Buchanan

Update on Non-Compete Agreements

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ACC Association of Corporate Counsel
NATIONAL CAPITAL REGION

UPDATE ON NON-COMPETE AGREEMENTS

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Agenda

- Background: Why target non-compete agreements?
- Federal and State Enforcement
- Varying Impacts on your Businesses
- Preparing Your Business - Practical Tips

Background: Why Target Non-Compete Agreements?

Employee Perspective vs. Employer Perspective

The Employee's Perspective

- Restriction on freedom to move between jobs, particularly when they have been a long-term member in the industry
- Restriction on freedom to market their skillset and experience
- Restriction on freedom to find a better job – e.g., higher wage, better benefits
- Restriction on freedom to negotiate a higher wage
- Restriction on freedom to seek improved quality of employment, including access to better innovations
- Restriction on speaking out against employer
- Debate on their knowledge vs. employer know how

[The FTC] estimates that the new proposed rule could increase wages by nearly $300 billion per year and expand career opportunities for about 30 million Americans.

– FTC Press Release

Employees Experience a "Chilling Effect"

The NLRB Memo on Non-Compete Agreements discusses five ways that these agreements chill employees in the exercise of Section 7 rights:

1. They discourage threats to resign by rendering these threats futile
2. They discourage employees from carrying out threats to resign
3. They prevent employees from seeking better working conditions from local competitors
4. They prevent solicitation amongst co-workers
5. They limit employment ability required to engage in protected activity, like organizing unions

The Employer's Perspective

- Protect proprietary information
- Protect the company's investments and product development
- Protect the time, money, and energy invested in the recruitment and development of key employees who develop specialized knowledge and expertise
- Protect against the loss of critical information, technology, and products developed over time
- Protect customer and other relationships established through employment, including vendor relationships

"If adopted, according to the Commission's own data, the rule would immediately outlaw more than 30 million noncompete provisions that have been negotiated by companies and workers…"

– Chamber of Commerce

Federal and State Enforcement

Federal Approaches

Setting the Stage

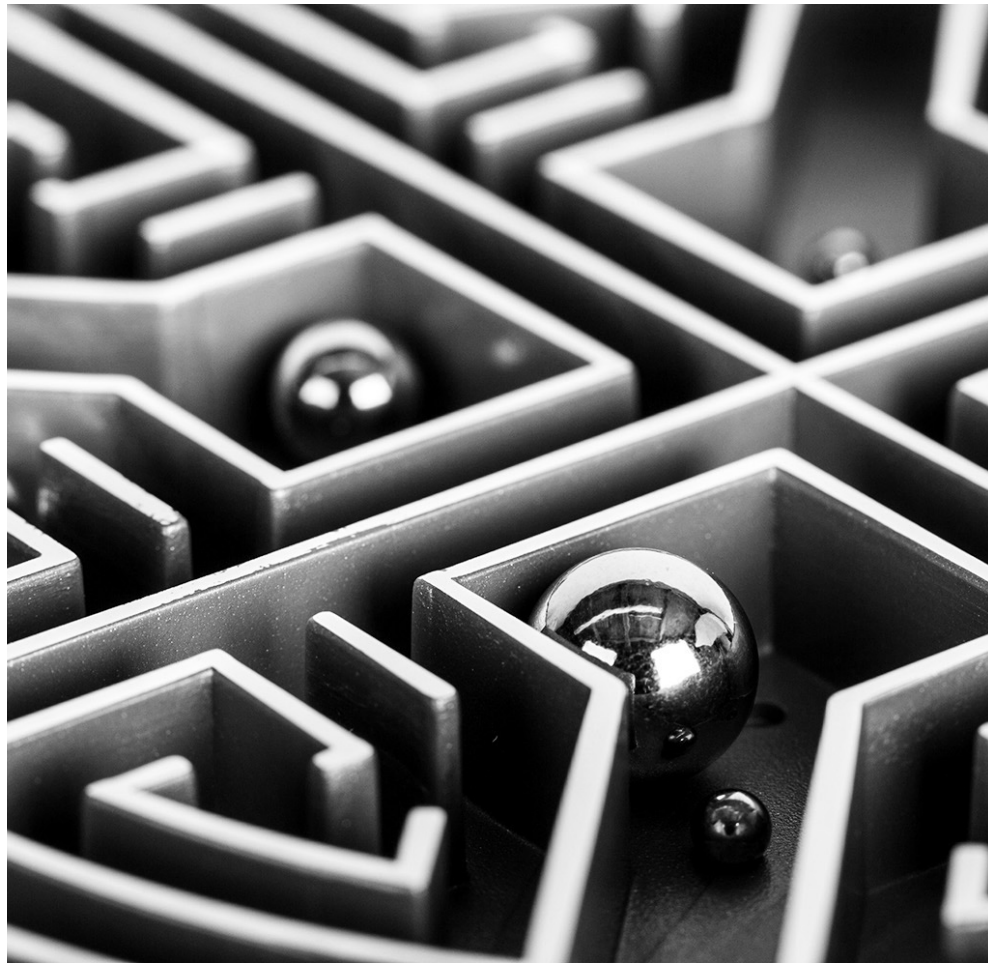
- July 9, 2021 – President Biden published his Executive Order on Promoting Competition in the American Economy, directing the FTC to exercise its statutory authority:
  - "[T]he Chair of the FTC is encouraged … to exercise the FTC's statutory rulemaking authority under the Federal Trade Commission Act to ***curtail the unfair use of non-compete clauses*** and other clauses or agreements that may unfairly limit worker mobility"
- Emphasized "whole of government" approach and cites to a host of laws, stating "Congress has also enacted industry-specific fair competition and anti-monopolization laws that often provide additional protections."

