Restrictive Covenant Strategies for Employers in Anticipation of the Enactment – or Not – of the FTC's Proposed Ban on Non-Competes

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Since January, employment lawyers and their clients have been eagerly awaiting the outcome of the Federal Trade Commission's controversial proposed rule that would ban non-competition agreements in the employment context entirely, as well as prohibit non-competes in the sale of business context with workers whose ownership interest being sold is less than 25 percent.[1] The FTC recently extended the public comment period on its proposed rule by a month, through April 19, 2023. Employers may wish to use this additional time to evaluate their restrictive covenant practices in preparation for either (A) the FTC's proposed rule going into effect, or (B) the FTC's proposed rule not going into effect, which could lead to non-competes being challenged in myriad other ways. Here, we discuss strategies for employers – particularly acquisitive entities such as private equity firms and their portfolio companies – to consider in preparing for both such outcomes.

Actions and Considerations if the FTC's Proposed Rule is Enacted

If the FTC's proposed rule becomes the law of the land, one of the first orders of business for employers will be to prepare mandatory notices of rescission to current or former employees with non-competes rendered unenforceable by the new rule. Specifically, the proposed rule provides that each such notice must be:

[1] The FTC's proposed rule appears not to cover non-competes with non-worker business owners (for example, individuals who own a passive interest in a family business but do not actually work for the business), regardless of the percentage of their ownership interest. The proposed rule would prohibit any "employer" from entering into or maintaining a "non-compete clause" with a "worker" (including employees, independent contractors, volunteers, and other service providers, whether paid or unpaid), and defines a "non-compete clause" 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." The proposed rule then provides for an exception, whereby non-compete clauses entered into by a person selling his or her ownership interest of at least 25 percent in a business entity are excluded from the rule. However, because the proposed rule defines a "non-compete clause" as an agreement between an "employer" and a "worker," a reasonable argument could be made that a non-compete between the purchaser of a business and anyone who is not a "worker" for that business is not covered by the proposed rule. To take this argument a step further, query whether the proposed rule would cover a non-compete with a shareholder-employee who sells his or her business interest of less than 25 percent and does not continue working for the business after the sale closes – would such a covenant be a "non-compete clause" within the scope of the proposed rule, even though the individual was never a "worker" for the buyer-employer? If the FTC's proposed rule is enacted, employers (particularly private equity sponsors and other acquisitive companies) may wish to scrutinize whether this ambiguity is clarified in the final version of the rule.

- an "individualized communication" informing the worker that his or her non-compete is no longer in effect and may not be enforced (the proposed rule contains model language that employers may, but are not required to, use for this communication);
- provided on paper or in a digital format, such as email or text message; and
- provided within 45 days of the "compliance date" (which the proposed rule defines as 180 days after publication of the final rule).

To prepare for fulfilling these notice requirements, employers would need to identify all current and former employees with non-competes invalidated by the proposed rule (which need not include former employees with non-competes expiring prior to the compliance date), gather their contact information, draft the necessary language for the notices, and implement a plan for distributing the notices.

More fundamentally, employers will need to re-evaluate their restrictive covenant practices going forward. The easy (though perhaps painful for many) part of this process for employers will be to eliminate post-employment non-competes from their form employment agreements. The more challenging exercise will be to scrutinize their remaining restrictive covenants – most notably, covenants not to solicit employees, customers, or other business relations – bearing in mind the dual purpose of ensuring that such covenants are sufficiently broad to protect the employer's legitimate business interests, yet narrowly tailored enough to mitigate the risk of attacks on their enforceability. In a world without non-competes, these non-solicitation covenants will become the "first line of defense" – and thus, more important than ever – for employers seeking to protect their critical business relationships, but may be ripe for challenge by employees and their counsel as well as state legislatures or other government officials, who may feel emboldened by the new legal framework ushered in by the FTC.

Scrutinizing existing non-solicitation clauses is especially important because the FTC's proposed ban on non-competes includes any "*de facto* non-compete," defined as a clause that "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." As examples of such a clause, the proposed rule lists a non-disclosure agreement that is "written so broadly that it effectively precludes the worker from working in the same field," and a requirement for repayment of training costs that is "not reasonably related to the costs the employer incurred for training the worker." While the proposed rule does not discuss non-solicits specifically (and their absence from the list of "*de facto* non-compete" examples could be an indication that the FTC did not intend to include such covenants within the scope of the rule), employees and their counsel may argue that some non-solicits are drafted so broadly as to constitute *de facto* non-competes – an argument that courts will inevitably be confronted with in litigation if the FTC's proposed rule takes effect.

