# What California Can Teach Us About a World Without Non-Competes

**By Anna Pletcher, Julia Schiller and Mike Rosenblatt**

In January 2023, the Federal Trade Commission brought its first ever enforcement actions to curb the use of non-compete agreements. The resulting settlements forced three companies and two individuals to stop using non-competes entirely. A few days later, the FTC announced a Notice of Proposed Rulemaking (NPRM) that would ban virtually all non-compete agreements, branding them as unfair methods of competition in violation of Section 5 of the FTC Act. If adopted, this change would be consequential and far-reaching: Not only would it prohibit non-compete agreements going forward, but it would also be retroactive, voiding existing agreements. The FTC estimates that 18 percent of U.S. workers—about 30 million people—are covered by these contracts.[1]

Non-compete agreements are restrictive covenants that prevent former employees from engaging in certain activities that are competitive with their former employers—such as accepting a new job or operating a business—after the conclusion of their employment. Employers use non-compete agreements to safeguard trade secrets and client lists from competitors and to ensure that they recoup the investments they make in training employees. Acquiring companies also commonly use non-compete agreements to protect the value of businesses they acquire.

While the FTC recognizes these justifications, it contends that non-compete agreements place unnecessary restrictions on employee mobility and limit competition for employees. The FTC says its new rule would "increase wages by nearly $300 billion per year and expand career opportunities for about 30 million Americans."[2]

To understand the possible effects of its proposed ban, the FTC looked to how states have implemented laws restricting non-compete agreements. In a January 2023 *New York Times* op-ed, FTC Chair Lina Khan cited California as an example of an economy that functions well without non-compete agreements.[3] With limited exceptions, non-competes have been unenforceable in California for more than 150 years.[4] In its NPRM, the FTC highlighted California's economic success, noting it is home to "four of the world's ten largest companies by market capitalization" and is "the global center of the technology sector."[5] The FTC also noted that North Dakota and Oklahoma,

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1 Non-Compete Clause Rule, 88 Fed. Reg. 3482, 3485 (Jan. 19, 2023) (to be codified at 16 C.F.R. pt. 910).

2 Federal Trade Commission, FTC Proposes Rule to Ban Noncompete Clauses, Which Hurt Workers and Harm Competition (Jan. 5, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc-proposes-rule-ban-noncompete-clauses-which-hurt-workers-harm-competition.

3 Lina Khan, *Noncompetes Depress Wages and Kill Innovation*, N.Y. Times (Jan. 9, 2023), https://www.nytimes.com/2023/01/09/opinion/linakhan-ftc-noncompete.html.

4 Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3507.

5 *Id.*

which have long histories of prohibiting non-compete agreements, are home to successful energy industries.[6]

California has the longest and most robust history of prohibiting non-compete agreements, and a rich jurisprudence on the subject has developed there. What can California's experience tell us about a world without non-competes? In this article, we examine the strategies that California businesses have used to protect their legitimate interests without relying on non-compete agreements and the case law that has developed in response to these efforts.

We first provide a historical overview of California's ban on non-competes and compare California's statute to the FTC's proposed rule. Then we examine three of the most challenging issues that non-compete bans present for businesses: safeguarding trade secrets, protecting investments in employees, and preserving the value of a company during a merger or sale. Finally, we explore the meaning of "de facto" non-compete agreements and provide practical tips for employers gleaned from how California courts have applied the state's ban.

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## Legal Landscape

Under federal law, non-compete agreements are subject to scrutiny under Section 1 of the Sherman Act as restraints of trade.[7] In the context of an employment agreement or the sale of a business, non-compete agreements pass muster under Section 1 if they are "ancillary" (i.e., reasonably necessary to protect legitimate business activity) and reasonably limited in scope to protect legitimate interests.[8] The rule-of-reason inquiry is fact-specific; courts typically examine the duration and scope given the business justifications for the restraint.[9]

There is currently no broad federal prohibition on non-compete agreements, but California,[10] Minnesota,[11] North Dakota,[12] and Oklahoma[13] have enacted statutes deeming all non-compete agreements unenforceable, subject to certain limited exceptions. Eleven additional states and the District of Columbia have also enacted statutes that make certain non-compete agreements

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[6] *Id.*

[7] Non-compete clauses also have been challenged under Section 2 of the Sherman Act, but those challenges have not been successful. *See BRFHH Shreveport, LLC v. Willis Knighton Med. Ctr.*, 176 F. Supp. 3d 606, 625 (W.D. La. 2016) ("[Plaintiff] has offered no authority specifically holding or suggesting that non-compete agreements . . . are anticompetitive under section 2.").

[8] ABA Antitrust Law Section, 2022 Ann. Rev. of Antitrust L. Dev. 36–37 (2022). There are different formulations for determining whether a restraint is ancillary. *See, e.g., Aya Healthcare Services, Inc. v. AMN Healthcare, Inc.*, 9 F.4th 1102, 1109 (9th Cir. 2021) (ancillary restraints are "subordinate and collateral to a separate, legitimate transaction" and "reasonably necessary to achieving that transaction's procompetitive purpose"); *Polk Bros., Inc. v. Forest City Enters., Inc.*, 776 F.2d 185, 189 (7th Cir. 1985) (ancillary restraints are "part of a larger endeavor whose success they promote"); *Major League Baseball Props. v. Salvino, Inc.*, 542 F.3d 290, 339 (2d Cir. 2008) (Sotomayor, J., concurring) (to be ancillary, "a challenged restraint must have a reasonable procompetitive justification related to the efficiency-enhancing purposes of the joint venture.").