The "Whole-of-Government Approach"

- July 9, 2021 – Executive Order references the following agencies and the need for "a whole-of-government approach" to address **overconcentration, monopolization, and unfair competition** in the American economy:
  - The Department of the Treasury, the Department of Agriculture, the Department of Health and Human Services, the Department of Transportation, the Federal Reserve System, the Federal Trade Commission (FTC), the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Federal Communications Commission, the Federal Maritime Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the Consumer Financial Protection Bureau, and the Surface Transportation Board.
  - Agencies can influence the conditions of competition through their exercise of regulatory authority or through the procurement process. See 41 U.S.C. 1705.

FTC – Rulemaking Authority

- Section 5 of the Federal Trade Commission Act declares "unfair methods of competition" to be unlawful
  - It directs the FTC "to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in or affecting commerce." 15 U.S.C. §§ 45(a)(1)-(2)



FTC – Rulemaking Authority (Cont.)

- Section 6(g) of the FTC Act empowers the FTC to "make rules and regulations for the purpose of carrying out the provisions of [the Act]." *Id.* § 46(g)
- BUT – debate on whether 6(g) gives the FTC authority to issue rules directed at competition versus consumer protection
- AND – the FTC has never successfully issued a rule directed at a "method of competition" (versus consumer protection)

FTC Proposed Rule – Key Points

- **No Non-Competes**: Majority of post-employment non-compete agreements/clauses between an employer and any "worker" would be prohibited
  - Applies to any provision that ***functions*** as a non-compete
- **No carve-outs** for executives or salespersons
- Rule also would **ban non-competes** with **independent contractors** providing services to the company
- **Retroactive Application**: Employers would be required to rescind ***existing*** non-compete clauses no later than the date of compliance. § 910.2(b)(1)
- Employers will be required to provide **written notice to workers** that the worker's non-compete is no longer enforceable. § 910.2(b)(2)(A)

FTC Proposed Rule – Key Points (Cont.)

