Proposed Ban on Non-Compete Agreements: What You Need to Know and Potential Alternatives

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The FTC Proposed Ban on Non-Compete Agreements, in its current form, will have significant consequences for companies that use non-competition agreements ranging from the negotiation of employment agreements, incentive plan designs, merger considerations and taxation. This rule will impede the flow of capital and will make it difficult to sell business entities that are based on intellectual capital and relationships as the buyer will not have assurance that the value will not be impaired by the departure of key people competing against the former business. This change will make certain businesses unsellable as it will not be economically viable. In a notice of the proposed rulemaking, which is over 200 pages, the FTC said that research has shown that "the use of non-compete clauses by employers has negatively affected competition in labor markets, resulting in reduced wages for workers across the labor force—including workers not bound by non-compete clauses." This article reviews current legislation, regulatory issues, and the consequences of all.

BACKGROUND

There are major changes on the immediate horizon for the business world involving the radical departure of generally accepted business practice of using non-compete provisions to cover some or all employees, depending on the industry. State legislatures and the federal government are formulating new laws and rules that will ban the use of non-compete provisions for almost all employees. This will be particularly disruptive for selling businesses and hiring key employees. There may be still

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time to provide guidance to change the course of this legislation and rule-making activities to come up with a more sensible and fair solution that benefits workers, businesses, consumers and owners, alike. This article outlines the issues and suggests some more sensible alternatives.

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A non-compete agreement (also referred to as a "post-employment restriction" or a "non-competition clause"),[1] is a contract between an employer and employee wherein the employee agrees to not work (i) for their employer's competitors (ii) and/or within a certain geographical region in the same industry, and (iii) for a designated amount of time after they leave employment. At their core, non-compete agreements are a contract whereby an employee agrees to a post-employment restriction, thus limiting their career prospects, than they would have had otherwise. In return, the employee must be given something in exchange, typically in the form of employee wages, training or severance protection.

Approximately 85 percent of states in the US recognize and enforce various forms of non-compete agreements. As of today, a non-competition clause is generally considered reasonable when it (1) is necessary to protect the employer's legitimate business interests, (2) does not impose an undue hardship on the employee, (3) does not harm the public, and (4) is reasonable in time period and geographical scope.

However, in recent years, the legal landscape for non-compete agreements has shifted. Increasingly courts and state legislatures are pushing back against what they perceive to be an overuse (and in some cases abuse) of restrictive covenants in agreements with employees who do not pose a credible competitive risk. Each state has its own laws and rules about whether, when, and to what extent a non-compete agreement is enforceable.

Some states, such as California, Minnesota, Montana, North Dakota, and Oklahoma, as well as the District of Columbia, ban or severely restrict the use of non-compete agreements. New York State may also be on the verge of joining these states in banning the use of non-compete arrangements, provisions or clauses. Both houses of the New York State Legislature have passed the identical bill that would prohibit all non-compete restrictions on employees and certain other service providers and allow them to recover civil damages from their employers who impermissibly impose such restrictions.[2] At the time of writing, the bill is currently being reviewed by the New York State Governor. If not vetoed by the Governor, the ban will take effect 30 days after the bill becomes law and will apply to all non-compete agreements entered into or modified on or after the effective date.

In his July 9, 2021, Executive Order, President Joe Biden encouraged the Federal Trade Commission ("FTC") to engage in rulemaking to "curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility." In response, on January 5, 2023, the FTC proposed a new rule that, if made final, would (on its face) effectively prohibit non-compete agreements other than in very limited circumstances.

In a notice of the proposed rulemaking, which is over 200 pages, the FTC said that research has shown that "the use of non-compete clauses by employers has negatively affected competition in labor markets, resulting in reduced wages for workers across the labor force—including workers not bound by non-compete clauses."

AT A GLANCE: THE FTC'S NOTICE OF PROPOSED RULEMAKING ("NPRM")

In connection with the FTC's NPRM[3] regarding non-competition agreements, the FTC provided the following summary:

> Pursuant to Sections 5 and 6(g) of the FTC Act, the Commission proposes the Non-Compete Clause Rule. The proposed rule would provide it is an unfair method of competition—and therefore a violation of Section 5—for an employer to enter into or attempt to enter into a non-compete clause with a worker; maintain with a worker a non-compete clause; or, under certain circumstances, represent to a worker that the worker is subject to a non-compete clause.

