TECHNOLOGY MARATHON
Restrictive Covenants and Noncompete Agreements
May 11, 2023
Agenda

- Overview of FTC Proposed Rule
- The Rulemaking Process
- Transactional Considerations
- Labor & Employment
- Intellectual Property Considerations
- Executive Compensation Considerations
- What Is Reasonable to Restrict
Overview of FTC Proposed Rule

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Antitrust Focus on Competition in Labor Markets

- Labor market competition a key policy focus for US antitrust authorities:
  - **October 2016:** FTC/DOJ Guidance for HR Professionals – policy to criminalize “no poach”
  - **July 2021:** Executive Order on Promoting Competition in American Economy
    - Ordered FTC/DOJ to focus on labor market competition in various ways
    - Specifically called on FTC to engage in rulemaking concerning noncompetes
  - **March 2022:** Treasury study on effect of market concentration on wages
  - **2022:** Penguin/Random House – merger challenge focused on purchasing competition
  - **2022:** Civil Consent Decree re Wage Information Sharing

- FTC Proposed Rule Banning Noncompetes (January 2023)
  - First “unfair methods of competition rule” in at least 55 years (arguably first ever)
  - FTC’s authority to engage in “antitrust” rulemaking is untested and subject of debate
    - Magnuson-Moss Act prescribes rules for “unfair and deceptive acts” rulemaking
    - Possible rulemaking authority pursuant to §6(g) of the FTC Act
FTC’s Proposed Noncompete Rule

Proposed Rule Text:

*Unfair methods of competition.* It is an unfair method of competition 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 represent to a worker that the worker is subject to a non-compete clause where the employer has no good faith basis to believe that the worker is subject to an enforceable non-compete clause.

Proposed Rule Would:

- **Ban noncompetes with “workers”**
  - Broad definition of “workers”: any person “who works, whether paid or unpaid, for an employer”
  - Applies to explicit and *de facto* noncompetes
- **Require rescission of existing noncompetes**, with notice to workers
- Only **exception in connection with sale of business**, for noncompetes applicable to “substantial owners,” which is defined to mean those owning more than 25% of business
Application of the FTC’s Rule

- Rule would apply nationally to the full extent of FTC jurisdiction
  - FTC lacks jurisdiction over “banks, savings and loan institutions described in section 57a(f)(3) of this title, Federal credit unions described in section 57a(f)(4) of this title, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to part A of subtitle VII of title 49, and persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act, 1921”
  - FTC lacks jurisdiction over most nonprofit organizations
- No penalties or private causes of action specified in the FTC Rule, but FTC may explore fines and the rule could be incorporated automatically into state “Little FTC Acts”
  - Twenty states have Little FTC Acts that explicitly incorporate and require deference to FTC interpretations of “unfair methods of competition”
  - Those state statutes permit civil penalties, and most permit private rights of action, several with treble damages
FTC’s Proposed Noncompete Rule

- FTC has and is considering alternatives, and has specifically requested comments on:
  - Alternative #1 would categorically ban the use of noncompete clauses for some workers and apply a rebuttable presumption of unlawfulness to noncompete clauses for other workers.
  - Alternative #2 would categorically ban the use of noncompete clauses for some workers and not apply any requirements to other workers.
  - Alternative #3 would apply a rebuttable presumption of unlawfulness to noncompete clauses for all workers.
  - Alternative #4 would apply a rebuttable presumption of unlawfulness to noncompete clauses for some workers and not apply any requirements to the other workers.

- **COMMENTS DEADLINE WAS MARCH 20, 2023**

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The Rulemaking Process
APA Rulemaking

• 60-day comment period, extended by 10 days, ended March 20, 2023

• Next steps by the agency:
  – Reopen the comment period
  – Issue a new proposed rule
  – Terminate its rulemaking, or
  – Move on to a final rule

• Response to comments: “An agency must consider and respond to significant comments received during the period for public comment.” Perez v. Mortgage Bankers Ass’n, 575 U.S. 92, 96 (2015).
  – “[W]e find that the Commission’s approval of FINRA’s proposal was arbitrary and capricious under the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), because the Commission failed to respond to significant and relevant concerns Bloomberg raised in its comments objecting to FINRA’s proposal.” Bloomberg L.P. v. SEC, 45 F.4th 462, 472 (D.C. Cir. 2022).
Other Constraints

• Office of Information and Regulatory Affairs (OIRA) reviews the rule and must provide a final analysis of the estimated cost of the rule, as measured by the rule’s impact on the economy