- Mandated compliance within 180 days of Final Rule publication
- **Preemption**: Rule will supersede any State law, regulation, order, etc. that is inconsistent with it. § 910.4
  - That said, states are permitted to impose requirements and restrictions against non-competes if they provide greater protections than those provided in the proposed rule
- The Rule would only apply to those entities and persons **covered by the FTC Act**
  - Non-profits and FDIC-insured banks are not covered
  - ***Inconsistency across and within industries***

De Facto Non-Competes

- Proposed rule would apply to *de facto* non-compete agreements as well
  - *De facto* non-compete agreements = agreements that have the effect of prohibiting workers from seeking or accepting employment
  - These include, **for example**:
    - Broadly written non-disclosure/confidentiality agreements that effectively preclude workers from entering the same field after the conclusion of the workers' employment with the employer, and
    - Agreements requiring workers to repay training costs if the worker terminates employment within a specific time period and where repayment is not reasonably related to the costs of training

Non-Solicitation Agreements – Gray Area

- Not explicitly part of the Proposed Rule
- FTC's Notice of Proposed Rulemaking provides, "the definition of non-compete clause[s] would generally not include . . . client or customer non-solicitation agreements" because these agreements do not generally prevent workers from competing with their employer altogether
- **BUT BEWARE**: A broadly drafted non-solicitation agreement could be challenged as a *de facto* non-compete otherwise proscribed by the Rule
  - Any clause that has the *effect* of prohibiting the worker from seeking or accepting work with a person or operating a business after the conclusion of the worker's employment with the employer

Non-Solicitation Agreements – Gray Area (Cont.)

- Overbroad NDA: defined "confidential information" as any information that is "usable in" or "relates to" the securities industry
- Overbroad liquidated damages provision: partners "who withdraw from the firm and within two years thereafter serve a client served by the firm at the time of their withdrawal must pay the firm 200 percent of the fees earned from the client by the firm during the twelve months preceding their (post-withdrawal) commencement of service to the client."
- Overbroad training costs: requires the worker to pay back training costs, where the required payment is not reasonably related to the costs the employer incurred for training

Limited Exceptions

- No exceptions for senior level employees or employees with intellectual property or trade secret information
- **One Exception → Sale of a Business**
  - The Rule would still allow non-competes with a "natural person" in the context of the sale of a business IF the person restricted is an owner, member, or partner holding **at least 25% ownership interest** in the business entity
    - But other specific employees could not be subject to a non-compete
  - Note – no prohibition on two companies agreeing to a non-compete in the sale of business context (although beware of running afoul of antitrust laws generally)

Published Comments

- Chamber of Commerce comments generally call for the Rule to be rescinded
- Other associations and industry actors have since submitted comments opposing the rule, e.g., National Association of Manufacturers, Computer and Communications Industry Association (CCIA), American Nurses Association (ANA)
- The AHA and other healthcare associations have also submitted comment letters
- The public comment period ended on April 19, 2023 - over 26,000 comments
- FTC must address comments (as a whole) in its Notice of Final Rule

Expected Legal Challenges

- Expect strong challenges from the Chamber of Commerce and other groups representing employers to any rule the FTC adopts
- US Chamber has already released a statement regarding the Proposed Rule as "blatantly unlawful" and criticizing the FTC's authority to implement the Rule
- Others have publicly stated that the Proposed Rule goes too far
- Remains unclear what the final rule will look like
- No immediate action required based on it
- But be proactive as discussed in our tips!

Expected Legal Challenges (Cont.)

- If some version of the Rule as currently written is published, expected legal challenges include:
  - That the FTC lacks authority to promulgate any substantive rule that addresses "unfair methods of competition"
  - That the FTC lacks clear Congressional authorization to impose rulemaking on a matter of such political and economic significance – the "major questions doctrine"
- As well as . . .
  - Congress did not set out "an intelligible principle" to direct the FTC to regulate non-compete agreements – the non-delegation doctrine
  - Even if the FTC had that authority, designating all non-compete agreements as an unfair method of competition is too overbroad and incorrect:
    - Non-competes were lawful when the FTC Act was passed
    - Non-competes are not per se violations of antitrust laws
    - The rule would displace many state laws, contract law and existing public policy

US Department of Justice

- Antitrust Division going after agreements that impact workers as *per se* violations of antitrust laws
- Primarily focused on employer-to-employer wage fixing and no-poach agreements – as opposed to employer/employee agreements
- Have made it to jury trials – but lost at trial
- Able to secure one plea deal in criminal case
  - Historically able to secure settlements in civil cases; recently secured settlement against poulty companies and consultant for sharing wage information
- DOJ has the authority to pursue non-compete agreements

Overbroad Non-Competes Violate the National Labor Relations Act

"Non-compete provisions reasonably tend to chill employees in the exercise of Section 7 rights when the provisions could reasonably be construed by employees to deny them the ability to quit or change jobs by cutting off their access to other employment opportunities that they are qualified for based on their experience, aptitudes, and preferences as to type and location of work."