[9] *Perceptron, Inc. v. Sensor Adaptive Machs., Inc.*, 221 F.3d 913, 919 (6th Cir. 2000).

[10] Cal. Bus. & Prof. Code §16600.

[11] Minn. Stat. Ann. §181.988.

[12] N.D. Cent. Code §9-08-06.

[13] Okla. Stat. tit. 15, §217.

void or unenforceable, often based on a worker's earnings.[14] There is clear momentum at the state level to further restrict non-compete agreements[15]: Eight of these states and the District of Columbia have enacted or amended non-compete laws since 2018.[16] Minnesota's ban took effect July 1, 2023.

***California's Section 16600: History and Development of the Non-Compete Ban.*** California's attention to non-compete agreements dates to 1868, when the California Supreme Court held that agreements restraining trade are valid only if reasonably limited in duration and scope and entered into for sufficient consideration.[17] In *Wright v. Ryder*, an Oregon steamboat company agreed to acquire a steamboat from a California operator on the condition that it would not be used in California waters for ten years. Citing a long history of English and American common law, the court reasoned that "private citizens should not be allowed, even by their own voluntary contracts, to restrain themselves unreasonably from the prosecution of trades, callings, or professions, or from embarking in business enterprises in the promotion and encouragement of which the public has an interest."[18]

The California Legislature banned non-competes in 1872.[19] The current statute, enacted in 1941, declares void any agreement "by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind."[20] Section 16600 renders unenforceable any agreement that restrains an employee's ability to seek future lawful employment, whether or not the restraint is labeled as a "non-compete agreement."[21]

Against this backdrop, courts initially adopted different positions on whether Section 16600 prohibited covenants that partially or narrowly limited future employment. Some courts concluded that non-competes were enforceable where employees were not completely precluded from practicing

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[14] *See* Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3494. These state law limits take various forms. Some of these states impose temporal restrictions on non-compete agreements. For example, Utah's non-compete law prohibits non-compete agreements that last more than one year. Utah Code Ann. §34-51-201. Others permit non-competes where they are restricted to a territory near the original employer and narrowly tailored. Wisconsin's non-compete law, for example, requires non-compete agreements to be limited "within a specified territory . . . only if the restrictions imposed are reasonably necessary for the protection of the employer or principal." Wis. Stat. §103.465; *Madison Auto Ctr., LLC v. Lallas*, 2023 WI App 39, ¶12 (Wis. Ct. App. June 8, 2023) (per curiam) (finding that a 100-mile non-compete radius was not reasonable where the business had a 30-mile radius for its customer base). Several others permit non-competes but prohibit their enforcement with respect to certain types of workers. For example, New Hampshire's non-compete law prohibits employers from entering into non-compete agreements with low-wage employees, which are defined as employees earning less than 200 percent of the federal minimum wage. NH Rev. Stat. §275:70-a. Similarly, Rhode Island's non-compete law prohibits employers from entering into non-compete agreements with employees who are considered "non-exempt" from certain overtime provisions, students participating in an internship, and employees aged 18 or younger. R.I. Gen. Laws §28-59-3.

[15] *See, e.g.*, Ian T. Clarke-Fisher et al., *New York Inches Closer to Banning Non-Compete Agreements*, Nat'l Law Rev. (June 24, 2023), https://www.natlawreview.com/article/new-york-inches-closer-to-banning-non-compete-agreements (outlining the New York legislature's passage of a law prohibiting non-compete agreements).

[16] Specifically, Minnesota (Minn. Stat. Ann. §181.988), Massachusetts (Mass. Gen. Laws ch. 149 §24L), Maryland (Md. Code Ann., Lab. & Empl. §3-716), Washington (Wash. Rev. Code §49.62.005, *et seq.*), Nevada (Nev. Rev. Stat. 613.195, *et seq.*), Oregon (Or. Rev. Stat. §653.295), Illinois (820 Ill. Comp. Stat. 90/1, *et. seq.*), Colorado (Colo. Rev. Stat. §8-2-113), and Washington, D.C. (D.C. Code §§32-581.01, *et seq.*).

[17] *Wright v. Ryder*, 36 Cal. 342, 357 (Cal. 1868).

[18] *Id.*

[19] Cal. Civ. Code §1673 (repealed 1941) ("Every contract by which any one is restrained from exercising a lawful profession, trade, or business of any kind, otherwise than is provided by the next two sections, is to that extent void.").

[20] Cal. Bus. & Prof. Code §16600.

