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Non-Compete Enforceability Overview and Developments

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Non-Compete Enforcement – State of Play

FTC recently proposed a rule banning most employee non-competes

- If enacted as proposed, would broadly curtail existing practices
- Timeline to enactment and final form are uncertain
- If enacted, rule will very likely face significant legal challenges

State statutes and case law continue to govern non-competes

- Pending a final FTC rule (and related challenges), parties should continue to focus on state law principles of enforceability

Enforcement is becoming less predictable and more challenging

- State law trend is unfavorable
- Creating enforceable restrictive covenants requires careful consideration of scope: activities + geographies + duration + form of consideration
- Applies to all restrictive covenants (i.e., employment & sale of business)

Key areas of focus

1. Antitrust considerations
2. State legislative efforts
3. State case law developments

FTC Proposes Banning Noncompete Clauses for Workers

THE WALL STREET JOURNAL

Delaware Invalidates a Selling Stockholder's Non-Compete Covenant

JDSUPRA

FTC Finds Three Firms Engaged in Illegal Noncompete Agreements

Bloomberg Law

1 Traditional Antitrust View and FTC Proposed Non-Compete Ban

Growing focus by Biden administration antitrust regulators on restrictive covenants, which they perceive to harm workers, culminated in January 5 notice of proposed FTC rule that would ban most employee non-competes

Traditional view	▸ Non-competes (and other restrictive covenants) have not been a priority of the antitrust agencies ▸ Restrictions compliant with state law typically do not raise concerns under federal antitrust law
Increased agency interest	▸ July 2021 executive order encouraged FTC to curtail non-competes that limit worker mobility ▸ DOJ has brought criminal cases regarding alleged wage-fixing and "no-poach" agreements (non-hires or non-solicits unrelated to furthering a legitimate transaction) ▸ DOJ *amicus* brief in private lawsuit asserted that in narrow scenarios, employment related non-competes may be *per se* violations (no "rule of reason" analysis balancing benefits and harms)
Proposed new FTC rule would prohibit employee non-competes	▸ Would prohibit new employee non-competes and require rescission of existing ones — Must notify current and former workers that non-competes have been rescinded — Aggressive approach: a rule focused on low-wage workers would be more consistent with state law — Exception: non-competes relating to the sale of a business (by ≥ 25% owner) — Could apply to other types of restrictive covenants (e.g., non-solicit, non-interference, or broadly drafted non-disclosure agreement) if they are functionally equivalent to a non-compete ▸ Based on broad but little-used law ("Section 5") by which FTC may ban "unfair methods of competition" ▸ See our Alert for more detail regarding the proposed rule

1 Antitrust Considerations for Restrictive Covenants

Pending a final non-compete rule (and related legal challenges), state law enforceability remains the key factor, but agencies will continue to focus on this area

Path forward for proposed FTC rule is long and uncertain

- Public comment period ends March 10, after which FTC may vote at any time to enact the rule as proposed or with modifications; draft rule envisions effective date 180 days after enactment
  - Comment requested, e.g., on whether different rules should apply to executives or high-paid workers
- Rule will very likely face significant legal challenges if enacted in any form
  - Sole Republican commissioner issued a pointed dissent that foreshadows expected legal challenges by questioning the logic of the proposed rule and the FTC's authority to issue it
- Unknown how the FTC would enforce the rule (or how violators would be sanctioned)
  - Unlike laws providing for other FTC-enforced rules, Section 5 does not address these points

Antitrust considerations remain a factor regardless of potential rule on non-competes

- Typical non-competes related to employment or the sale of a business remain lawful under antitrust laws (pending the enactment by the FTC of a non-compete ban, if any, and depending on its scope)
  - Risks may arise from agreements perceived as naked restraints on competition, such as agreement that bars seller of business from competing in areas or regarding products outside deal scope
  - Be wary of non-competes that apply broadly to low wage workers or to all company employees; in parallel with announcement of proposed rule, FTC brought and settled two cases alleging, based on specific facts, that such practices (and others) by three companies were unfair under Section 5
  - Be wary of non-competes that could impact market-wide competitive situation (e.g., restrictions that tie up a broad swath of the applicable labor supply)
- Expect merger investigations to include scrutiny of non-competes
  - E.g., in a deal in which FTC required divestitures of overlap gas stations, it also forced unwinding of non-compete that restricted seller in areas where no gas stations were in deal scope
  - Parties may be subject to pressure to roll back lawful restraints, particularly where agency has process-based leverage (e.g., parties wish to avoid delay or need settlement to obtain HSR clearance)

2 Employment Based Non-Compete Rules Vary Widely By State

- Recent legislation by various states creates increasingly disparate rules nationwide for employment based non-competes
  - With some exceptions, such legislation is increasingly favorable to employee protection (substantively and procedurally)
  - ~30 different sets of potentially applicable state statutes with bills pending in many others