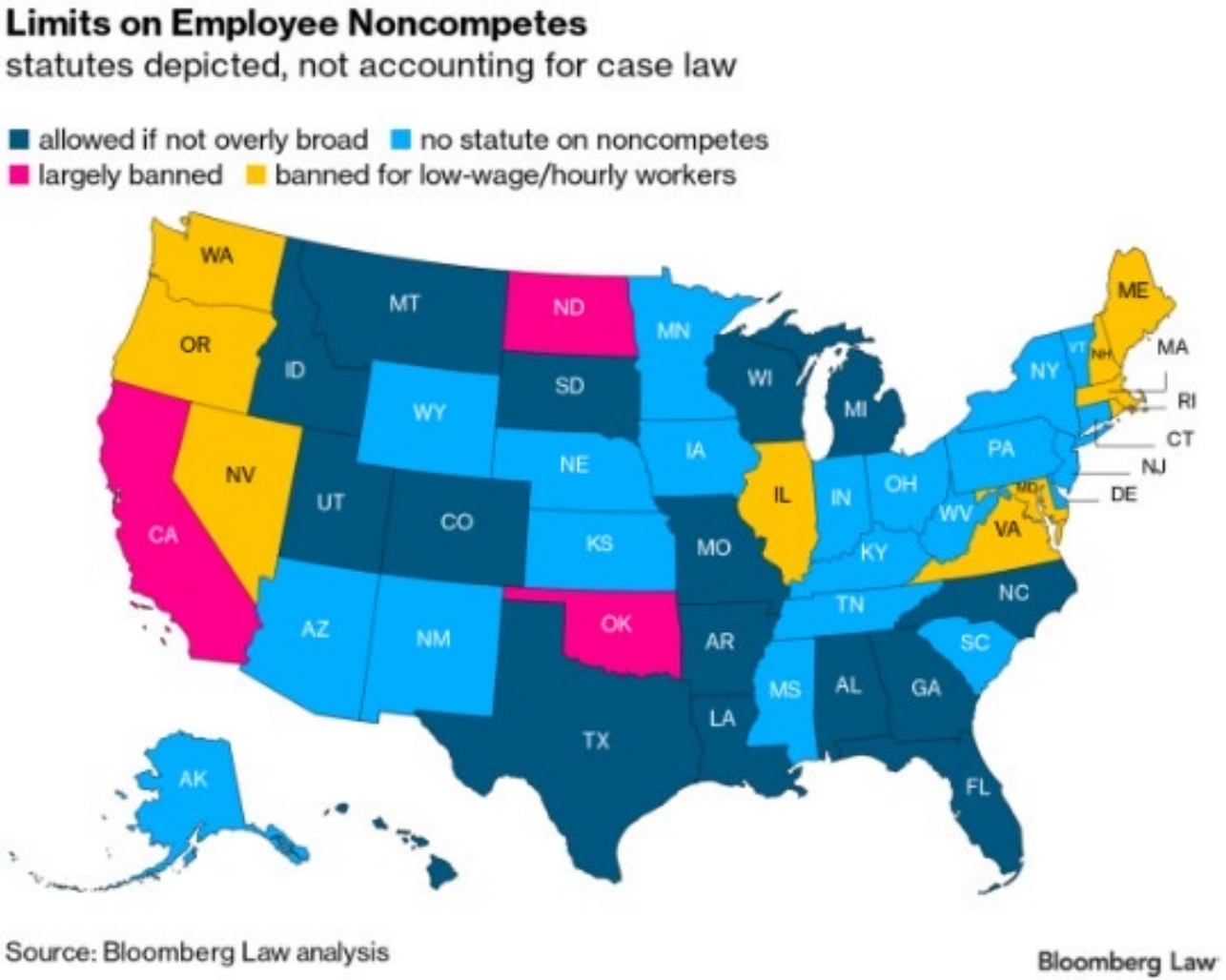
NLRB Office of General Counsel, Memorandum GC 23-08 (May 30, 2023)