[21] *Blank v. Kirwan*, 39 Cal. 3d. 311, 328 (1985) (section 16600 does not only apply to explicit covenants not to compete, and instead "generally proscribes contracts under which one or more of the parties agrees to restrict his activity in the marketplace in some way").

their trade or profession,[22] while others rejected this interpretation allowing so-called "narrow restraints." In *Edwards v. Arthur Andersen*, the California Supreme Court held that even "narrow restraints" on future employment are incompatible with the text of Section 16600, and reaffirmed the state's public policy in favor of employee mobility: "California courts have been clear in their expression that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat."[23] California recently amended Section 16600 (effective January 1, 2024) to codify this result: a new subsection instructs that the statute "shall be read broadly, in accordance with *Edwards v. Arthur Andersen*," so any non-compete agreement "no matter how narrowly tailored" is void unless it satisfies a statutory exception.[24]

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As broad as Section 16600 is, California has enumerated certain limited exceptions that permit non-compete agreements in connection with the sale of a business or dissolution of a partnership.[25] For example, Section 16601 provides that the owner of a business may be bound by an agreement not to carry on a similar business within a specific geographic area after the sale.[26] The party seeking to enforce the agreement must "clearly establish that it falls within this limited exception."[27] Section 16601 is a codification of the application of the rule of "reasonableness" to a sale of a business.[28]

***The FTC's Proposed Rule.*** On January 5, 2023, the FTC announced a notice of proposed rulemaking that would broadly classify non-compete agreements as unfair methods of competition in violation of Section 5 of the FTC Act. Specifically, the law "would prohibit an employer from entering into or attempting to enter into a non-compete clause with a worker and maintaining with a worker a non-compete clause."[29]

The FTC's proposal would be retroactive, requiring employers to "rescind non-compete clauses entered into before the compliance date," in addition to banning non-compete agreements going forward.[30] Employers would be required to notify both current and former employees that any non-compete agreements are no longer in effect.[31] The proposed rule includes an exemption that allows non-competes that restrict individuals who sell a business, but only if they are a "substantial owner," defined as owning 25 percent or more of the business.[32]

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[22] *See, e.g.*, *Campbell v. Bd. of Trs. of Leland Stanford Junior Univ.*, 817 F.2d 499, 502 (9th Cir. 1987) (adopting the "narrow restraint" standard).

[23] *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 293 (Cal. 2008).

[24] Assem, Bill 1076, 2023-2024 Reg. Sess. (Cal. 2023) (codified as amended at Cal. Bus. & Prof. Code §16600(b) (2024)).

[25] Cal. Bus. & Prof. Code §§16601 (exception for sale of business), 16602 (exception for dissolution of, or dissociation from, partnership), 16602.5 (exception for dissolution or sale of limited liability company).

[26] *See, e.g., Monogram Indus., Inc. v. Sar Indus., Inc.*, 64 Cal. App. 3d 692, 702 (1976) (holding that the geographic restrictions under §16601 may be "the entire area in which the parties conducted all phases of their business including production, promotional and marketing activities as well as sales").

[27] *Blue Mountain Enters., LLC v. Owen*, 74 Cal. App. 5th 537, 550–51 (2022) (internal quotation marks and citation omitted). Note, however, that the exception under Section 16601 is not unrestrained; California courts have held that "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.'" *Hill Med. Corp. v. Wycoff*, 86 Cal. App. 4th 895, 903 (2001) (quoting *Monogram Indus.*, 64 Cal. App. 3d at 701).

[28] *Monogram Indus.*, 64 Cal. App. 3d at 698.

[29] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3511.

[30] *Id.*

[31] *Id.* at 3512–13.

[32] *Id.* at 3515.

The FTC's rule would also expressly preempt state laws, though states would be permitted to create more stringent prohibitions on non-compete agreements.[33]

***Following California's Lead, the FTC Would Prohibit "De Facto" Non-Competes.*** The FTC's proposed rule expressly applies not just to explicit non-compete agreements, but also to "de facto" non-competes, a clear nod to California jurisprudence.

The NPRM defines a de facto non-compete as "a contractual term between an employer and a worker that typically blocks the worker from working for a competing employer, or starting a competing business, within a certain geographic area and period of time after the worker's employment ends."[34] The FTC reasons that prohibiting de facto non-competes is critical because such an agreement "has the effect of prohibiting the worker from seeking or accepting employment" with a competitor after leaving the original employer.[35] The NPRM provides the example of a non-disclosure agreement (NDA) written so broadly so as to preclude the employee from working in the same field for another employer as a de facto non-compete.[36] The NPRM states that an over-broad NDA that restricts an employee from working in the same field may constitute a de facto non-compete.[37]

The FTC's example of an overly broad non-disclosure agreement appears to be directly inspired by *Brown v. TGS Management Co.*, a recent decision from the California Court of Appeal that held that an overly broad confidentiality agreement violated Section 16600 as a de facto non-compete provision because it forever prevented a former employee from working in his field. In that case, the former employer's broad definition of confidential information included "all information that is 'usable in' or that 'relates to'" the employer's industry.[38] The *Brown* court assessed whether agreements with employees, even if not drafted as non-compete agreements, violated California's expressed policy of promoting employee mobility.[39] The court found that such a provision constituted a de facto non-compete as it "bar[red] Brown in perpetuity from doing any work in the securities field, much less in his chosen profession."[40]

## Protecting Employers' Incentives to Invest in the Absence of Non-Compete Agreements

The FTC acknowledges there is evidence that non-compete clauses increase employers' willingness to invest in their employees and cites this as the "primary justification" for their use. Employers may, for example, be more willing to invest in training and share trade secrets or other confidential information with workers when they feel more confident that employees will not depart for competitors.