Anti Non-Compete	Increasingly Restrictive Jurisdictions	Middle of the Road / Largely Common Law	Permissive / Generally Pro-Employer (for now)
California	Colorado	Illinois	Alabama (exc. professionals)
Minnesota	D.C.	Maryland	Florida
North Dakota	Louisiana	Michigan	Georgia
Oklahoma	Massachusetts	New Jersey	Kansas
	Nevada	New York (?)*	Ohio
	Oregon	North Carolina	
	Utah	Pennsylvania	
	Washington		

** Pending legislation would (if enacted) move New York to the Anti Non-Compete column

2 Select Employment Based Non-Compete State Legislation

State	Modifications
California	Made it illegal to ask an employee to sign an employment agreement requiring litigation outside of CA or applying law other than CA unless the employee is "in fact individually represented by counsel"
Colorado	Tightened statutory circumstances for non-compete enforcement and made it a criminal violation (a Class 2 misdemeanor) for pressing restrictions that do not satisfy the statutory criteria
District of Columbia	Generally banned non-competes other than for highly compensated employees (as of 10/1/2022)
Illinois	Banned non-competes for those earning less than $75k/year (and non-solicits for those earning less than $45k/year) and embraced certain consideration case law
Massachusetts	Inserted many nuances before employment non-competes will be enforced, but generally limited employment-based non-competes to one year and required litigation of non-compete disputes under MA law and in a specific MA court
Minnesota	Broadly banned non-competes (as of July 1, 2023) – exceptions in sale of business context
Nevada	Banned non-competes for those paid by the hour and required specific consideration for covenants
Oregon	Limited non-compete term to one year post-employment and banned non-competes for those making less than $100k without severance
Washington	Many changes, most important being an 18-month presumptive statutory cap on non-competes which purports to apply retroactively
Various (e.g., Maine, Maryland, NH, RI)	Made any non-compete for "low-wage" workers (defined by reference to some multiple of the federal poverty limit) unenforceable

3 Risks of Overly Broad Sale of Business Restrictive Covenants

A new Delaware Chancery decision (*Kodiak*) highlights the risk of buyers seeking overly broad non-competes and other restrictive covenants even in the context of acquiring a business

Background

- Plaintiff is a consolidated construction business – sum of many acquisitions over time
- Plaintiff bought a company focused on roof truss construction with one location in Idaho
- One seller (Adams) owned 8.33% of the company and was bought out in the deal
- Deal focused covenants bound him to not compete with or solicit actual or potential customers from seller, buyer, and all of buyer's other affiliates, for 30 months
- Adams quit and went to work for a roof truss supplier (overlapping somewhat with seller) in Spokane, WA; after one customer was lost, buyer sued

Court Holding

- The Court refused the buyer's request for a preliminary injunction
- With respect to the non-solicit, non-compete and confidential information provisions, the Court held they were overbroad because (1) they extended to the buyer's other businesses and were not limited to the business acquired from the seller and (2) the geographic scope (which was based on the buyer's whole business and not just the acquired company's business) was overly broad
  - Further, the Court refused to "blue-pencil" the restrictions at the injunction stage, depriving the buyer of even that which would have been appropriate protections
- The Court also rejected the buyer's argument that the seller was precluded from challenging the reasonableness of the restrictive covenants based on broadly worded provisions in the agreement whereby the seller conceded the reasonableness and covenanted not to challenge them. The Court held these provisions were unenforceable as a matter of public policy as parties cannot stipulate against court review of restrictive covenants

Despite Delaware's reputation as being more receptive to restrictive covenants than many other states, this decision highlights the risks of seeking overly broad restrictions in relation to businesses covered, duration or geography, even in a sale context

3 Delaware Decision Invalidates Overly Broad Restrictive Covenants and Addresses Benefit-Forfeiture Provisions (1/2)

Another recent Delaware decision further develops the Delaware case law limiting overly broad non-compete covenants and addresses the treatment of benefit-forfeiture provisions upon competition

Background

- The case involved six former employees of Cantor Fitzgerald Hong Kong (CF), who voluntarily departed
- The former employees were subject to a limited partnership agreement containing a (i) one-year non-compete; (ii) two-year non-solicit; and (iii) four-year benefit-forfeiture provision upon competition (i.e., CF was entitled to withhold payments otherwise owed if the former employees competed)
- CF first sued in Hong Kong and lost with the Court holding the parties' restrictions unenforceable under Hong Kong law; CF claimed the former employees competed and withheld payments otherwise due
- The employees sued in Delaware, challenging the four-year forfeiture for competition clause