NLRB General Counsel Jennifer Abruzzo's Memo

- Non-competes are almost always impermissible when enforced against **low or middle-wage** workers.
- **Narrowly-tailored** non-competes are permissible in special circumstances: **(1)** when the provisions clearly restrict only individuals' managerial or ownership interests in a competing business; **(2)** when they pertain to true independent contractor relationships; and **(3)** when they are narrowly tailored to protect proprietary trade secret information.
- But remember: Section 7 applies to **non-supervisory** employees (with limited exceptions).

State Trends

Looking Back: Non-Competes in 2022



https://www.competitionpolicyinternational.com/are-businesses-shying-away-from-non-competes-in-response-to-increased-antitrust-scrutiny-of-labor-related-issues/

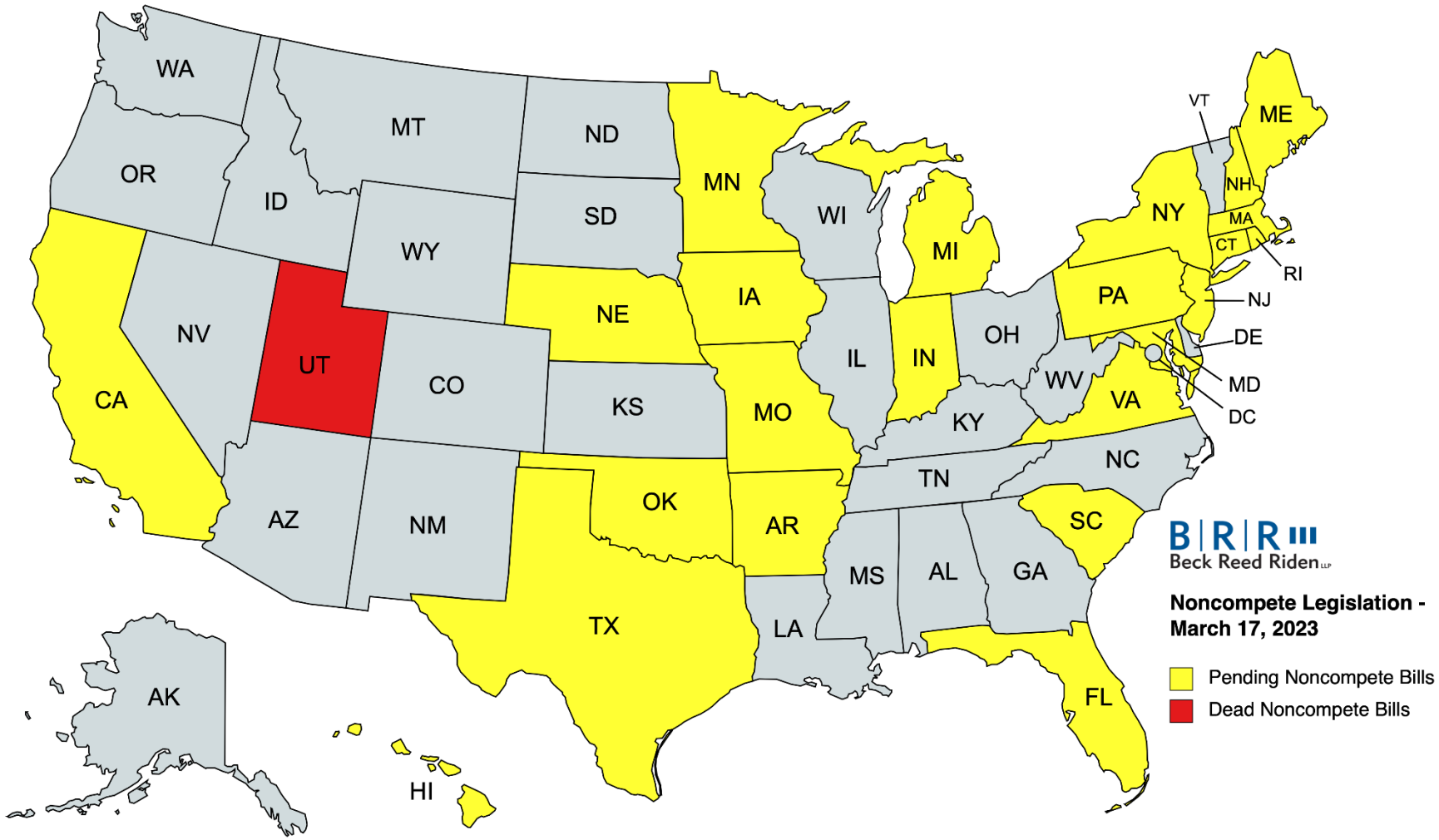
Enacted Laws

- 2023 Near-total bans: California, Montana, North Dakota, Oklahoma, Washington, D.C., Minnesota
- Salary-based bans: Colorado, Connecticut, Illinois, Maine, Maryland, New Hampshire, Oregon, Rhode Island, Virginia, and Washington
- Profession-based bans: Hawaii, Iowa, Kentucky, Rhode Island, South Dakota

Pending Legislation

- May 30, 2023: The Missouri Senate passed SB 103, which imposes restrictions on overbroad non-solicitation and non-compete provisions
- June 20, 2023: New York State Assembly approved a bill banning non-compete agreements for most employees, with limited exceptions for certain client non-solicitation agreements.

Trends in Proposed Legislation



Non-Competes in Delaware Courts

- Delaware courts have also recently subjected non-competes to stricter scrutiny.
  - Since 2022, Delaware state courts struck down two non-competes and refused to uphold the DE choice of law provision for a third non-compete.
    - *Kodiak Building Partners, LLC v. Adams*, 2022 WL 5240507 (Del. Ch. Oct. 6, 2022)