While the FTC acknowledges that the loss of this investment "would likely represent the greatest cost of the proposed rule,"[41] it also notes that employers have alternatives for protecting their

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[33] *Id.*

[34] *Id.* at 3482.

[35] *Id.* at 3535.

[36] The NPRM provides another example of a de facto non-compete, in the form of a Training Repayment Agreement where the repayment is not "reasonably related to the costs the employer incurred for training the worker." *Id.* at 3510.

[37] *Id.* at 3509–10.

[38] *Brown v. TGS Mgmt. Co, LLC*, 57 Cal. App. 5th 303, 317 (2020).

[39] *Id.* at 314–16.

[40] *Id.* at 319.

[41] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3493.

investments in employees: They can rely on trade secret laws,[42] NDAs,[43] fixed duration contracts,[44] or can increase pay and improve working conditions.[45] While these options "may not be as protective as employers would like," the commission argues that they "reasonably accomplish the same purposes as non-compete clauses while burdening competition to a less significant degree."[46]

Employers in California have long grappled with how effectively these alternatives protect their interests in a world without non-compete agreements. In this section, we look to California's experience to see how well these alternatives have worked.

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***Alternatives for Protecting Confidential Information.*** In place of non-compete agreements, the FTC cites two primary strategies employers can use to protect confidential proprietary information when employees depart: pursuing claims for tortious misappropriation of trade secrets and entering into confidentiality agreements.

**State and Federal Statutes Protect Trade Secrets from Misappropriation.** Trade secrets are protected under both state and federal law. California, along with 47 other states and the District of Columbia, has adopted the Uniform Trade Secrets Act (UTSA, or CUTSA, in California),[47] which provides a civil cause of action for trade secret misappropriation. In addition, the Defend Trade Secrets Act (DTSA) of 2016 established a civil cause of action under federal law for trade secret misappropriation.[48] Both California's CUTSA and the DTSA provide for injunctive relief, damages (including punitive damages), and recovery of attorneys' fees.

CUTSA broadly defines "trade secrets" as information, formulas, programs, and processes that derive "independent economic value" from not being generally known to the public and are subject to the owner's reasonable efforts to maintain confidentiality.[49] California courts have held "trade secrets" to include client lists,[50] copyrighted or source code material,[51] and other proprietary materials, including software and algorithms.[52] Federal law defines trade secrets similarly.[53] Trade

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[42] *Id.* at 3505–06.

[43] *Id.* at 3506–07.

[44] *Id.* at 3507.

[45] *Id.*

[46] *Id.* at 3505.

[47] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3506 (noting adoption by 47 states and the District of Columbia). Massachusetts has also adopted the UTSA, bringing the total to 48. *See* Mass. Gen. Laws ch. 93 § 42A. States that have not adopted the UTSA protect trade secrets under a different statute or common law. Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3506.

[48] Defend Trade Secrets Act of 2016, 18 U.S.C. § 1836.

[49] *See* Cal. Civ. Code § 3426.1 for definition of trade secret.

[50] *Am. Credit Indem. Co. v. Sacks*, 213 Cal. App. 3d 622, 631 (1989).

[51] *Cadence Design Sys., Inc. v. Avant! Corp.*, 57 P.3d 647 (Cal. 2002) (applying CUTSA to claim concerning source code material).

[52] *Multiversal Enters.-Mammoth Props., LLC v. Yelp Inc.*, 74 Cal. App. 5th 890, 905–06 (2022).

[53] Both statutes employ the same definition of a trade secret. *Compare* 18 U.S.C. § 1839(3) *with* Cal. Civ. Code § 3426.1(d).

secret protections help safeguard employers' confidential information even when they are barred from using non-competes.[54]

**Section 16600 Shapes Contractual Protections of Trade Secrets.** California's Section 16600 shapes the relief that employers may obtain when pursuing claims for tortious misappropriation of trade secrets. These cases also provide valuable insights on how Section 16600 limits employment covenants.

*Agreements Not to Solicit Customers.* For many years it was unclear whether a covenant not to solicit customers might be upheld if its purpose was to protect a trade secret (specifically, a customer list). In *Retirement Group v. Galante*, the California Court of Appeal examined an injunction prohibiting former employees from soliciting their former firm's customers and declared such covenants unenforceable—even if their purpose is to protect trade secrets.[55] The court explained that "section 16600 bars a court from specifically enforcing (by way of injunctive relief) a *contractual* clause purporting to ban a former employee from soliciting former customers . . . but a court may enjoin *tortious* conduct . . . by banning the former employee from using trade secret information to identify existing customers, to facilitate the solicitation of such customers, or to otherwise unfairly compete with the former employer."[56] In *Galante*, the former employee could be barred from using information found solely in the firm's secure customer database but could not be barred from soliciting former customers if he used information from another source.

