NIESAR & VESTAL LLP
Law Alert
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Non-Compete Agreements in a State of Flux

With a Federal Rule proposed but on hold, and recent amendments to the California law on non-compete agreements, it is appropriate to update our thinking in this area of business law. First, we will address the recent federal law developments. Second, we will address California law, as employers must still remain mindful of the state-specific limitations that govern non-competes. Finally, we will discuss the recent case *Samuelian v. Life Generations Healthcare, LLC*, Court of Appeal, 4th Dist. California (August 20, 2024).

Federal Law

On April 23, 2024, the Federal Trade Commission ("FTC") announced a Rule that would ban enforcement of substantially all non-compete agreements in employment contracts. The Rule was to become effective on September 4, 2024.

On July 23, 2024, Judge Kelly Hodge of the U.S. District Court for the Eastern District of Pennsylvania denied a request for a preliminary injunction that would block the Rule (*ATS Tree Services, LLC v. Federal Trade Commission*). Then on August 20, 2024, Judge Ada Brown, U.S. District Court for the Northern District of Texas, held that the FTC had exceeded its authority in promulgating the Rule because the FTC lacks substantive rulemaking authority. Judge Brown's ruling stated the injunction was to have nationwide effect, thus blocking enforcement of the Rule throughout the United States (*Ryan LLC v. Federal Trade Commission*).

Note that the FTC Rule would apply only to contracts of employment.

Since the Rule will not go into effect, if ever, until it is found to be within the FTC's area of rulemaking authority, we have made no attempt to determine if and how it might affect California law. It would appear, however, that most likely California law will impose much greater restrictions on post-employment covenants not to compete, such that the Federal Rule will likely have little or no practical effect with regard to employees in the State of California.

California Law

California has long mandated that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void". This was, until January 1, 2024, Section 16600 of the Business and Professions Code. California case law did not limit the application of Section 16600 to employment agreements. The recent amendments to the law primarily express the legislature's sentiment that, as to employment contracts, we really mean what we say in Section 16600. Briefly the changes resulted in:

(a) Old Section 16600 is now Section 16600(a).

(b) Reference is made to *Edwards v. Arthur Andersen LLP,* a California Supreme Court decision that held that there is no exception in Section 16600 for a "narrow restraint", as had been found to be the intent of the law in an earlier Ninth Circuit opinion.

(c) And the Section applies to agreements where two persons agree that one of them shall not do business with a third person.

(d) A new Section 16600.1 was added to further emphasize that the legislature really means it, so much so that a violation constitutes an act of unfair competition.

(e) And Section 16600.5 was added to say any attempt by an employer to impose or enforce a non-compete is a civil violation and the employee may bring a private action for injunctive relief and damages and, if successful, recover reasonable attorney's fees and costs.

There are limited exceptions. Section 16601 says that the law does not apply in the case of a person giving a non-compete in connection with selling the goodwill of a business, or all of the seller's interest in a business entity, so long as the covenant is enforceable only where the relevant person or entity had done business and only for so long as the buyer conducts a like business in the relevant area. Likewise, Section 16602 provides an exception in the case of a covenant executed by a partner leaving a partnership, and/or upon the dissolution of the partnership. And Section 16602.5, *ditto* with respect to limited liability companies.

Note that case law has found a covenant unenforceable when an employee purchases a minimal interest in an entity and enters into an agreement providing that, upon termination of employment, the company will have the right to repurchase the interest and the seller will thereafter be prohibited from engaging in competition with the company. These cases focus on the reality of the situation; if the repurchase price is virtually identical with the original purchase price of the relevant ownership interest, or the price specified clearly does not reflect the full enterprise value of the company, including its goodwill, the court may find the covenant not enforceable under any one of the exceptions. *See*, e.g., *Bosley Medical Group v. Abramson,* 161 Cal. App. 3d (1984).

While Section 16000, et seq, focuses heavily on employment contracts and employees, generally, it is important to note that statute also applies to non-employee situations. With regard to covenants agreed to by employees, these laws are applied very strictly, the "per se standard". If there is a covenant that imposes any restraint at all, it will almost certainly be found void, unenforceable, and now even a civil wrong that may lead to the employer paying damages and attorney fees. In cases not involving an employee where Section 16600 has been employed, the law is more flexible. For a covenant by a non-employee, such as a business-to-business covenant, or a service provider agreement in an LLC where the service provider is not a W-2 employee, the enforceability is determined with reference to a "reasonableness standard". In short, the court makes a determination that the covenant either promotes competition, or impedes competition; in the former case the covenant is enforceable, but not in the latter case.

Finally, in the employee context, Section 16600 is not usually relevant unless the covenant is being analyzed with respect to post-employment activities. Employees will in almost all cases be deemed to have duties of loyalty to the employer, and those duties prohibit competition by the employee with the employer's business.

Samuelian v. Life Generations Healthcare, LLC

This case presents a mix and match conglomeration of issues involving a non-compete covenant in an Operating Agreement created in connection with the LLC's purchase of approximately one-half of Samuelian's membership interest. Samuelian had been a founder and Manager of the LLC, but was not a Manager at the time of the sale transaction. The new Operating Agreement restrained the LLC's members from competing with the Company. The Operating Agreement also reserved to Samuelian important voting rights that may have meant he could be found to have been a control person with fiduciary duties to the LLC and its members. Finally, however, the new operating agreement provided that all members owed fiduciary duties to the other members.

The facts and the law issues in the case are numerous and complicated. For purposes of this Law Alert, it seems best to present a list of issues and conclusions from the case that will help demonstrate the minefield that one may have to navigate to have an enforceable non-compete agreement:

(a) The exemption from 16600 that is based upon sale of the seller's entire interest in the entity is not available in a "partial sale" as existed in Samuelian.

(b) In the case of a partial sale, a covenant may still be enforceable if it passes the reasonable test, i.e., more likely to promote competition than diminish it.

(c) If the person executing the covenant is not an employee, such as a member of an LLC who may or may not be a service provider, the enforceability of the covenant also will be dependent upon it passing the reasonableness test.

(d) If the person who agreed to the non-compete is a fiduciary to the other party to the agreement containing the non-compete provision, generally Section 16600 will not apply because the duty of loyalty of a fiduciary to the beneficiary of the fiduciary's duties would be violated by the fiduciary competing with the beneficiary.

If you have questions arising out of the aforementioned Federal Rule and/or recent amendments to the California law on non-compete agreements, please feel free to contact Gerald Niesar (gniesar@nvlawllp.com), Oscar Escobar (oescobar@nvlawllp.com) or Carolina Aricu (caricu@nvlawllp.com).