

# Non-Competes Under Attack: Not So Obvious Consequences of the FTC Ban

July 23, 2024



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# Speakers



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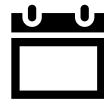
Employee Benefits and  
Executive Compensation

## Overview: When



Proposed rule originally published January 2023

- Through April 19, 2023, FTC received over 26,000 public comments about both the proposed non-compete ban and various alternatives to it.



Final rule scheduled to become effective September 4, 2024

- Applies to all then existing non-competes with non-senior executives
- Does not impact already accrued claims



Requires employers notify, prior to the effective date, employees and former employees covered by non-competes that clauses cannot be enforced

## Overview: What, Where & Who

- Bans “a term or condition of employment that **prohibits** a worker from, **penalizes** a worker for, or **functions to prevent** a worker from (1) seeking or accepting work” in the US with a different employer or (2) operating a business in the US after leaving current employment
- Definition of the term “worker” extends beyond low-wage employees typically the focus of ban advocates
  - natural person regardless of title or status under other laws, including, but not limited to, whether the worker is an employee, independent contractor, extern, intern, volunteer, apprentice, or a sole proprietor who provides a service to a person



# Functional Non-competes & Penalties

- **“Functions to prevent” -- ban also applies to terms and conditions that restrict such a large scope of activity that they essentially prevent a worker from seeking or accepting other work or starting a new business**
  - Commentary provides examples of functional non-competes: NDAs, training repayment agreements, non-solicitation agreements, no-hire agreements, and no-business agreements
- **“Penalizes” – “requires a worker to pay a penalty for seeking or accepting other work or starting a business”**
  - Commentary provides examples of penalties: liquidated damages or other “forfeiture-for-competition” clauses that impose adverse financial consequences on a former employee expressly conditioned on the employee seeking or accepting other work or starting a business or “severance arrangement” where worker is paid only if they refrain from competing

# Senior Executive

**The Ban does not apply to non-competes for Senior Executives that are in place before the effective date.**

- Senior Executive means a worker who
  - (1) held a policy-making position (e.g., c-suite, final decision-making authority) and
  - (2) received compensation of at least \$151,164 last year



# Exceptions

## The rule does not apply to:

- Loyalty/duty to current employer restraints
- Non-profits, banks, savings and loan institutions, or credit unions
- Franchisee in the context of a franchisee-franchisor relationship
- Non-solicits, unless it “function[s] to prevent a worker from seeking or accepting other work or starting a business”
- Accrued claims: where a cause of action related to a non-compete accrued prior to the effective date
- Good faith: where a party has a good-faith basis to believe the ban is inapplicable
- Bona fide sales of business:

*“The requirements of this part 910 shall not apply to a non-compete clause that is entered into by a person pursuant to a bona fide sale*

*of a business entity,*

*of the person’s ownership interest in a business entity, or*

*of all or substantially all of a business entity’s operating assets.”*

## Current Status



- *Ryan v. Federal Trade Commission*
  - Preliminary injunction issued by the Northern District of Texas on July 3
  - Stays the Rule's September 4 effective date as to the plaintiffs in the case, but a ruling (to include whether broader relief is proper) is expected by August 30
  - To be clear: The Rule is still set to go into effect on September 4
  - Holdings:
    - The FTC lacks authority to issue the Rule because the agency “lacks substantive rulemaking authority with respect to unfair methods of competition.”
    - The Rule is arbitrary and capricious under the Administrative Practices Act because no basis for why the FTC had “chose[n] to impose such a sweeping prohibition — that prohibits entering or enforcing virtually all non-competes — instead of targeting specific, harmful non-competes.”



## Current Status (cont'd)

- *ATS Tree Services, LLC v. The Federal Trade Commission*
  - Separate challenge pending in the Eastern District of Pennsylvania
  - Nationwide injunctive relief sought
  - Oral argument held on July 11
  - No order issued at this time
- *Loper Bright Enterprises v. Raimondo*
  - June 28 Supreme Court decision overruling the doctrine of *Chevron* deference
  - The district courts and appellate courts should approach the question of whether the FTC has authority to issue the Rule without deference to the agency's reading of the statute

# Executive Compensation – A World of Unintended Consequences

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**Forfeiture for  
Competition  
Provisions**

**Parachute  
Payments**

**Income Tax  
Recognition**

# Forfeiture for Competition Provisions

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Forfeiture for competition provisions condition payment of compensation and benefits after termination of employment upon an employee not engaging in competition while the compensation and benefits remain unpaid.

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- Not enforceable via injunction, only nonpayment of the outstanding amount.
  - Commonly used in equity plans, award agreements, severance plans, supplemental executive retirement plans (“SERPs”), deferred compensation plans, etc.
  - Allows employers to bridge long-term employees to retirement, reward “good leavers,” and similar.
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The FTC rule prohibits this type of provision as a “functional” non-compete which imposes a penalty on employees.

# Forfeiture for Competition Provisions

## Other “Functional” Non-competes

Provisions which cancel unpaid amounts or require repayment of previously-paid amounts based purely on termination of employment, unrelated to subsequent competitive activity.