The NPRM states generally that non-solicitation agreements are not included in the definition of a non-compete clause because such agreements "do not generally prevent a worker from competing with their former employer."[57] However, the FTC also warns that if such a covenant were overly restrictive so as to function as a non-compete, non-solicitation agreements could be considered de facto non-competes.[58]

*Non-Disclosure or Confidentiality Agreements*. In California, employers may protect trade secrets and other confidential information by using confidentiality agreements. For example, an employer may include provisions in employee agreements or handbooks that require employees to acknowledge that they cannot violate the employer's rights under other laws, such as CUTSA, or that they must maintain secrecy of sensitive and confidential information.

Under the California law, employers can prohibit employees from using or disclosing trade secrets, proprietary information, or confidential information, both during employment and after

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[54] Some states employ the "inevitable disclosure" doctrine to establish misappropriation of trade secrets. The "inevitable disclosure" doctrine states that a departing employee who accepts a job with a new employer that is sufficiently close to a previous job will inevitably require the employee to use or disclose the previous employer's trade secrets. *See PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995). For example, in *PepsiCo, Inc. v. Redmond*, PepsiCo sought an injunction to prevent a former employee from divulging trade secrets and confidential information at his new job with Quaker. *Id.* at 1264. The employee in question "possessed extensive and intimate knowledge about [PepsiCo's] strategic goals . . . in sports drinks and new age drinks." *Id.* at 1269. The Seventh Circuit reasoned that Quaker would be "unfairly armed with knowledge of [PepsiCo's] plans, will be able to anticipate its distribution, packaging, pricing, and marketing moves." *Id.* at 1270 ("PepsiCo finds itself in the position of a coach, one of whose players has left, playbook in hand, to join the opposing team before the big game."). Notably, California courts have rejected this theory, holding that is it a form of de facto non-compete. *See Whyte v. Schlage Lock Co.*, 101 Cal. App. 4th 1443, 1462 (2002). In California, "the inevitable disclosure doctrine transforms employee access to trade secrets into a de facto non-competition agreement." *Id.* at 1463 (internal quotation marks and citation omitted).

[55] *Ret. Grp. v. Galante*, 176 Cal. App. 4th 1226 (2009).

[56] *Id.* at 1238.

[57] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3509.

[58] *Id.*

separation.[59] Similarly, when an employee is discharged or leaves a company, the employer can execute a separation agreement that prohibits the employee from using or divulging trade secrets and other proprietary information.[60]

While confidentiality agreements are enforceable, if they are too broadly drafted, they may be considered a de facto non-compete. In *Brown*, for example, a former employee challenged a confidentiality agreement that applied in perpetuity and purported to protect "*all* information that is 'usable in' or that 'relates to' the securities industry."[61] The court determined that the agreement operated as a de facto non-compete in violation of Section 16600 because it effectively barred the employee from ever working in the securities field as a whole—a restriction far broader than his specialty of statistical arbitrage.[62] The court considered both the scope and the duration of the confidentiality agreement.[63]

***If NDAs are appropriately tailored, . . . restrictive covenants [to protect confidential information] fall outside of the FTC's proposed ban on non-competes . . .***

The FTC suggests that employers can use NDAs to protect confidential information.[64] If NDAs are appropriately tailored, such restrictive covenants fall outside of the FTC's proposed ban on non-competes because NDAs "generally do not prevent workers from working for a competitor or starting their own business altogether."[65] However, the FTC again cautions that a confidentiality agreement that is "unusually broad in scope" may function as a de facto non-compete.[66]

*Assignment Clauses.* Employers should also exercise caution when drafting assignment clauses, which courts in California have held can violate Section 16600 if they function as de facto non-competes. Assignment clauses typically require employees to assign their own rights in an invention to their employer. California law places limits on assignment clauses: employers may not require the assignment of inventions that employees develop entirely on their own time and without using the employer's resources or trade secrets unless a specific exception applies, such as if the invention results from any work the employee performed for the employer.[67] Courts have also held assignment agreements unenforceable if they function as de facto non-competes. In *Applied Materials, Inc. v. Advanced Micro-Fabrication Equipment (Shanghai) Co.*, the employer's assignment clause was found to violate Section 16600 because it required employees to "assign any invention disclosed within one year of terminating employment" at the company if it "relates to work the employee performed" for the company.[68] The court found that the assignment clause was "overly broad with respect to both subject matter and temporal scope." According to the court, the agreement operated as a restriction on employee mobility because it "touches post-employment inventions, regardless of when they were conceived or whether they were based on [the company's] confidential information."[69]

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[59] Cal. Gov. Code §12964.5(f).

[60] State of California Civil Rights Department, Employment, Separation, and Settlement Agreements: Limitations on Confidentiality and Non-Disparagement Clauses 4 (Nov. 2022), https://calcivilrights.ca.gov/wp-content/uploads/sites/32/2022/11/Employment-Separation-and-Settlement-Agreements-Limitations-FAQ_ENG.pdf.

[61] *Brown*, 57 Cal. App. 5th at 317.

[62] *Id.* at 319.

[63] *Id.* at 317.