In examining their existing non-solicitation covenants, employers should ask themselves:

- ***Does the non-solicit identify the right types of business relations that are of critical importance in the context of the employer's business?*** For companies such as service

providers, this may mean their customers or clients. For private equity firms, this may mean their investors, or businesses they are targeting for acquisition. For companies such as manufacturers, this may mean their vendors or suppliers. For most (if not all) employers, this would also include their employees. An employer may reasonably conclude that its list of business relations protected by a non-solicitation clause should include many or all of the foregoing examples. But the types of business relations that warrant protection may differ from company to company, or sometimes even from employee to employee (depending on their role at the company or the nature of their business relationships). Employers would be prudent to assess this question from a business perspective, to ensure that their non-solicitation agreements cover the business relations that are of critical importance to that company, but (to protect against an argument of overbreadth) not those that are of little to no import.

- ***Does the non-solicit apply reasonable limitations to the scope of those who cannot be solicited?*** For example, some non-solicitation covenants include language limiting the applicability of the restriction to customers or employees whom the restricted employee actually had contact with or learned confidential information about during a defined lookback period. Any such limitation should be crafted to ensure that the employer's interests are still protected – typically, the relationships that the employer cares most about protecting are those that the restricted employee was actually involved with or knew confidential information about during a reasonably recent period – while guarding against arguments that the covenant is overbroad because it is not narrowly tailored to the company's legitimate protectable interests. If the FTC's proposed rule goes into effect, employees and their counsel will undoubtedly assert that some non-solicits are "*de facto* non-competes" because (the argument would go) they are drafted so broadly as to effectively preclude the employee from working in the same field. For example, one can envision this argument being made in the context of a covenant prohibiting solicitation of a large employer's "customers and prospective customers" with no guardrails on who would be deemed a "prospective customer" of that large employer. Considering the logical response to that hypothetical argument may be a helpful litmus test for employers in assessing their existing non-solicitation covenants.

- ***Does the non-solicit apply equally to all company employees, or does it differ based on role or responsibilities?*** While a "one size fits all" non-solicit may make sense for many companies (particularly smaller ones), employers should consider, for example, whether their non-solicitation agreements could be improved through appropriate variations to their standard language based on an employee's role (taking into account the nature of the employee's business relationships and their access to confidential information), or whether non-solicitation covenants are warranted at all (or, perhaps, in modified form) for lower-level employees.

- ***Does the non-solicit account for any state-specific issues in the states where the company has employees?*** Although most state laws concerning restrictive covenants currently focus on non-competes rather than non-solicits, that is not universal. For

example, in California, many courts have deemed *customer* non-solicits unenforceable (viewing them as akin to post-employment non-competes, which California expressly prohibits) outside the limited context of protecting confidential information, though many California courts have enforced *employee* non-solicits. In Illinois, the "Freedom to Work Act" prohibits non-solicits with employees earning less than $45,000 per year (a threshold that will rise beginning in 2027), and imposes various other requirements that apply to both non-solicits and non-competes.[2] Moreover, if the FTC outlaws employment non-competes at the federal level, state legislatures (which have largely focused their efforts to date in this space on non-competes) may pivot their attention to non-solicits.

Actions and Considerations if the FTC's Proposed Rule is *Not* Enacted

While employers may breathe a sigh of relief if the FTC's proposed rule is not enacted, employers should not assume that the lack of a federal ban on non-competes means that they can safely proceed with the status quo. Of course, the FTC may seek to enact a variation of its proposed rule that would limit the use of non-competes in unknown other ways (which this article will not attempt to predict). But even without any formal rulemaking from the FTC, given the heightened attention in this area as a result of the FTC's proposed rule and the Biden administration's focus on non-competes as an enforcement priority,[3] employers should anticipate that restrictive covenant scrutiny will only continue to rise, both from the federal government and state legislatures as well as in courtrooms around the country.

To that end, what prophylactic measures can employers take to insulate themselves against such increased scrutiny, which may manifest in unpredictable ways?

First, the considerations discussed above with respect to non-solicits apply whether or not the FTC's proposed rule takes effect. Even if a non-solicit is an employer's "second line of defense" behind a non-compete, employers should not blindly assume that their non-competes will be enforced – particularly as legislators and regulators continue to tighten the reins in this area – thus bringing the non-solicit back to the forefront.

Second, employers should examine how the enforceability of their existing non-competes might be susceptible to attack and consider ways to potentially shore up any vulnerabilities they identify. For example:

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[2] For example, Illinois requires that employers provide "adequate consideration" for any agreement containing a non-compete or non-solicit (defined as the employee working for the employer for at least two years after signing the agreement or receiving other consideration to support the agreement), advise the employee in writing to consult with an attorney before entering into the agreement, and provide at least 14 days for the employee to review the agreement.

[3] President Biden touted the proposed non-compete ban in his recent State of the Union address, and issued an Executive Order on Promoting Competition in the American Economy on July 9, 2021, which precipitated the FTC's proposed rule.