    - *Hightower Holding, LLC v. John Gibson*, C.A. No. 2022-0086-LWW, memo. op. (Del. Ch. Feb. 9, 2023)
  - These non-competes were in **the sale of business context** which is generally subject to a lower standard of scrutiny than agreements in the employment context.

State Antitrust Enforcement | Non-Compete

- 2018 NY AG/WeWork Co. Settlement required WeWork to release 1400 employees nationwide from non-compete agreements and narrow the scope on hundreds more.
- 2019 Illinois AG/Check Into Cash Settlement prohibits Check Into Cash from requiring non-competes for store-level employees.
- 2016 NY AG/Law360 Settlement requires Law360 to release all but their top executives from non-competes.

State Antitrust Enforcement | Non-Compete (Cont.)

Jimmy Johns – in Illinois & New York

Jimmy John's, a sandwich franchise, mandated non-compete clauses for its sandwich makers and delivery drivers as a condition of their employment.

The Non-Compete clause compelled employees to agree that

- During their employment & 2 years ***after***
- Not work at any business that earns more than ten percent of its revenue from selling "submarine," "hero-type," "deli-style," "pita," and/or "wrapped" or "rolled sandwiches"; and
- Is within 3 miles of any Jimmy Johns

Restraint:

- Involuntary
- Lacked Consideration
- Too Broad
- Negative impact on competition

Under agreement with New York Attorney General, Jimmy John's agreed to stop using the non-compete agreements and to inform its franchises that that Attorney General had concluded the provisions were unlawful and should be voided

People of the State of Illinois v. Jimmy John's Enterprises LLC et al., case number 2016CH07746, in the Circuit Court of Cook County, Illinois, County Department, Chancery Division

https://www.washingtonpost.com/news/wonk/wp/2015/05/14/map-where-every-popular-sandwich-chain-is-located-in-the-u-s/

Varying Impacts on Businesses

Where Do These Agreements Remain Enforceable?