[64] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3506–07.

[65] *Id.* at 3507.

[66] *Id.*

[67] Cal. Lab. Code §2870.

[68] *Applied Materials, Inc. v. Advanced Micro-Fabrication Equip. (Shanghai) Co.*, 630 F. Supp. 2d 1084, 1090-91 (N.D. Cal. 2009).

[69] *Id.*

***Alternatives for Protecting Investments in Employees.*** The FTC cites several potential alternatives to non-compete agreements to protect employers' investments in employee training. According to the FTC, the key question is whether the agreement "restrict[s] a worker's ability to work for a competitor of the employer or a rival's ability to compete against the worker's employer to attract the worker."[70]

*Training Repayment Agreements*. The NPRM cites training repayment agreements (TRAs) as a permissible covenant restricting former employees. TRAs are a type of liquidated damages provision in which the worker agrees to pay the employer for the employer's training expenses if the worker leaves the job before a certain date.[71] TRAs typically do not meet the definition of a non-compete clause because they "generally do not prevent a worker from seeking or accepting work with a person or operating a business after the conclusion of the worker's employment with the employer."[72] However, the FTC explains that a TRA may constitute a de facto non-compete when the amount the worker must repay is not reasonably related to the employer's training cost.[73]

In California, an employer may require an employee to repay the employer for training if the employee leaves within a certain timeframe. In *City of Oakland v. Hassey*, the court upheld an employment agreement that required the employee to repay the cost of training if the employee resigned before a specified date.[74] The court found that the agreement did not run afoul of Section 16600 because the agreement did not "prevent[] him from working" for another employer and did not restrain him "from engaging in his lawful trade, business, or profession."[75] In *Hendrickson v. Octagon Inc.*, the court also upheld an agreement that allowed the employer to recoup the cost of training a former employee who left within a specified period of time.[76] The court specified that such fees are allowed provided they are not imposed as a penalty for joining a competitor.[77]

*Fixed-Term Employment Agreements*. The FTC notes that an employer who wants to retain a worker after providing valuable training "can sign the worker to an employment contract with a fixed duration."[78] The California Court of Appeal likewise rejected an argument in *Twentieth Century Fox Film Corporation v. Netflix, Inc.* that Fox's fixed-term employment agreements constitute de facto non-compete agreements in violation of Section 16600.[79] The court noted that the fixed-term employment agreement "does not purport to restrain [the] employee *after* he or she leaves Fox" and thus, does not violate Section 16600.[80] The court stressed that fixed-term employment agreements are mutually beneficial in that they ensure companies will maintain employee continuity and limit the risk of fast employee departures while providing employees with job security for the fixed term.[81] The court highlighted public policy favoring "stability and predictability of

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[70] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3507.

[71] *Id.* at 3509.

[72] *Id.*

[73] *Id.*

[74] *City of Oakland v. Hassey*, 163 Cal. App. 4th 1477, 1486 (2008). *See also USS-Posco Indus. v. Case*, 244 Cal. App. 4th 197, 209–10 (2016) (upholding the *Hassey* decision after *Edwards*' rejection of the narrow restraint doctrine).

[75] *Hassey*, 163 Cal. App 4th at 1491 (cleaned up).

[76] *Hendrickson v. Octagon Inc.*, 225 F. Supp. 3d 1013, 1027 (N.D. Cal. 2016).

[77] *Id.* at 1027.

[78] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3507.

[79] *Twentieth Century Fox Film Corp. v. Netflix, Inc.*, No. B304022, 2021 WL 5711822, at *8 (Cal. Ct. App. 2021).

[80] *Id.* at *9.

[81] *Id.* at *8.

fixed-term employment relationships."[82] The court explained that "[w]hen parties enter a contract not terminable at will, they cement their bargained-for intentions in accordance with the terms of that contract into the future. The concreteness of this relationship means that contracting parties as well as other entities may structure their decisions, invest resources, and take risks in reliance on it."[83] The court further explained that the fixed-term agreements did not serve as a restraint on employee mobility,[84] which Section 16600 seeks to protect.

*[S]everal California appellate courts have concluded that [employee non-solicitation] agreements are unenforceable under California's Section 16600.*

*Employee Non-Solicitation Agreements*. While the FTC does not address agreements not to solicit employees,[85] several California appellate courts have concluded that these agreements are unenforceable under California's Section 16600. In *AMN Healthcare, Inc. v. Aya Healthcare Services, Inc*. a California appellate court rejected a non-solicitation agreement purporting to restrict recruiters for a healthcare staffing company from soliciting their former employer's travel nurses.[86] The facts of the case made the restraint particularly onerous: Because the recruiters "were in the *business* of recruiting and placing" healthcare professionals, the non-solicitation provision "restrained individual defendants from engaging in their chosen profession."[87] In two subsequent cases, the U.S. District Court for the Northern District of California rejected the proposition that *AMN Healthcare*'s holding was limited to the particular facts of that case and expanded the holding to invalidate an employee non-solicitation agreement involving an employee who did not work as a recruiter.[88] The California Supreme Court has not directly addressed this issue.