The FTC also provided that under Sections 5 and 6 of the Federal Trade Commission Act ("FTC Act"),[4] the FTC is authorized to make such changes. Specifically, it provides:

> Section 5 of the FTC Act declares "unfair methods of competition" to be unlawful. Section 5 further directs the Commission "to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in or affecting commerce." Section 6(g) of the FTC Act authorizes the Commission to "make rules and regulations for the purpose of carrying out the provisions of" the FTC Act, including the Act's prohibition of unfair methods of competition. Taken together, Sections 5 and 6(g) provide the Commission with the authority to issue regulations declaring practices to be unfair methods of competition.

If the NPRM is adopted as proposed, all contrary state laws would have to conform to it, including the sweeping and expansive definition of "non-compete clauses" that fall within the FTCs definition of unfair competition.

The NPRM also extends to "de facto" non-compete clauses—that is, other contractual provisions that have the "effect" of prohibiting workers from seeking or accepting employment or operating a business after the conclusion of the worker's current employment. In this regard, the NPRM may affect broadly drafted non-disclosure-of-confidential-information restrictions and repayment-of-training-costs provisions. The NPRM also could implicate customer non-solicitation restrictions, depending on the surrounding facts and circumstances.

If adopted, the proposed rule will require all employers that use any agreement with a non-compete clause (or with a clause that could be deemed to be a non-compete clause under the expansive definition in the proposed rule) to take action to *rescind* the non-compete clause. Remarkably, any provision negotiated in exchange for the non-compete (for example, a severance provision) would remain intact. This rescission action will require individualized communications from the employer to all current- and former-employees. While the proposed rule contains a sale-of-business exception, even that is exceptionally narrow, being limited to individuals with at least a 25 percent ownership stake in the business.

The proposed rule would ban non-competes for executives; there is no carve-out for senior executives (the C-X suite). There is no segregation of employees, as with other government agency rules (e.g., IRS) into highly compensated employees, lower than median compensated employees, older employees, etc.

The process to implement a rule can take quite a while, and in some cases may never be adopted. The public comment period for the NPRM closed on April 19, 2023. During this consultation period, the FTC received more than 26,000 comments on the proposed changes, including many from individuals working in insurance as well as insurance businesses and organizations. Leading themes included (1) the adverse impact on the protection of intellectual property (IP) and the absence of any IP exception to the proposed non-compete ban; (2) the proposed rule's tendency to discourage investments in worker training; and (3) concerns that non-profit healthcare providers would be unfairly advantaged by the proposed rule since they are exempt from it.

As of May 25, 2023, a recent report from Bloomberg Law speculated that the FTC's vote to formally ban non-compete agreements in most employment agreements won't take place until April 2024.

Based on several comment letters from various organizations, it is likely that there will be significant legal challenges, if or when such rulemaking is adopted. One significant issue raised by opponents of the NPRM is whether the FTC actually has the legal authority to make such far reaching changes. This point was raised by commentators and Congressional leaders alike. Moreover, the United States Supreme Court recently held in Environmental Protection Agency, 597 U.S. (2022) that a far-reaching change in rules would fall under the "Major Question Doctrine." This doctrine specifically provides that where a government agency seeks to decide an issue of vast economic or political importance, a general delegation of authority from Congress is not enough and that the agency must have clear statutory authorization to decide the issue.

It is not hard to see how a proposed rule affecting 30 million workers,[5] based upon law that was enacted in 1914 (which does not mention non-competition restrictions) might run afoul of the Major Questions Doctrine. Moreover, the FTC may also have a difficult time arguing that almost all non-competition agreements are abusive, when Congress explicitly provides for them in other areas of the tax law, specifically Internal Revenue Code ("IRC") Section 280G (Golden Parachute Tax). Under IRC Section 280G, a reduction to what constitutes a parachute payment is provided for where a taxpayer can demonstrate that payment in exchange for such restrictions constitutes post CIC reasonable compensation.[6]

KEY EXECUTIVE COMPENSATION ISSUES AFFECTED BY PROPOSED RULE

The NPRM would prohibit new contracts with executives that include non-compete clauses, which will fundamentally change the dynamics at play when companies negotiate arrangements in connection with hiring, promoting, or designing new incentives with key executives. In light of these potential rules, there are three key areas that companies will need to consider with regard to executive compensation:

1.) Employment Arrangements.

Many executive compensation arrangements, including employment agreements, severance plans, equity plans and award agreements, contain provisions that would qualify as non-compete clauses under the proposed rule. The inclusion of a non-compete clause, and the duration of the non-compete clause following an executive's termination of employment, is often subject to significant negotiations as part of the executive compensation arrangements. For example, where otherwise permissible under applicable state law, employment or severance agreements often provide that an executive will receive severance payments for a specified period of time following a qualifying termination of employment if, among other things, the executive does not compete with the company or violate any other applicable restrictive covenants during the severance period. Even in instances where the severance is paid in a lump sum immediately upon a qualifying termination of employment, the severance is often provided at least partially in consideration of the applicable restrictive covenants. Similarly, many equity awards are made at least partially in consideration of the applicable restrictive covenants included in the equity award agreement.