It Depends!

"It is unlikely an employer's justification would be considered reasonable in common situations where overbroad non-compete provisions are imposed on low-wage or middle wage workers who lack access to trade secrets or other protectible interests, or in states where non-compete provisions are unenforceable."

NLRB Office of General Counsel, Memorandum GC 23-08 (May 30, 2023)

Patchwork of Laws, Coverage, and Enforcement

- Results in inconsistent impacts to employers and employees
- FTC proposed rule – doesn't cover franchises, non-profits, or banks
  - But one industry can have for-profit companies competing with non-profits
  - Banks can have FDIC insured divisions as well as investment divisions
  - FTC can still bring challenges – can only seek injunction at outset, usually includes on-going reporting obligations
- DOJ can pursue as criminal or civil in any industry – can seek fines as well as injunctions

Patchwork of Laws, Coverage, and Enforcement (Cont.)

- NLRB – generally covers only non-supervisory employees and allows for make-whole remedies and informational remedies, such as the posting of a notice by the employer promising to not violate the law; may issue cease and desist
- Federal Agencies and Government Procurement may be the next trend in regulating non-competes
- States have varying non-compete laws that cover variety of industries and types of employees
  - Some AGs are more aggressive than others in pursuing antitrust violations to protect employees – results in attorneys fees, injunctions and on-going reporting obligations

Preparing Your Business – Practical Tips

Trade Secret Protections

Importance of Trade Secret Protection

- Ban takes effect = Trade secret protection law importance increases
- The Defend Trade Secrets Act
- Trade secret protection laws provide for injunctive relief and attorneys' fees when employees, independent contractors, or others misappropriate confidential, valuable information
- Non-competes were designed to protect investments in employees and sensitive, confidential, valuable information

What Should We Do?

- If non-competes are banned, employers will have to rely on trade secret protection laws:
  - Better define "trade secrets" (beginning, during, and conclusion of employment)
    - Require employees -- before hire -- to sign confidentiality agreements
    - During onboarding, take the time to explain the confidential, valuable information
      - Acknowledge difficulty with providing specifics but not limiting the list, i.e., new confidential, valuable information will emerge
      - Remind employees of their obligation to understand and know the trade secrets

What Should We Do? (Cont.)

- If non-competes are banned, employers will have to rely on trade secret protection laws:
  - Better, interactive training on how to identify and protect trade secrets, including through:
    - Being steeped in the industry but not sharing within the industry
    - Encrypting information, cybersecurity measures, and monitoring
  - More reminders for trade secrets and NDAs
    - Use performance evaluations to remind and rate employees on confidentiality
    - Have built in reminders in your systems (e.g., when employee logs in to Sales Force or other systems, a reminder pops up)

What Should We Do? (Cont.)

- If non-competes are banned, employers will have to rely on trade secret protection laws:
  - Treat them like secrets!
    - Restrict access to them
    - Explain the ways to keep them secret
    - Monitor and review employees' activity regularly!
  - Consider compartmentalizing information within the organization
    - Is this always feasible?
    - This can have advantages when receiving third-party confidential information
  - Do Not Forget About Patents

Protecting Trade Secrets: Protecting American Intellectual Property Act (PAIP Act)

- President Biden signed the PAIP Act into law on January 5, 2023
- Law seeks to protect American business from the theft of trade secrets by foreign actors
- The law mandates listing of and sanctions on entities and individuals identified by the President as having committed "significant theft of U.S. trade secrets"
- Potentially a substantial deterrent when available, but probably not useful as a proactive measure

(Re)Examine Existing Agreements

Employer Considerations

- Employers should take notice of FTC's aggressive stance towards non-competes and continue to track developments in state and federal law
- Even if final rule is substantially changed or even abandoned, the FTC views non-compete clauses as a potential antitrust violation
- Recent enforcement actions culminated in consent agreements, so FTC's stance has not been challenged in court
- FTC does not **NEED** the proposed rule to challenge non-compete agreements
- Recent FTC complaint and consent decree alleged that a company's non-compete agreements with "over 300 employees" are a **violation of Section 5 of the FTC Act as an unfair method of competition**

Employer Considerations (Cont.)

