Recall Law Applicable to Certain Industries

The law affords recall rights to laid-off employees of certain businesses whose most recent separation from active service was due to a reason related to the COVID-19 pandemic.

S.B. 93 is effective immediately and will remain in effect through Dec. 31, 2024. It applies generally to hotels, private clubs, event centers, airport hospitality operations and airport service providers, while also applying specifically to janitorial, building maintenance and security services provided to office, retail and other commercial buildings.[1]

Importantly, the obligations under S.B. 93 will attach even with changes to business structure and operations. The law is applicable in any of the following circumstances:

- The ownership of the employer changed after the separation from employment of a laid-off employee, but the enterprise is conducting the same or similar operations as before the COVID-19 state of emergency.
- The form of organization of the employer changed after the COVID-19 state of emergency.
- Substantially all of the assets of the employer were acquired by another entity that conducts the same or similar operations using substantially the same assets.
- The employer relocates the operations at which a laid-off employee was employed before the COVID-19 state of emergency to a different location.

As such, if a buyer acquires a company through a share deal or a business in an asset deal in one of the covered industries, it may still have an obligation to offer certain previously laid-off employees specific information about job positions that become available for which the laid-off employees are qualified, and to offer positions to those laid-off employees based on a preference system, in accordance with specified timelines and procedures.

Note that several cities in California have also already adopted right-to-recall ordinances — Carlsbad, Long Beach, Los Angeles, Oakland, Pasadena, Sacramento and San Francisco.

S.B. 93 does not preempt these laws.

2. Board Diversity Mandates

Following in the steps of precedent-setting legislation mandating representation of women on boards of directors two years ago, in September 2020, Newsom signed A.B. 979[2] into law mandating diversity on certain public company boards of directors.

The new law requires publicly held corporations headquartered in California to include at least one person from an underrepresented community on their boards by the end of next year, with additional appointments required in future years.

Corporate transactions may present opportunities to appoint new directors for the target company and the parties should be mindful of their obligations particularly if a special-purpose acquisition company is utilized as an acquisition vehicle.

3. A.B. 5

California's wage and hour laws provide significant protections to employees, and are generally far more favorable to workers than federal labor laws. In the independent contractor context, the law recently became much stricter when the state passed the ABC test.

The ABC test was first adopted by the California Supreme Court in 2018, in a landmark case called Dynamex Operations West Inc. v. Superior Court of Los Angeles County.[3] Then, in September 2019, Newsom signed A.B. 5 — which codified the ABC test and made it harder to classify workers as independent contractors — into law.

Now, in most contexts under California law, the default presumption is that a worker is an employee if they provide labor or services for someone else in exchange for pay. The burden is on the engaging entity to establish that the worker is not an employee.

As part of due diligence for a transaction, buyers should evaluate a target company's independent contractor arrangements by reviewing the independent contractor agreements, IRS 1099 forms and the independent contractor census, which provides current and historic information on independent contractor use.

In order to pass the ABC test, not only must the contractors be free from the target company's direction and control in practice and on paper, but they must perform work outside the usual course of the target company's business and be customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the services performed.

As such, the team conducting due diligence should have an understanding of the type of business that the target company is engaged in and the nature of the services that are provided by the contractors. Very often, this type of analysis is difficult to perform simply by looking at documents, and it is helpful to arrange a call with the target company's management team to understand the current and historic business practices.

Independent contractor misclassification can result in material liabilities including, among other things, back pay, employment and tax penalties, interest, and attorney fees. If a misclassification risk is identified, the buyer should ensure that the transaction agreement includes appropriate employment representations and warranties to cover any misclassification claims.

If the risk is material, the buyer can consider negotiating a special indemnity for independent contractor misclassification claims or request a price adjustment. Buyers should then also consider remediation measures on a going-forward basis.

4. Noncompetition Agreement Restrictions

While noncompetition agreements are generally unenforceable in California, they may be enforceable when entered into in conjunction with the sale of a business provided certain conditions are satisfied.[4]

In a transactional context, a founder or other substantial shareholder of a business in California may be bound by a noncompetition agreement if the shareholder sells all of their substantial ownership interest in the target company, or substantially all of its operating assets and goodwill of the business, to a buyer who will carry on the business. The noncompetition agreement must be limited in scope to the business that the target company carried on prior to closing and the geographic area where the business was conducted.

California case law also implies a substantial ownership requirement to avoid subterfuge of the statute even though the statute does not have such verbiage. There is currently no bright-line rule of what constitutes substantial ownership; however, anything below 3% ownership is likely subject to challenge.

In technology transactions, it is not uncommon for buyers to seek a two- to five-year post-closing noncompetition and nonsolicitation covenant covering the geographic area where the business was conducted prior to closing. That said, each noncompetition agreement should be tailored with the specific facts and circumstances of the deal in mind.