The removal of non-compete clauses would represent a fundamental shift in the negotiation and design of new executive compensation arrangements in many jurisdictions. The requirement to rescind existing non-compete clauses and inform current and former employees that they have been canceled would result in employers—in many cases—losing the "benefit of the bargains" they made.

2.) Sale of Business.

The application of the proposed rule to non-compete clauses entered into with individuals who are workers and/or equity owners in connection with M&A and investment transactions is currently unclear. On its face, the proposed rule purports to apply to such transactions and could have a material impact on how parties approach the use of non-compete clauses accordingly. Generally, the proposed rule would be far more restrictive than currently applicable laws of many states that govern the use of non-competes. Buyers and sellers in M&A and investment transactions routinely use non-compete clauses to protect the interests of the relevant businesses (and buyer) and for which separate and valuable consideration is received by the individual agreeing to the non-compete clause. The sale of business exception in the proposed rule is very narrow in scope and would not allow transaction participants to use non-compete clauses in the same manner going forward, which could have a material impact on how parties structure transaction consideration and other terms. Further, buyers in transactions often seek to enter into non-competes with key employees who might not be selling shareholders, but the proposed rule would prohibit that practice unless the employee owns 25% or more of the target. Finally, the proposed rule would invalidate non-compete clauses entered into in connection with completed transactions.

3.) Internal Revenue Code Section 280G.

As discussed previously, a key exemption in the 280G regulations provides that the term "parachute payment" does not include any payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the change in control date. For purposes of IRC Section 280G, "reasonable compensation for personal services" the statute includes reasonable compensation for refraining from performing services, such as under a non-compete clause, to the extent that it is demonstrated by clear and convincing evidence that the non-compete clause substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the non-compete will be enforced against the individual. Assuming that these conditions are met, a portion of the parachute payments may be attributed to the executive's non-compete clause as reasonable compensation for post-closing services, which may reduce the aggregate parachute payments, including, in some cases, to a level that avoids any imposition of the excise tax. However, if the final NPRM broadly prohibits non-compete clauses for executives, this may otherwise result in the imposition of a 20% excise tax as well as a loss of corporate deduction, specifically for executives who are not named executive officers ("NEO"). This potential imposition of excise tax may have unintended consequences as companies may adjust remuneration programs that may be more 280G efficient (such as a higher percentage of time-based awards) which unfortunately may be less optimal with respect to pay for performance philosophies.

Lastly, in situations where company performance is strong, but executives are in a tax situation where much of their remuneration will now be subject to excise tax, such executives may be less inclined to explore strategic alternatives that are in the best interests of shareholders. For example, if a transaction were to emerge, an extremely costly gross-up on such excise tax may end up being negotiated as part of the transaction in order to keep the management team engaged.

DISSENSION WITHIN THE FTC

One the more controversial aspects of NPRM is that much of the support for the FTC's conclusions are centered around selected academic studies based on limited data from which sweeping conclusions were drawn. Moreover, the FTC appears to dismiss the notion that executives and/or business owners who negotiate remuneration and/or purchase price as part of such consideration requiring non-competes, understand how best to advance their business interests. FTC Commissioner Christine S. Wilson issued a strong dissent of the NPRM, noting the following:

> The proposed Non-Compete Clause Rule represents a radical departure from hundreds of years of legal precedent that employs a fact-specific inquiry into whether a non-compete clause is unreasonable in duration and scope, given the business justification for the restriction. The Commission undertakes this radical departure despite what appears at this time to be a lack of clear evidence to support the proposed rule. What little enforcement experience the agency has with employee non-compete provisions is very recent (within the last week) and fails to demonstrate harm to consumers and competition. Lacking enforcement experience, the Commission turns to academic literature - but the current record shows that studies in this area are scant, contain mixed results, and provide insufficient support for the scope of the proposed rule. And one study illustrates clearly, in the financial services sector, the negative unintended consequences of suspending non-compete provisions, including higher fees and broker misconduct. The suspension of non-competes across all industry sectors in the U.S. undoubtedly will impose a much larger raft of unintended consequences.[7]

In fairness to the FTC, although they advanced arguments in favor of a comprehensive ban, they specifically requested advice on a number of components of the rule including but not limited to the 25% threshold for business owners as well as how to classify senior executives (if they were to adopt different standards for senior executives). Of specific interest the NPRM provided the following:

> The Commission seeks comment on how, if the Commission were to adopt different standards for senior executives, this category of workers should be defined. The Commission is not aware of a generally accepted legal definition of "senior executive." This term may be challenging to define, given the variety of organizational structures used by employers.

