Services

Business, Corporate & Securities

FTC's Proposal to Ban Most Noncompetes Would Significantly Alter Middle Market Mergers and Acquisitions

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Overview

On January 5, 2023, the Federal Trade Commission ("**FTC**") proposed an expansive new rule which would prohibit the use of almost all noncompete clauses between a worker and his or her employer (the "**Proposed Rule**").[1] The Proposed Rule effectively deems such noncompete clauses as an unfair method of competition in the market for workers. It is clear that the Proposed Rule invalidates almost all noncompete clauses that restrict a worker *after the conclusion* of his or her employment; while it is not explicit that the Proposed Rule permits noncompete clauses *during the employment term*, that is the clear implication of the Proposed Rule. [This Client Alert will refer to the former as "**Post-Employment Noncompete Clauses**" and the latter as **"In-Term Noncompete Clauses**."]

A 60-day public comment period will begin once the FTC publishes the Proposed Rule in the Federal Register. After the notice-and-comment period concludes, the FTC will consider the comments and then publish a final version of the rule. The Proposed Rule will preempt any state law that is inconsistent with the rule. While it is not addressed in this alert, the Proposed Rule will likely face legal challenges, including with respect to whether it has the authority to regulate noncompete agreements.

Proposed Rule

The Proposed Rule generally invalidates almost all Post-Employment Noncompete Clauses. In addition, an employer is prohibited from informing its workers that they are subject to a noncompete, absent a good faith basis to believe that such a noncompete is enforceable. The Proposed Rule broadly defines noncompete clauses as: "a contractual term between an employer *and a worker* that prevents the worker from seeking or accepting employment with a person, or operating a business, *after the conclusion* of the worker's employment with the employer." (emphasis added)[2]

The Proposed Rule would encompass all workers, whether paid or unpaid. The definition of "workers" includes not just employees, but also interns, volunteers and independent contractors.

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[1] https://www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking
[2] Notice of Proposed Rulemaking, Fed. Trade Comm'n at 4.

Under the Proposed Rule, employers must rescind existing Post-Employment Noncompete Clauses with workers within 180 days following publication of the final rule. Additionally, employers must provide notice to workers that their Post-Employment Noncompete Clauses are no longer enforceable within 45 days after rescission. The Proposed Rule provides model language for such notice.

In general, the Proposed Rule does not invalidate other typical restrictive covenants like non-solicitation, non-disclosure and other confidentiality agreements. However, the FTC notes:

- the term "non-solicitation agreement"[3] is intended to refer to contractual provisions prohibiting workers from soliciting clients or customers, not agreements not to solicit employees.

- Some non-disclosure and other restrictive covenants may be so broad that they are *de facto* non-competition agreements.[4]

M&A Impact

In addition to employment repercussions, the Proposed Rule is expected to have significant consequences for M&A transactions. The FTC acknowledged that noncompete clauses in the M&A context may implicate "unique interests and have unique effects."[5]

Noncompete clauses appear in at least three different contexts in M&A transactions, as described below.

Sale of Business Noncompete Clauses. Sellers (or the owners of Sellers in asset sales) are typically subject to noncompete agreements in connection with the sale of their business (so-called "Sale-of-Business Noncompete Clauses"). The Proposed Rule provides for a narrow exception in the context of a sale-of-business to the extent that the worker subject to the restriction is an owner holding at least a 25% interest in the target company.

We note that the Proposed Rule generally restricts workers only; however, the narrow-exception for Sale-of-Business Noncompete Clauses addresses owners but not workers. Despite this ambiguity, because the definition of noncompete clauses subject to the Proposed Rule includes only agreements *with workers*, it appears that the Proposed Rule (and the exception) would apply to owners who are also workers, but would not apply to owners who are not workers. For owners who are not workers, the definition of a noncompete clause suggests that the Proposed Rule would not restrict the enforceability of the Sale-of-Business Noncompete Clause.

The 25% ownership threshold may result in inconsistent application, as many targets may have significant minority ownership. For example, the target may be owned 25% by Person A, and the ownership balance (75%) scattered among various Persons B through Z, none of which own 25% or more, each of which works in the business. In this scenario, the buyer may legally bind Person A to the Sale-of-Business Noncompete Clause (because Person A owned 25% or more of target) but the Buyer may not legally bind Persons B through Z (because each owned less than 25% of target). Even though Persons B through Z may have intimate and crucial knowledge of the target's confidential and proprietary information, none of them can be bound to a Sale-of-Business Noncompete Clause due to their ownership percentages.

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[3] *Id.* at 11.
[4] *See, e.g., id.* at 11 and 99.
[5] *Id.* at 4.

Employment Noncompete Clauses. In many acquisitions, key employees of the target are considered one of the most highly valued assets. In an equity purchase, the buyer typically receives comfort that any acquired confidential and proprietary information is protected by means of noncompete clauses in employees' existing employment agreements (if such agreements remain in place). If the acquisition is an asset sale, the buyer might introduce new employment agreements with noncompete clauses.

However, if the Proposed Rule is adopted, all Post-Termination Noncompete Clauses for workers will be invalid. In-Term Noncompete Clauses seem to be valid, though.