• Congressional Review Act: House and Senate can disapprove rules
Possible Legal Challenges

Commissioner Wilson – The NPRM is vulnerable to meritorious challenges that:

1. The Commission lacks authority to engage in “unfair methods of competition” rulemaking;

2. The major questions doctrine addressed in *West Virginia v. EPA* applies, and the Commission lacks clear congressional authorization to undertake this initiative; and

3. Assuming the agency does possess the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the nondelegation doctrine.
Transactional Considerations
Noncompetes in Sale of Business

- Historically less scrutiny than general employer/employee noncompetes
  - Protection of lost value viewed as legitimate
  - Must have reasonable scope, duration, and geography in relation to acquired business
- Used to restrict sellers when entering into employment with buyer or walking away
- FTC required changes to noncompete in recent merger review
Noncompetes in Sale of Business

- Prohibits noncompetes for sellers and target business employees entering into employment with a buyer
  - As drafted, does not restrict noncompetes entered into with sellers walking away (i.e., not becoming employed by buyer)

- Exception for “substantial owners, members or partners” of target entity
  - Substantial owner means holding at least a 25% ownership interest in such business entity
  - Proposed Rule does not explain how to determine ownership interest
  - Uncertainty as to whether 25% bright line threshold will stick – highly impractical for “people” businesses
Noncompetes for Partners of Partnerships/Members of LLC

- Historically less scrutiny than general employer/employee noncompetes
- Partnership/membership interest needs to be bona fide/significant to distinguish from employment
- Provides an exception to California and other state-level restrictions
- Unclear whether partners/members will be treated differently under Proposed Rule
Real World Implications of Prohibiting Noncompetes in Transactions

- Pronounced effect on acquisitions of businesses where PEOPLE are the value (e.g., asset management businesses)
  - Employment of sellers often critical part of deal
  - Often key sellers are not 25% owners

- Approaches if noncompetes become unavailable
  - Back-end loaded consideration through earnouts or staged purchases
  - Retained equity stakes in business post-departure with tail/sunset repurchases
State Overview of Restrictive Covenants – Covenants Generally Prohibited
State Overview of Restrictive Covenants – Covenants Subject to Income Thresholds

<map of the United States with states marked in red>

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State Overview of Restrictive Covenants – Covenants Subject to No Salary Thresholds
Proposed Ban on “De Facto” Noncompetes

(2) Functional test for whether a contractual term is a noncompete clause. The term noncompete clause includes a contractual term that is a *de facto* noncompete clause because it has the effect of prohibiting 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. For example, the following types of contractual terms, among others, may be *de facto* noncompete clauses:

- i. A non-disclosure agreement between an employer and a worker that is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker’s employment with the employer.

- ii. A contractual term between an employer and a worker that requires the worker to pay the employer or a third-party entity for training costs if the worker’s employment terminates within a specified time period, where the required payment is not reasonably related to the costs the employer incurred for training the worker.
Overly Broad Confidentiality Clauses Can Be De Facto Noncompete Clauses

• In considering whether a confidentiality agreement operates as a de facto noncompete, we anticipate that courts will likely consider whether the agreement has temporal and geographic limitations, and scrutinize the scope of the confidentiality clause and its exceptions to determine if, for example, the employer is precluding the former employee from using any of the following:
  – Any and all information received, encountered, or learned during the employment
  – Any and all information that is used or usable in; originated, developed, or acquired for use in; or about or relating to an entire industry
  – General knowledge, skill, or facility acquired through training or experience
  – Information that is not in fact confidential, proprietary, or trade secret information because it is public knowledge or readily accessible through legitimate means
  – Information properly provided to the former employee by third-party sources such as clients

• Courts may also analyze how employers seek to enforce confidentiality clauses by, for example, demanding the return of all information and materials received, encountered, or learned during the employment, in determining whether the confidentiality clause operates as a de facto noncompete.
Current Guidance on De Facto Noncompetes


– The nondisclosure provision defined “Confidential Information” to mean “information, in whatever form, used or usable in, or originated, developed or acquired for use in, or about or relating to, the Business.” “The Business,” in turn, was defined to include “without limitation, analyzing, executing, trading and/or hedging in securities and financial instruments and derivatives thereon, securities-related research, and trade processing and related administration[.]”