- ***Does the non-compete account for any state-specific issues in the states where the company has employees?*** By way of example only (as many states have enacted non-compete laws in recent years with varying requirements, which this article will not attempt to summarize in full), employers should identify any applicable earnings thresholds, durational limits, notice or consideration requirements, or other rules that may apply to non-competes in the states where the employer resides or operates. Employers should also consider the rules concerning judicial "blue-penciling" (*i.e.*, modifying or reforming otherwise unenforceable restrictive covenants) in the relevant states, as each state's approach – which can range from a strict "no blue pencil" rule, to a limited blue pencil rule (allowing courts to delete but not substitute language), to a discretionary approach, to mandatory blue penciling – may impact how aggressive or conservative an employer chooses to be in its restrictive covenant agreements.

- ***Does the non-compete appropriately define the scope of the restricted business (especially in the sale-of-business context)?*** A recent Delaware Chancery Court decision highlighted the importance of this factor. In *Kodiak Building Partners, LLC v. Adams* (Del. Ch. Oct. 6, 2022), the Court refused to enforce non-compete and non-solicit covenants in the context of a sale of a business because their scope covered not only the business of the acquired company, but also the business of the buyer and its affiliates. The Court explained that in this context, the buyer has a legitimate interest in protecting the assets and goodwill of the business being acquired, but that legitimate interest does not extend to other industries (outside the scope of the acquired business) in which the buyer may also be involved. Hypothetically, if a buyer were to employ an individual seller (after acquiring the seller's business) in a role that extends into other industries in which the buyer is also involved, the buyer would have a reasonable basis for including restrictive covenants in the seller's employment agreement that extend into those other industries. As a basic guidepost, employers should endeavor to tailor their sale-of-business non-competes to the scope of the business being acquired, and their employment non-competes to the scope of the business for which the employee works.

- ***Would the non-compete be vulnerable to the "secretary or janitor" argument?*** A recent decision from a federal district court in Georgia, *AmSpec, LLC v. Calhoun, et al.* (S.D. Ga. Dec. 16, 2022), illustrated the oft-used argument that a non-compete is overbroad (and therefore unenforceable) if it is drafted so broadly that it would prohibit the employee from working even as a "secretary or janitor" at a competitor. In *AmSpec*, the non-compete at issue purported to prohibit the employees from working in any role in which they would "contribute [their] knowledge … to an entity engaged in the same or similar business as AmSpec." The employees argued that the non-compete was overbroad because it would prohibit them from working even in non-competitive roles (such as a "secretory or janitor") for any entity engaged in the same business as AmSpec. The Court concurred, refusing to enforce the non-compete because it would prohibit the employees from working "in any capacity" for a competitive business (*i.e.*, even in a non-competitive role). While other courts could have analyzed the non-compete at issue in this case and come to a different conclusion, the takeaway for employers from the

Amspec decision is that some courts may view a non-compete that prohibits working for a competitor *in any capacity* as overbroad. To guard against that possibility, employers may consider, for example, limiting their non-competes to prohibit employment only in certain roles (such as managerial or executive roles, sales roles, etc.), or perhaps in roles in which the employee would likely or inevitably use confidential information learned during their prior employment.

- ***Does the non-compete contain reasonable durational and geographic limits?*** While most employers recognize that non-competes are only enforceable for reasonable durations following the termination of employment (or the sale of the business), an employer's standard non-compete duration may be worth revisiting in view of state legislative developments and in the context of generally heightened scrutiny on non-competes. As for geographic limits, while the internet and other factors have allowed many more businesses to legitimately claim to have nationwide or even global reach, employers would still be wise to consider appropriate geographic limits on the scope of their non-competes. For example, in a very recent decision from another Delaware Chancery Court, *Intertek Testing Services NA, Inc. v. Eastman* (Del. Ch. Mar. 16, 2023), the Court refused to enforce a sale-of-business non-compete that purported to apply "anywhere in the world" because the plaintiff did not allege that the acquired business actually "provided services globally." Employers – even those with expansive business operations – should not overlook the reasonable geographic scope requirement in evaluating their non-compete practices.

- ***Does the non-compete apply equally to all company employees, or does it differ based on role or responsibilities?*** While considering employee-specific factors based on role and responsibilities is prudent in the non-solicit context (as discussed above), doing so can be even more important in the non-compete context, given that non-competes (relative to non-solicits) are more restrictive on employee activities, subject to more statutory requirements at the state level, and generally subject to more scrutiny in courts and in the public eye. For example, an employer might reasonably decide that all of its employees should have non-solicits, but that only employees in a certain department or at a certain level need also have non-competes in order to protect the company's legitimate business interests. This analysis may differ widely from company to company, but it is an inquiry that employers would be wise to undertake, especially in a world where a withdrawal of the FTC's proposed rule could lead to increased scrutiny on non-competes in other, unpredictable ways.

While employers will soon learn the fate of the FTC's proposed rule, whether the rule is enacted or not, employers who rely on restrictive covenant agreements as an important measure to protect their business interests would be prudent to begin the process now of earnestly evaluating and fortifying their non-competition and non-solicitation covenants in preparation for either outcome.