*Garden Leave*. Garden leave provisions grant departing employees their salary for a fixed period but prohibit them from working for other employers during that time. During that period, the employee still owes the employer a common law duty of loyalty.[89] While implementing garden leave prohibits an employee from departing to a competitor, the employer may be barred from seeking damages for breach of contract for the employee's early departure because the employee is not considered to have left the company.[90] Currently, several states have laws that permit non-compete agreements, but require employers to pay employees while they are bound by the non-compete as a form of garden leave.[91]

*Blue Penciling*. "Blue penciling" allows a court to modify a non-compete agreement to remove clauses that would otherwise make the non-compete unenforceable. States' adoption of the "blue pencil" doctrine varies widely. California has explicitly rejected blue penciling as method for

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[82] *Id.* at *10.

[83] *Id.* at *8 (citation omitted).

[84] *Id.* at *10.

[85] The NPRM clarifies that non-solicitation agreements, in the context of the NPRM, refer only to agreements to not solicit clients and customers rather than agreements to not solicit another company's employees. Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3484 n. 34. Non-solicitation agreements where a company agrees not to solicit another company's employees are governed by the Sherman Act. *Id.* at 3494 n. 147.

[86] *AMN Healthcare, Inc. v. Aya Healthcare Servs., Inc.*, 28 Cal. App. 5th 923, 936 (2018).

[87] *Id.* at 938–39

[88] *Barker v. Insight Global, LLC*, No. 16-CV-07186, 2019 WL 176260 at *3 (N.D. Cal. Jan. 11, 2019); *WeRide Corp. v. Huang*, 379 F. Supp. 3d 834, 852 (N.D. Cal. 2019).

[89] California courts have not directly addressed the enforceability of garden leave.

[90] *See Fitzgerald v. Chandler*, No. C.A. 15689, 1998 WL 442440, at *2–*3 (Del. Ch. July 20, 1998).

[91] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3494.

revising an otherwise unlawful non-compete,[92] while other states permit, or even require, a court to modify an otherwise unlawful non-compete to make it enforceable.[93] For example, in Nevada, a "court shall revise. . .to the extent necessary" a non-compete covenant that imposes a greater restraint than is necessary to protect the employer, that is unreasonable in scope or imposes undue hardship on an employee.[94] Indiana permits blue penciling, but only to remove problematic language, specifying that the doctrine "is really an eraser."[95]

## Protecting the Value of Acquisitions

The FTC acknowledges in its NPRM that a non-compete "may be necessary to protect the value of the business acquired by the buyer" when a business is sold to another entity.[96] The FTC explains that "non-compete clauses between the seller and buyer of a business may be distinct from non-compete clauses that arise solely out of employment" due to the necessity of protecting the value of the business.[97]

Both California and the FTC proposal include exceptions that allow non-competes related to the sale of a business.[98] The FTC justifies this exception as one that "may help to protect the value of a business acquired by a buyer."[99] The FTC points to California Section 16600, along with non-compete laws in Massachusetts and Rhode Island, highlighting the proposed rule's consistency "with many state laws that exempt non-compete clauses from certain requirements when they are between the seller and buyer of a business."[100]

Although both California and the FTC would permit some non-competes in connection with the sale of a business, the scope of these exceptions differs in important ways. California's exception applies to the "owner of a business entity,"[101] so long as the individual is disposing of *all* of their ownership interests in the company.[102] In order for the non-compete exception to apply, California

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[92] *See Kolani v. Gluska*, 64 Cal. App. 4th 402, 406–07 (Cal. Ct. App. 1998) ("[C]ourts reform contracts only where the parties have made a mistake . . . and not for the purpose of saving an illegal contract." (citations omitted)).

[93] *See* Non-Compete Clause Rule, 88 Fed. Reg. 3495 at nn.169–170 (citing Russell Beck, Beck Reed Riden LLP, *Employee Noncompetes: A State-by-State Survey* (Aug. 17, 2022)).

[94] *Tough Turtle Turf, LLC v. Scott*, 139 Nev. Adv. Op. 47 (Nev. Nov. 2, 2023); Nev. Rev. St. §613.195(6) (providing that where "the court finds the covenant is supported by valuable consideration but contains limitations as to time, geographical area or scope of activity to be restrained that are not reasonable, imposes a greater restraint than is necessary for the protection of the employer for whose benefit the restraint is imposed or imposes undue hardship on the employee, the court shall revise the covenant to the extent necessary and enforce the covenant as revised").

[95] *Heraeus Med., LLC v. Zimmer, Inc.*, 135 N.E.3d 150, 151 (Ind. 2019).

[96] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3510.

[97] *Id.* at 3514.

[98] Each state that prohibits non-compete agreements (North Dakota, Oklahoma, and Minnesota) includes a similar exception. *See, e.g.* Minn. Stat. Ann. §181.988, subd. 2(b).

[99] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3509.

[100] *Id.*

[101] This includes "any partner" where the business is a partnership, or "any member" if the business is an LLC, or "any owner of capital stock" where the business is a corporation. Cal. Bus. & Prof. Code §16601.