– Noting that the nondisclosure provision and associated provisions were “strikingly broad,” the Court held that, “[c]ollectively, these overly restrictive provisions operate as a de facto noncompete provision; they plainly bar [the employee] in perpetuity from doing any work in the securities field, much less in his chosen profession of statistical arbitrage.”
Current Guidance on De Facto Noncompetes


- The non-disclosure agreement defined “confidential information” to exclude “publicly known” information and further defined “publicly known” as information “readily ascertainable to the public in a written publication.” Notwithstanding these exclusions, the agreement stated that confidential information included information that is available through “substantial searching of published literature” or that has to be “pieced together from a number of publications.” The agreement also defined confidential information as “any information” that the employee “learned of, possessed as a result of, or accessed through employment” with the employer.

- The court noted that the nondisclosure agreement’s definition of “confidential information extends far beyond the ‘truly confidential.’” “Not only does it impermissibly prohibit [the employee] from using public information, its prohibition of [the employee]’s use of any information she may have learned from her employment with [the employer] is nothing more than an unlimited restriction against competing with [the employer].”
Current Guidance on De Facto Noncompetes

- **TLS Mgmt. & Mktg. Services, LLC v. Rodriguez-Toledo, 966 F.3d 46, 58 (1st Cir. 2020)**

- The non-disclosure agreement broadly defined “confidential information” to include “[a]ll information . . . regarding [the employer’s] business methods and procedures, clients or prospective clients, agent lists, marketing channels and relationships, marketing methods, costs, prices, products, formulas, [etc.]” The agreement also defined confidential information to include, among other things, “any other information that [the employee] may obtain knowledge [about] during his/her tenure while working at [the employer].” The court iterated three principles in finding the non-disclosure agreement overbroad.

- In juxtaposing the non-disclosure agreement to “noncompetition clauses,” the court noted that the agreement’s “astounding breadth and lack of any meaningful limitation restricted [the employee]’s freedom to compete. The nondisclosure agreement ‘exceeded the real need to protect [the employer] from . . . competition,’ essentially tied [the employer]’s clients to its services, and ‘excessively and unjustifiably restricted . . . the general public’s freedom of choice.’”
What Should Employers Be Doing?

- Do not panic or do anything drastic
- Take inventory of current agreements (including nondisclosure provisions)
  - Ensure no “de facto” noncompetes
- Comment before the deadline
- Be prepared to implement

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Intellectual Property Considerations
Development of State and Federal Trade Secrets Laws

- Trade secrets laws developed from state court opinions
- The Uniform Trade Secrets Act of 1979 (UTSA) has been adopted in various forms in 49 states and the District of Columbia

The DTSA defines a “trade secret” as all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if—
  - (A) the owner thereof has taken reasonable measures to keep such information secret; and
  - (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.
Reasonable Measures to Protect Trade Secrets

- Nondisclosure/Confidentiality Agreements
- Marking confidential and trade secret documents
- Using heightened protections beyond what applies to confidential information
- Restricting disclosure or access based on need-to-know basis
- Restricting how and where access is granted, prohibiting access on personal devices and accounts
- Employee training regarding data security and confidentiality obligations
- Audit and inspection rights
- Facility security measures (e.g., locked cabinets, clean desk policy)
- Contractual obligations on employees, including post-employment obligations (return of all confidential information, return of computers and cell phones, etc.)
What Is “Misappropriation”?  

The DTSA defines misappropriation as:

- (A) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
- (B) disclosure or use of a trade secret of another without express or implied consent by a person who—
  - (i) used improper means to acquire knowledge of the trade secret;
  - (ii) at the time of disclosure or use, knew or had reason to know that the knowledge of the trade secret was—
    - (I) derived from or through a person who had used improper means to acquire the trade secret;
    - (II) acquired under circumstances giving rise to a duty to maintain the secrecy of the trade secret or limit the use of the trade secret; or
    - (III) derived from or through a person who owed a duty to the person seeking relief to maintain the secrecy of the trade secret or limit the use of the trade secret; or
  - (iii) before a material change of the position of the person, knew or had reason to know that—
    - (I) the trade secret was a trade secret; and
    - (II) knowledge of the trade secret had been acquired by accident or mistake.
Potential Impacts of the Proposed Rule on Executive Compensation

- The current proposal would have significant impact on many aspects of executive compensation, including:
  - Negotiation of employment and separation agreements
  - Terms of equity awards
  - 280G parachute tax penalties
  - Timing of taxation under Sections 83 and 3121(v) of the Internal Revenue Code (Code)
- The proposal has not yet been adopted and may change between the proposal and any final rule

The FTC has specifically solicited comments on:

- whether senior executives should be exempt from the rule, or subject to a rebuttable presumption rather than a ban
- whether low- and high-wage workers should be treated differently under the rule
# Executive Arrangements

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<tr>
<th>The Proposed Rule</th>
<th>Potential Issue Under the Proposed Rule</th>
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<td>Prohibits noncompete clauses in contracts with workers</td>
<td>Unclear whether applicable to garden leave situations where an executive remains an employee and is paid not to compete</td>
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<td>Applies to broad range of workers, including executives and sales employees</td>
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<td>Requires employers to rescind existing noncompete covenants and provide notice of rescission</td>
<td>Unclear whether benefits provided as consideration for a rescinded noncompete covenant can be cancelled or forfeited (including severance pay and equity grants)</td>
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<td>Applies to noncompete covenants in connection with prior terminations of employment</td>
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<td>Will apply to equity compensation arrangements</td>
<td>Unclear whether applicable to equity grants where the only remedy for breach of noncompete covenant is forfeiture of equity grant and return of previously issued stock</td>
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<td>Includes a limited exception for the sale of a business where an individual is an owner, member, or partner holding at least 25% ownership interest in a business entity</td>
<td>Applies to noncompete covenants in connection with completed sales of businesses (unless the 25% holder exception applies)</td>
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Section 280G and Parachute Payment Determinations

• Code Section 280G
  – Imposes tax penalties on corporations and certain executives with respect to excess parachute payments made in connection with a change in control

• Reasonable Compensation Exempt
  – Section 280G exempts amounts paid for reasonable compensation for services provided after the change in control
  – Exemption includes refraining to provide services under a noncompete covenant
  – Exemption is often used to reduce the value of parachute payments, and the parachute tax penalties, for purposes of Section 280G

• Effect of the Proposal
  – Eliminates a significant tool used to reduce the parachute tax penalties, potentially increasing the cost of transactions
  – Contains no provision that would exempt completed transactions
Tax Implications of the Proposal

• Code Section 83
  – Addresses the taxation of transfers of property in connection with performance of services
  – Such transfers are included in gross income in the first taxable year in which the property is not subject to substantial risk of forfeiture or is transferable
  – Noncompetes can be used to support a substantial risk of forfeiture, thereby postponing taxation under certain circumstances

• Effect of the Proposal
  – Companies would have to reevaluate their reliance on noncompete covenants for Section 83 transfers
Tax Implications of the Proposal

- Code Section 3121(v)
  - Addresses when amounts deferred under nonqualified deferred compensation plans are taken into wages for purposes of FICA tax
  - Such amounts are taken into wages at the later of the performance of the services or when the amount is no longer subject to a substantial risk of forfeiture
  - Uses the same definition as Section 83, so a noncompete covenant currently may be used to postpone FICA tax in certain circumstances

- Effect of the Proposal
  - Companies would have to reevaluate the FICA tax treatment of certain deferred compensation
Read our publications on the FTC’s proposed noncompete ban:

- A Practical Guide for Submitting Comments to the FTC’s Proposed Noncompete Clause Rule
- FTC’s Proposed Ban on Noncompete Clauses May Have Far-Reaching Implications for Executive Compensation
- FAQs on Federal Trade Commission’s Proposed Rule Banning Worker Noncompete Clauses
- Federal Trade Commission Proposes Banning Noncompete Clauses for Workers
Restrictive Covenants

What Is Reasonable to Restrict

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Agreements

- Employment Agreements/Offer Letters
- Annual Bonuses/LTIPs
- Equity Grants
- Stand-alone
- Separation/Releases
Types of Restrictive Covenants

- Noncompete
- Customer Nonsolicitation/Nonengagement
- Employee Nonsolicitation/No-hire
- Garden Leave
- Confidentiality
- Intellectual Property
- Nondisparagement
**Patchwork of State Laws**

- California and several other states prohibit noncompetes
  - Washington, DC noncompete ban becomes effective Oct. 1, 2022, unless extended again
- Increasing number of state laws restrict but still allow noncompetes, for example:
  - Illinois
  - Massachusetts
  - Washington
- In many states, still no statutory restrictions on noncompete clauses, which generally remain enforceable if they satisfy certain criteria
- Executive and legislative efforts at the federal and state level, including New York and Connecticut, reflect trend to promote employee mobility
Key Considerations

- Duration
- Geographic Scope
- Subject-matter Scope
- Employees
- Sale-of-business? Partnership? LLC?
- Remedies
- Choice-of-law
- Choice-of-forum
- Remote Workers

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