- According to the 3-page complaint, the non-compete agreements were **for one (1) year** and prohibited the employees from working for a company that provides **"rigid packaging sales and services which are the same or substantially similar to those in which [company] deals.“**
- It also prohibited employees from providing such products or services to **"any customers or prospective customers of [company] with whom the worker had any interaction."**
- This wording is **often used** in non-compete agreements
- Historically, **one (1) year** has been found acceptable by courts in terms of duration
- Because the company entered a settlement with the FTC, there was **no determination by a court** based on past case law as to whether the company's non-compete agreements were reasonable

Employer Considerations (Cont.)

- The company agreed **to rescind all existing non-compete agreements** and not require any new ones, for a period of **ten years**
- Be aware of the scope and purpose of every non-compete, non-solicit, and confidentiality agreement
- You must answer these questions:
  - What is the legitimate purpose for the restriction?
  - How well is that legitimate purpose documented?
  - Is there a lesser means to accomplish the restriction?

Non-Solicit of Customers, Distributors, Etc.

During employment and for **[months]**, Employee will not, directly or indirectly, for Employee's benefit or as an agent or employee of any other person or entity, solicit or induce **any customers, distributors, vendors, licensors or suppliers** of the Company or the Company's Affiliates **that Employee solicited, contacted, or communicated with during Employee's employment**, or for **whom Employee received Confidential Information and Trade Secrets**, to divert their business from the Company or the Company's Affiliates to any other person or entity or in any way interfere with the relationship between any such customer, distributor, vendor, licensor or supplier and the Company or the Company's Affiliates (including, without limitation, making any negative statements or communications about the Company or the Company's Affiliates).

WARNING: THIS IS NOT A SAMPLE! THE FACTS MATTER!

Non-Solicit and No-Hire Language for Employee

- During employment and for 12 months following, Employee will not directly or indirectly, for Employee's benefit or as an agent or employee of any other person or entity, solicit the employment or services of any Person Employed by the Company **or the Company's Affiliates**, induce any Person Employed by the Company **or the Company's Affiliates** to leave his or her employment with the Company **or the Company's Affiliates** (other than terminations of employment of subordinate employees undertaken in the course of Employee's employment with the Company), or **hire any Person Employed by the Company or the Company's Affiliates**. For purposes of this Section, the term "Person Employed by the Company or the Company's Affiliates" means any person who is or was an employee of the Company or one of its Affiliates at the time of or within the twelve (12) months preceding the solicitation, inducement, or hiring.

WARNING: THIS IS NOT A SAMPLE! THE FACTS MATTER!

Employer Considerations

- Review and update current employee handbooks
  - Are there confidentiality policies?
  - Are there appropriate carve outs, such as the DTSA whistleblower provision?
  - Is there information supporting the scope of the business and the legitimate interests that require protection?
  - Are there strong Use of Electronic Systems policies?
  - Are there open-door policies, making sure employees know who to ask about trade secrets?
  - Are there policies on the return of Company property, including clarity on what constitutes Company property?

Employer Considerations (Cont.)

- Review and update exit interview and return of Company property procedures
  - Are employees asked about return of Company property, including their understanding of what constitutes Company property?
  - Are they required to complete a protocol to search for company property?
  - Are they asked about emails that they sent to their personal accounts?
  - Are they asked about any printed materials?
  - Are they asked about their use of USBs, external hard drives, drop boxes, or other storage?
  - Are they required to sign a verification under penalty of perjury that they returned all Company property, including trade secrets?

Possible "Garden Leave"

- Some states have already banned or severely limited non-competes
- Even still, employers remain able to prevent current employees from competing
- "Garden Leave"
  - Non-competes may remain, but employees remain in a "transition" state longer being paid to work for the employer and not a competitor (without access to confidential information and strategies)
- Could evolve with the Proposed Rule, but these would currently not fall under the ban because the employee **remains employed**
- What if the required "transition" time was at half salary?

Questions? Thank you!

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