[102] Section 16601 of the California Business and Professional Code states that "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 . . ." may agree, under §16602(a) "that he or she will not carry on a similar business within a specified geographic area where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any such other member of the partnership, carries on a like business therein." Cal. Bus. & Prof. Code §§16601, 16602(a).

courts examine whether the seller sold all her ownership stake in the business.[103] California courts have upheld a non-compete agreement where the seller held only 3 percent of the outstanding shares of the company because the purchaser of a business is entitled to enforce a reasonable restriction on competition "on the theory that such competition would diminish the value of the business which had been purchased."[104]

*[W]ith the limited scope of the FTC's exception [for non-competes when a business is sold], acquiring companies would bear the risk that employees of the target company . . . , could leave after the merger and found or join competing businesses—a risk that could reduce some valuations or even scuttle some deals.*

In contrast, the FTC's proposed rule would allow non-competes only where the party with the non-compete in question holds at least a 25 percent ownership stake, a threshold that many founders or senior executives may not exceed.[105] The FTC argues that the 25% threshold is justified as middle ground "between a threshold that may be too high (and would exclude many scenarios in which a non-compete clause may be necessary to protect the value of the business acquired by the buyer) and a threshold that may be too low (and would allow the exception to apply more broadly than is needed to protect such an interest)."[106]

Should the NPRM become law, companies pursuing acquisitions may be able to employ alternative protections—such as confidentiality agreements—provided they are not so broad that they are viewed as de facto non-competes. But with the limited scope of the FTC's exception, acquiring companies would bear the risk that employees of the target company, including top executives, could leave after the merger and found or join competing businesses—a risk that could reduce some valuations or even scuttle some deals.

## Conclusion and Tips for Drafting Agreements

While the FTC's proposed ban has not yet been implemented, there is a clear trend towards greater restriction of non-compete agreements, and businesses may have to adjust to a world without them. To ease this transition, employers may wish to consider alternatives to non-compete provisions that protect their incentives to invest in their employees:[107]

- **Non-Disclosure Agreements:** Employers can require employees to abide by NDAs or confidentiality obligations as long as they are not so broad that they function as de facto non-competes. Employers can define what constitutes confidential information, either in employment agreements or employee handbooks. Employers should note that if they do not take care to preserve the information as confidential, confidentiality provisions may be less likely to be enforceable.
- **Training Repayment Agreements:** Requiring an employee to repay training costs would not be considered a non-compete clause unless the amount the worker must repay is not reasonably related to the employer's training cost.[108]
- **Customer Non-Solicitation Agreements:** Although these covenants restrict what employees may do after leaving their jobs, the FTC notes that they are not considered non-compete agreements because they generally do not prevent the employee from accepting employment

[103] *See Blue Mountain Ents.*, 74 Cal. App. 5th at 551.

[104] *Vacco Indus., Inc. v. Van Den Berg*, 5 Cal. App. 4th 34, 48 (1992).

[105] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3510.

[106] *Id.* at 3510–11.

[107] Federal and state antitrust enforcers have been aggressively prosecuting labor antitrust violations, including no poach agreements between employers. Employers looking to use no poach agreements in place of non-competes run the risk of a government investigation and potential criminal charges. *See, e.g.*, U.S. Dep't of Justice & Federal Trade Comm'n, Antitrust Guidance for Human Resource Professionals 3–4 (Oct. 2016), https://www.justice.gov/atr/file/903511/download.

[108] Non-Compete Clause Rule, 88 Fed. Reg. 3482 at 3484.

with a competitor.[109] Employers should note that in California, broadly drafted non-solicitation agreements may violate Section 16600, and the FTC notes that these agreements may function as de facto non-competes when they are too broad. Customer non-solicitation agreements are more likely to be enforceable when limited to customer information that may constitute a trade secret rather than a broadly drafted catch-all agreement that would restrict an employee from soliciting clients based on publicly available information.[110]

- **Fixed-Term Agreements:** Employment agreements of a fixed duration are an alternative to non-compete agreements endorsed in the NPRM and upheld in California courts. Fixed-term agreements, when drafted reasonably and narrowly, provide stability for both the employer and employee.[111]
- **Garden Leave:** Though untested in California, garden leave arrangements allow an employer to pay an employee not to work for a competitor and preserve the employee's duty of loyalty to the employer for the duration of the leave period.
- **Blue Penciling:** While not permitted in California, some other states allow (or even require) courts to remove provisions in a non-compete agreement that would render the agreement unenforceable.

Just as the FTC looked to California for its experience banning non-compete agreements, California law likewise provides guidance on alternative covenants that employers may consider to protect their confidential information, preserve their incentive to invest in employee training, and protect the value of acquisitions. ●

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[109] *Id.*

[110] *See Galante*, 176 Cal. App. 4th at 1237 ("In accordance with these principles, the courts have repeatedly held a former employee may be barred from soliciting existing customers to redirect their business away from the former employer and to the employee's new business *if the employee is utilizing trade secret information* to solicit those customers. . . . Thus, it is not the *solicitation* of the former employer's customers, but is instead the misuse of trade secret information, that may be enjoined." (citations omitted)).

[111] *Twentieth Century Fox Film Corp.*, 2021 WL 5711822 at *10.