Non-Compete Enforceability Holding

- The Court found the provisions facially overbroad and therefore void against public policy. As to the scope issues, the Court determined that:
  - Geographic Restriction: the worldwide scope was unreasonable and rejected as "not sufficient" despite CF's "conclusory argument that CF is a global business and therefore a global restrictive covenant is necessary"
  - Protected Parties: the scope of who was protected was "most patently unreasonable" in that it protected not just CF but also "any Affiliated Entity," noting that the fact that the employee may have profited from CF's other business lines is not sufficient reason to extend the scope of the non-compete to those other businesses where the employee did not have access to "any kind of information – proprietary or otherwise – that would warrant that restriction"
  - Restrictive Language: much of the language around the prohibited competitive and soliciting activities was too broad, covering vague concepts like "terminating other business arrangements," "inducing a customer or employee to adversely affect their relationship," "becoming connected with any Competing Business," "any third party that is or could be considered to be engaged in such Competitive Activity"
  - Duration: after noting that while Delaware courts have enforced five and even 10-year non-competes for "more tailored restrictive covenants," concluded the four-year temporal restriction here was unreasonable given the "broad and vaguely defined provisions"
- The Court also noted that the fact that CF had sole discretion to determine in good faith whether the employee has competed exacerbates the over-breadth of the restrictions and also tipped the balance of the equities against enforcement

3 Delaware Decision Invalidating Overly Broad Restrictive Covenants and Addressing Benefit-Forfeiture Provisions (2/2)

Forfeiture Provision Holding

- The Court also held that contractual provisions that require former employees to forfeit a benefit (in this case return of capital accounts) if they compete (as opposed to actually prohibiting the competition) are restraints of trade that are subject to the same reasonableness review applied to traditional non-competes
  - The court determined to follow other jurisdictions (and some Delaware precedent) holding that forfeiture provisions should be evaluated as "restraints of trade" subject to reasonableness review rather than following the "employee choice doctrine" (most commonly invoked in a robust body of New York law) which holds that these provisions should not be reviewed for reasonableness if the employee herself voluntarily terminated her employment
- The Court emphasized that the employee choice doctrine generally, including forfeiture-for-competition provisions, may be enforced in other factual circumstances on a case-by-case basis
- The Court did uphold a provision requiring a release as a condition to receiving return of capital payments even though one of the departed employees argued that separate ongoing litigation he was defending against CF made such a requirement unreasonable

This is yet another strong decision highlighting that courts are going to scrutinize all elements of the covenants as a package – geography, duration, activities prohibited, businesses protected, who determines breach, etc.

3 Delaware Again Invalidates Overly Broad Non-Compete

Carrying on the pattern described on our prior slides, the Delaware Chancery decision recently invalidated another non-compete based on excessive geographic scope

Background	▸ The case addressed claims against a founder / major shareholder / CEO by the acquirer based on behavior three years after closing of the sale ▸ In the face of a five-year worldwide non-compete, about three years after the sale the seller invested in and became a director of an entity formed by his son which allegedly competed with the business sold to the acquirer
Holding	▸ The court decided that it did not even need to address the question of whether the business competed because the "unreasonable geographic scope" rendered the non-compete "facially unenforceable" ▸ Importantly, the court did not at all address the fact that the conduct was three years after closing, suggesting that it could very well have reached this conclusion even if this competitive conduct happened right after closing
Geographic Restrictions	▸ Geographic Restriction Approach. In assessing acceptable geographic scope, the court quoted a 2007 case that held that "[T]he reasonableness of a covenant's scope is not determined by reference to physical distances" but by "the area in which a covenantee has an interest the covenants are designed to protect." ▸ Worldwide Restriction. The court invalidated the whole non-compete because of the "worldwide" coverage even if one were to concede that nationwide coverage was appropriate: — "[Acquirer] does not allege that [Target] provided services globally. The Complaint—viewed in the light most favorable to [Acquirer] — states that Texas-based [Target] served clients "nationwide." The incongruity between the geographic scope of the covenant and that of [Target]'s business leads me to conclude the non-compete is unreasonably broad and unenforceable." ▸ Applies in Sale Context. The court specified that reasonable geographic scope was a requirement in the sale context too (and not just employee non-compete) ▸ No Blue Pencil. Repeating recent reluctance to blue-pencil overreaching covenants, the court said: "In my view, revising the non-compete to save [Acquirer]—a sophisticated party—from its overreach would be inequitable"
Takeaway	▸ This decision illustrates the risk of restrictive covenant overreach, highlighting that each element – scope, duration, geography – will be evaluated individually for reasonableness. Failing on any one of these elements could invalidate the whole covenant even if the other two are reasonable
Non-Compete Ban Comment Period Extended	▸ On a related note, on March 6, 2023, the FTC announced that it has extended the period that the public has to comment on its proposed rule to ban non-competes ▸ The deadline has been extended to April 19 – was originally March 20