With the FTC's openness to commentary, there is some hope they will take such comments into consideration if and when they adopt final rules. Moreover, we believe that if FTC focuses its aim solely with respect to abusive practices which could lead to unfair competition, rather than an outright ban which could lead to many unintended consequences, the FTC could accomplish many of its goals and at the same time avoid or have a far better chance at surviving legal challenges—specifically issues that may arise with respect to the Major Questions Doctrine.

LOOKING FORWARD—A BETTER WAY

If the stated problem is that non-compete provisions have been misused as applied to lower income workers, why not focus more on the problem with a limited response, instead of making sweeping changes to generally accepted business norms? More simply put, why treat a minor infection in someone's leg via amputation, when antibiotics can solve the same problem.

In driving towards a better way, we propose a structure that does not ban non-competes, but rather, addresses the abusive practices, specifically whether consideration paid for such is reasonable. For example, if a low-income worker were to leave his/her job, the probability of an employer paying an employee to "sit on the beach" would be extremely low. Thus, the notion of paying for a non-compete (e.g., garden leave) is a key component for enforceability in some US States. What makes these provisions attractive is that they can universally be applied for all classes of employees.

As an alternative to the current NPRM, we believe that employing some combination of the following alternative strategies would effectively mitigate misuse without requiring such large-scale change.

1.) Reasonable Compensation & Garden Leave

As discussed earlier, IRC Section 280G permits consideration of "reasonable compensation" in exchange for not providing services. For this analysis, the 280G guidance requires that a taxpayer clearly and convincingly address two specific tasks: 1) to determine whether a non-compete agreement is likely to be enforced and substantially constrains the executives' ability to perform services; and 2) to consider what constitutes "reasonable compensation." In this analysis, the former is accomplished by preparing a report which demonstrates by clear and convincing evidence that absent a non-compete, an executive could cause considerable harm to the company and that the provisions are such that the executive is substantially constrained from providing services commensurate with his/her current skillset/knowledge. The latter considers both historic compensation (what the individual earned in the past) and market compensation (what the individual could earn in the marketplace if not for such restrictions).

With respect to the establishing rulemaking, we believe that the 280G regulations are instructive because Congress explicitly established "fairness" by determining that where an individual is reasonably compensated in exchange for a non-compete agreement1, such compensation should not be subject to an excise tax. Although not directly on point, the FTC could simply establish a minimum standard of reasonable compensation in order to have an enforceable non-compete. Furthermore, by requiring such a standard, the FTC essentially implements a tool that can be both universal and fair across all categories of employees/owners.[8] Simply stated, by requiring reasonable compensation or in the case of sale proceeds, capital consideration, parties that want to impose non-competition restrictions and whether it is worthwhile to pay those employees (i.e., garden leave)[9] in exchange for non-compete restrictions. Lastly, we note that this concept is not novel, as it is a key component of Massachusetts law.[10]

2.) Parse Highly Compensated Employees, Officers and Substantial Shareholders

Although we believe a garden leave provision would effectively protect all employees, and where less compensated employees are concerned it is highly unlikely an employer would pay employees not to work who could not otherwise harm a company, as noted previously, the FTC requested guidance on how to categorize certain workers. Accordingly, where the FTC is looking to "assess fairness" by looking at different classes of workers, the IRC Section 280G and 414(q) provide a reasonable basis for exemption from the non-compete protection sought in the NPRM. In the case of IRC Section 280G, the definition of a Disqualified Individual could also serve as a basis for exemption from the relief provided by the NPRM. Although there are some significant nuances within these provisions, the general rule provides that individuals who are subject to these rules are either within the top 1% of highest compensated employees at the company, officers of the Company, or 1% shareholders.[11] We note that IRC Section 280G applies to only C-Corporations (or partnership which elect to be treated as C-Corporation), if such a standard were to be used in providing an exemption to the NPRM, such standard should be applied to all types of business entities.

Another standard the FTC should consider is the highly compensated employee standard provided in IRC Section 414(q).[12] Currently this includes individuals who are 5%[13] business owners or earn 150k per year.