Equity Rollover Noncompete Clauses. In some transactions, particularly in deals whereby a private equity firm acquires a closely held business, it is common for the owners to "roll over" some of their equity into equity of the acquiring company. In connection with the equity roll over, the buyer will typically ask the owner rolling over equity to execute a noncompete clause covering the period during which such owner holds equity in the acquiring company and, in some instances, for a time period thereafter. The Proposed Rule does not explicitly address this variation of a noncompete clause, which leaves open the question of whether it may be treated as a Sale-of-Business Noncompete Clause since it was entered into in connection with the sale of the business previously owned by such party or whether it is not a Sale-of-Business Noncompete Clause because it is tied to the new equity acquired as part of the roll over rather than the equity in the company which was sold. In the first instance, the question appears still to be whether the owner is a worker. If the owner is not a worker but rolls over equity, it would appear that this this type of noncompete clause would not be subject to the Proposed Rule. However, if the owner is a worker and rolls over equity, it would appear that this would be treated as a noncompete with a worker which would be unenforceable during the period after the termination of employment unless the "sale of business exception" applies.

Case Study

Jill is the 70% owner of JillCo (and the balance of JillCo is owned by Jill's three siblings, 10% each). Jill and her brother Ronnie work in the business; however, the other two siblings do not work in the business, but instead are "silent partners." Jill and her siblings sell 80% of JillCo stock to Large Private Equity Group for cash and the sellers "roll over" 20% of their equity. At closing, Jill and her siblings enter into the following noncompete agreements:

Sale-of-Business Noncompete Clause. Jill and her siblings agree that they will not compete against the business for a period of five years.

Result under the Proposed Rule. Jill's noncompete clause is likely enforceable (given that she is a "significant owner," i.e., owning more than 25%). The noncompete clauses of her two siblings other than Ronnie are also likely enforceable since, even though they own less than 10% of the business, these siblings are not workers subject to the Proposed Rule. Since Ronnie is a worker and does not own 25% of the target company, his noncompete is likely unenforceable.

Employment Noncompete. Jill is retained as JillCo's CEO and Ronnie (Jill's brother) stays on as an independent contractor of JillCo. Both agree not to compete against the business during their employment and for a period of two years thereafter.

Result under the Proposed Rule. Both noncompete clauses are likely enforceable while they are employed and likely unenforceable after employment.

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Equity Rollover Noncompete. Regarding their 20% rollover equity, Jill and her siblings agree not to compete with the business during their ownership of the roll over equity and for a period of three years thereafter.

Result under the Proposed Rule. The clauses are likely enforceable as to those siblings who are not workers. On the other hand, the clauses are likely unenforceable against Ronnie since he is a worker and not a 25% owner in either the target entity or the acquirer. With respect to Jill, the outcome is unclear. In order to be enforceable, Jill's noncompete would need to fall within the "sale of business exception." This would require a conclusion that the noncompete relates to the sale of the business in which Jill had more than a 25% ownership interest, notwithstanding the fact that it is tied to her ownership of the roll over equity, rather than the consummation of the sale. Jill's continuing ownership interest after closing of the transaction is unlikely to be useful in arguing for the application of the "sale of business" exception since it is unlikely that she continues to hold at least a 25% ownership interest after the closing and, in any event, the entity in which she holds her roll over equity is not then being sold. If this noncompete is distinguished from a Sale-of-Business Noncompete Clause because it is tied to her post-closing ownership rather than the sale transaction itself, then it is likely that the noncompete is unenforceable after the termination of her employment with the acquiring company, even if she continues to hold her roll over equity.

Action Items

Employers should take the following measures in preparation for the Proposed Rule's finalization:

- **Introduce restrictive covenants like confidentiality agreements, non-solicitation agreements and other trade secret protections**. Employers should consider implementing restrictive covenants such as confidentiality agreements, non-solicitation agreements, and any other means that protect confidential and proprietary information and other legitimate business interests without acting as a *de facto* noncompete agreement.

- **Carefully draft "Sale of Business" noncompete clauses**. If a party to a noncompete clause is an owner and not a worker, this should be specifically referenced in the noncompete to clarify that such clause is not subject to the Proposed Rule. Additionally, if a party to a noncompete is a worker and a 25% owner, the clause should specifically reference the "sale of business" exception. Finally, if the transaction involves roll over equity for a 25% owner who is also a worker, the noncompete clause should note that the covenant is tied to the prior ownership in the business being sold (to trigger the "sale of business" exception), and not in connection with any ongoing employment relationship or ongoing ownership interest.

- **Review your current noncompete clauses**. Employers should identify agreements containing noncompete clauses in order to categorize what documents will need to be rescinded and who will need to be given notice of rescission in accordance with the Proposed Rule's timeline.

- **Submit comments on the Proposed Rule**. Employers and other interested parties should submit comprehensive comments highlighting concerns to the FTC during the public comment period.

For further information or questions about the Proposed Rule, please contact any member of Kutak Rock's Mergers & Acquisitions Group or Scottsdale Corporate and Securities Group. You may also visit us at www.KutakRock.com.