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Understanding Proposed Changes to Noncompete Agreements

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Noncompete agreements are under siege, facing attacks on the state and federal fronts.

This is vividly illustrated by what's happening within the Federal Trade Commission and the New York State Legislature. In the transactional context, employers should educate them- selves about the proposed changes and plan accordingly.

The FTC is leading the movement to implement sweeping bans against the use of noncompetes by all employers vis-à-vis all employees—regardless of an employee's position or compensation—with only narrow exceptions. At the same time, the New York Senate and Assembly passed a near-total ban on noncompete agreements in June, giving short shrift to the reality that the engine of New York is powered by the financial services and other professional sectors that often rely on noncompetes. The New York ban is more restrictive than what we've seen in any other state. Even California is more liberal than New York in this regard, as it allows the use of noncompetes in the sale of a business context. But as of this writing, the ban has not been signed by (or sent to) New York Governor Kathy Hochul.

In the meantime, these proposals should be prompting buyers, sellers and operating companies to understand the viability and permissible scope of noncompetes and adapt their practices. Whether this results in sellers being subject to a progressively limited scope and duration of restrictions on competition, or whether buyers will attempt to bulk up other restrictive covenants that protect against raiding a target company's employee and customer base, businesses should not expect to simply rely on historical practices.

FTC's Proposed Rule

On January 5, the FTC published its proposed rule to ban nearly all noncompetes. The proposed rule was promulgated in response to President Biden's July 9, 2021, executive order to promote competition. Three critical things the proposed rule would prevent employers from doing include:

1. Entering into or attempting to enter into new noncompete clauses;
2. Maintaining preexisting noncompete clauses; and
3. Representing to workers, under certain circumstances, that the worker is subject to a noncompete.

One of the only carve-outs is for the use of noncompetes entered into by a person who is selling a business entity (or their ownership interest in the entity), or selling all or substantially all of an entity's operating assets. But this exception only applies if the seller holds at least a 25% ownership interest in the business. That is an extremely narrow exception and would, in many instances, exclude almost all principals of a business. It's even more restrictive than the law in California, a state that's no friend to noncompetes but which broadly permits noncompetes in connection with the sale of a business.

Employers are rightly concerned: The comment period for the proposed rule generated over 26,000 comments.

New York's Legislation

Legislation introduced in New York would severely limit the use of noncompetes within the state. The bill passed both state houses, which means it just needs to be signed by Governor Hochul to become law. The bill has not been sent to the governor yet, and whether she actually signs it, and in what form, is the subject of debate and speculation.

In its current form, the bill includes a total ban on the use of noncompetes. It lacks exceptions for highly compensated employees or even for individuals who sell their business. These are fairly standard exceptions in other states (e.g., California) that impose some degree of restriction on the use of noncompetes.

If the bill is enacted, perhaps the only saving grace for New York employers and buyers may be that it is prospective, meaning it would only apply to "contracts entered into or modified on or after" the effective date.

Key Considerations for Employers and M&A Professionals

It is still unknown whether or when the FTC or New York will adopt their proposed noncompete restrictions. However, even without adoption, we are already beginning to see their impact manifest in employment negotiations and M&A transactions.

For traditional employment-related noncompetes, employers are increasingly seeking our counsel to draft bespoke restrictive covenants tailored to nuances of their business. Employers are also looking for other retention mechanisms, such as stay bonuses or forfeiture-for-competition provisions, to mitigate against the possibility that noncompetes will be unenforceable. Similarly, we see more key executives pushing back against post-termination noncompete restrictions in employment and partnership agreements, with many citing the proposed FTC rule as justification for rejecting historical market practices.

In the M&A context, a number of recent deals, particularly those with broad employee equity ownership, have seen sellers becoming emboldened to push back against long-lasting and broad noncompete obligations, often citing the proposed rules as part of the justification.

For example, in one recent sale transaction, the buyer proposed applying a five-year noncompete to all equity holders, including some who owned less than 1% of the business. Representing the seller, we successfully negotiated for: (1) a complete exception for the sponsor equity holders (as is market standard); and (2) a tiered non-compete for the employee equity holders, whereby sellers receiving less than $X were not subject to any noncompete; sellers receiving equal to or greater than $X and less than $Y were subject to a one-year noncompete; and only sellers receiving at least $Z were subject to a longer noncompete.

Even as we await new rules and legislation, employers and parties to M&A transactions must be mindful of the changing landscape, react to changing demands from sellers and employees, and anticipate how market expectations may evolve.

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