3.) Sun Setting Non-Compete Provision for New Hires

Some commentators pointed out that where companies invest significantly in the training of new employees, the NPRM may discourage training, as employees could simply get paid to be trained at one company and then leverage the training to move to another for a higher wage. In these cases, the solution is quite simple: where a company hires a new employee (at any level), and also provides significant training, a six to 12 months non-compete period after the initial training period ends would be fair and commensurate with the training investment. We would suggest some reasonable limits to the training period (e.g., not more than two months). This concept of a sunset non-compete would protect companies that invest in training, but also not constrain any employee for an unreasonable period of time, if an employment situation is not in the best interest of the employee. Lastly, a sunset provision would not apply to an employee who was terminated without cause by the employer or if the employee was subsequently outside the scope of the non-compete (e.g., move into another job function, where the training/knowledge is not applicable).

FINAL THOUGHTS

Rather than banning non-compete agreements, the FTC should limit the scope of their rulemaking to just address the abuses, specifically the notion of a company not providing ample consideration during the restricted period and/or focusing on a categories of employees who are highly compensated or substantial owners, the practical implications of the NPRM could be better achieved while at the same time providing a much stronger argument that such changes would not run afoul of the Major Questions Doctrine, or at a minimum provide a strong but reasonable framework for other states to follow.

Moreover, the FTC's proposed rule to abolish a long-standing business practice on the grounds that such practice fosters "unfair methods of competition in or affecting commerce" based upon a Congressional law enacted in 1914 is unwise and is likely will not survive judicial scrutiny. As noted previously, it is likely that upon challenge the Courts are likely to follow the United States Supreme Court holding in *West Virginia v. Environmental Protection Agency, 142 S. Ct. 2587, 213 L. Ed. 2d 896 (2022)* that a far-reaching change in rules would fall under the "Major Question Doctrine." The key issue with the current NPRM is the Commission's insistence that essentially all non-competition agreements constitute "unfair methods of competition in or affecting commerce." This in of itself, is a broad and unpersuasive claim—especially where parties to such arrangements have entered into them in good faith and for ample consideration, as is generally the case with business owners and highly compensated executives.

If non-compete agreements are banned, it will have an immediate and long-lasting effect on business practices which will raise the cost of providing goods and services, as well as, potentially, disrupting the supply chain by destabilizing business operations. There must be a better way!

NOTES:

[1]Throughout this article, we use the terms "agreement," "restriction," and "clause" interchangeably in relation to non-competes.

[2]New York Senate Bill 2023-S3100A.

[3]Commission File No. P201200.

[4]15 U.S.C.A. § 45.

[5]30 Million workers is an estimate computed by the FTC and was provided in the NPRM.

[6]See General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong.; Pub. L. No. 98-369) which provides:

> an amount to be made under an employment contract, consulting agreement covenant not to compete, or similar arrangement for a stated term entered into between the acquiring company and a disqualified individual with respect to the target corporation may constitute parachute payments. To the extent that payments under such an agreement, at the time such agreement is entered into, determined to be reasonable for the consideration (including consideration in the form of not competing) to be provided by the individual under the agreement, such payments are to be treated under the provisions of as reasonable compensation for personal services.

[7]See Dissenting Statement of Commissioner Christine S. Wilson Regarding the Notice of Proposed Rulemaking for the Non-Compete Clause Rule Commission File No. P201200-1

5. See NPRM Parts IV.A.1.b, IV.A.1.c.

[8]To be clear we are not advocating that enforcing a non-compete should require a burdensome non-compete valuation report, rather we point to the legal record indicates a reasonable amount of remuneration in exchange for a non-compete is an accepted legal practice.

[9]An employer does not require the employee to work but will still pay the usual remuneration during the period of garden leave.

[10]We note that this garden leave concept is also contained within the rules governing non-competition agreements in the State of Massachusetts. Pursuant to Section 24L(b)(vii) of chapter 149 of the General Laws of Massachusetts, an enforceable non-compete requires that a "employer agree to pay an employee during restricted period a minimum of 50% of the "highest annualized base salary paid by the employer within the 2 years preceding the employee's termination." We note that the above proposal has a substantially higher amount.

[11]Treasury Regulations Section 1.280G-1 Q/A 15 provides the following: For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation—(1) A shareholder (but see Q/A-17 of this section); (2) An officer (see Q/A-18 of this section); or (3) A highly compensated individual (see Q/A-19 of this section).

[12]Under Code section 414(q), a highly compensated employee is defined as any employee who was a 5-percent owner at any time during the preceding year or for the preceding year had compensation from the employer in excess of the amount that the Secretary of Treasury determines as highly compensated (currently $150,000).

[13]We note that the Section 280G standard provides a higher threshold for employees, but lower threshold than the Section 414(q) for business owners. Since 280G largely deals with publicly traded Corporations a 1% threshold is an indication of substantial ownership in a Company, whereby if an individual owned 1% in a smaller private Company such ownership may not be as substantial.