Corporate company-to-company no-hire agreements are likely unlawful under Section 16600 of the California Business and Professions Code because they unlawfully prevent third parties — i.e., the employees who work for the business — from engaging in their profession. California courts take the position that no-hire agreements essentially impose noncompetition restraints on all of the employees of the business, often without their knowledge, and are therefore unenforceable under Section 16600.[5]

In contrast, employee nonsolicitation provisions that only restrict the seller from soliciting or recruiting employees of the business — other than through general advertisements — are likely enforceable, provided they are reasonably tailored to protect the buyer's legitimate interests.

It is common for buyers to try and circumvent the stringent California legal requirements for an enforceable noncompetition agreement by including a non-California choice-of-law and forum selection clause in the document.

While employment agreements and other documents presented "as a condition of employment" to a California employee must have a California choice of law and forum, and may not contain post-termination restrictive covenants unless the employee is represented by their own counsel — a loophole that remains somewhat untested when it comes to noncompetition provisions — there is no law mandating that a specific choice of law or forum be included in other types of agreements.

In the context of a corporate transaction, the buyer and the selling shareholders could agree to a non-California choice of law and forum provided that there is a nexus to this alternative forum. While, historically, courts have acknowledged California's strong public policy against noncompetition agreements and have often disregarded the choice of law in favor of California law when the litigation involved an employee based in California,[6] buyers have a stronger argument that the choice-of-law provision should be enforced when the noncompetition agreement is with a selling shareholder restricting competition with the sold business.

The main risk with this approach is that a court outside California could still decide to disregard the choice of law selected by the parties in favor of California law. When this takes place, the noncompetition agreement can be deemed overbroad and unlawful under California law if it does not otherwise fall within the California exceptions. California residents also often try to win the race to the courthouse by filing preemptive declaratory judgment claims in California seeking a favorable outcome from a California court.

If the noncompetition agreement is deemed overbroad and unlawful under California law, not only will the court refuse to enforce the agreement, but it can also expose the buyer to unfair business practice claims under Business and Professions Code Section 17200 and punitive damages.

5. Salary History Ban

In 2018, California joined the growing number of cities, states and territories banning employers from asking applicants for their salary history during the employment screening and interviewing process.

Under Section 432.3 of the California Labor Code, all California employers and their agents:

- Are prohibited from seeking salary history information about an applicant for employment; and
- Are required, upon reasonable request, to provide the pay scale for a position to an applicant for employment.

No California court has weighed in on the impact of the legislation in a transactional context. Notwithstanding, this is a potential issue cropping up during due diligence — e.g., review of human resources census data and benefits and compensation data to ensure compliance — and when drafting the deal agreement itself — e.g., requirements to produce disclosure schedules, covenants to provide the same or substantially similar terms, and conditions as in effect at closing or to extend new individualized employment offers and agreements.

It is not uncommon for buyers to make offers to target companies' employees after evaluating what the employees currently make. The exchange of information relating to compensation and benefits is a routine part of due diligence and the planning process for post-acquisition integration.

Generally, in a share deal or a reverse triangular merger, this should be a nonissue because employees simply continue to remain employed by their current employer. In an asset deal, forward merger or another transaction where the buyer intends to change the employees' employing entity either on or following closing, this can be an issue because the employees will experience a technical termination and rehire and may arguably be considered applicants such that making new employment offers based on the information gleaned from the diligence or deal representations could be considered a violation of the statute.

6. WARN Act

In light of COVID-19-related layoffs, furloughs and other cost-cutting measures, termination issues have become an even more important focus in corporate transactions.

It is essential to consider whether the sale will result in employment loss that triggers the California Worker Adjustment and Retraining Notification Act, especially when considering recent layoffs that may have occurred. Recall that California's WARN Act defines "mass layoff" more broadly than federal law; it also has no similar unforeseeable business circumstances exception to the 60-day notice period.

If the WARN Act may come into play, companies should examine who will bear the burden of notice and/or pay obligations in relation to the sale. Strategically timing personnel terminations and drafting appropriate contract language can assist a buyer in avoiding WARN Act-related liabilities.

Sofia Chesnokova and Susan Eandi are partners, and Caroline Burnett is a professional support lawyer, at Baker McKenzie.

[1] https://www.theemployerreport.com/2021/04/california-establishes-statewide-right-to-recall-for-covid-related-layoffs-limited-to-certain-industries/.

[2] https://www.theemployerreport.com/2020/10/california-mandates-more-diversity-in-corporate-boardrooms/#more-6216.

[3] Dynamex Operations West v. Superior Court.

[4] Cal. Bus. & Prof. Code §§ 16600, 16601.

[5] See Silguero v. Creteguard, Inc., 187 Cal. App. 4th 60 (2010) and VL Systems, Inc. v. Unisen, Inc., 152 Cal. App. 4th 708 (2007).

[6] See Davis v. Advanced Care Techs., Inc., 2007 WL 2288298, at *7 (E.D. Cal. Aug. 8, 2007); but see Advanced Bionics Corp. v. Medtronic, Inc., 29 Cal. 4th 697 (2002).