Nonduplication provisions in severance arrangements which reduce or cancel payment of severance amounts upon starting a new job.

## Senior Executive Exemption

Arrangements in effect *prior to* implementation of the FTC rule with individuals who:

- (1) held a policy-making position; and
- (2) received compensation of at least \$151,164 last year (or when annualized, as applicable).

Note – the impact of extensions and modifications is unclear

## Garden Leave Alternative

- Paid period of reduced employment prior to termination
- Requires the employee to provide notice of intent to terminate
- Common in Europe
- Raises potential Code Section 409A issues

The FTC rule does not prohibit restrictions during the period of employment – that falls under the *duty of loyalty*.

# Parachute Payments

Code Sections 280G and 4999 impose a nondeductible 20% excise tax on “excess parachute payments” made to certain officers and other disqualified individuals in connection with a change in control.

Generally, an excess parachute payment is the amount received by an individual which exceeds three times their average annual compensation.

## Key Exemption:

- Reasonable compensation for performing (or, agreeing not to perform) services after the change in control.
- The exemption allows companies to offset the value of an enforceable non-compete against the value of parachute payments in order to minimize the impact of Code Sections 280G and 4999.



# Parachute Payments

Upon implementation, the FTC rule will extinguish the ability to use non-competes to reduce parachute payments unless one of two exceptions applies:

## Senior Executive

Only applies to arrangements in effect *prior to* implementation of the FTC rule with individuals who:

- (1) held a policy-making position; and
- (2) received compensation of at least \$151,164 last year (or when annualized, as applicable).

FTC “senior executive” ≠ 280G “officer”

## Bona Fide Sale

Applies to arrangements entered into *after* implementation of the FTC rule with a seller in relation to a bona fide sale.

Exclusions:

- (1) Springing noncompetes / repurchase rights
- (2) Sham transactions with wholly-owned subsidiaries

# Income Tax Recognition

If implemented, the FTC rule will impact arrangements which defer tax recognition by using non-competes to create a **substantial risk of forfeiture**.

A substantial risk of forfeiture is present when:

- a recipient's right to compensation or property is subject to the occurrence of a condition, and
- there is a substantial possibility that the right will be forfeited if the condition is not satisfied.

## Property Transfers

### Code Section 83

Compensatory property transfers (i.e., grants of restricted stock, payments in cryptocurrency)

## FICA Taxes

### Code Section 3121(v)(2)

FICA taxes on amounts deferred under nonqualified deferred compensation plans

## Section 457 Plans

### Code Section 457(f)

Section 457 plans sponsored by tax-exempt employers



# Practical Considerations and Next Steps



# Less-obvious Implications of the Rule

- **Signals the current FTC's view of non-competes**
- **Even without the Rule, the FTC could make individual non-competes an enforcement priority**
- **This could impact:**
  - Treatment of proposed mergers
  - Challenges to individual non-competes by warning letters, investigations, and administrative complaints
- **But, a change in administration could shift the agency's enforcement priorities**



*“An angry dinosaur wearing a shirt with the federal trade commission logo attacking a city”*

# Non-compete Trends

- **What if the FTC's rule never goes into effect?**
- **There is already a clear trend away from non-competes in the U.S. even without it**
  - Four states currently ban them outright (CA, OK, MN, ND)
  - Nine states have income restrictions (OR, WA, CO, IL, VA, MD, RI, NH, ME)
  - 23 States have some form of limitation, e.g., industry-specific bans, statutory limits to the scope of agreements, or other limits on non-competes not based on income
  - 27 bills proposed in various state legislatures this year to limit non-competes
- **Lots of variation by judge, but anecdotal evidence suggests judges are often loathe to enforce non-competes absent bad facts**
- **This begs the question: How heavily should your organization rely on non-competes? (Especially multistate employers)**

# Practical Alternatives

- **More or renewed focus on:**
  - Non-solicit provisions
  - NDAs/confidentiality agreements
  - Policing and enforcing trade secret rights
  - Policing and enforcing IP rights (including copyright)
- **But what does all of this entail?**



*“An employee violating a confidentiality agreement”*

# Non-solicit and Confidentiality Provisions



*“A salesman refusing to solicit a client”*

- **Identify who is or should be subject to a non-solicit and/or confidentiality provisions**
  - Customer, vendors, and/or employee restrictions may be available
  - Who has access to confidential materials?
- **Evaluate state law compliance issues**
  - Material contact required?
  - Geographic scope?
  - Temporal limits? (Even for confidentiality)
  - Specific list of customers, etc.?
  - Don't forget: Choice of law and venue issues

# Trade Secret Protections

- Most people are completely unaware of what is confidential or a trade secret
- Trade secrets are data, documents, or information that:
  - The owner thereof has taken reasonable measures to keep such information secret; and
  - 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



*“A person stealing a trade secret in an obvious way”*

# Trade Secret Protections (cont'd)

- Leadership must understand the problems and risks
- Policies must be in place and enforced
- Materials must be created from scratch or build on prior company knowledge/docs
- Must be vigilant of departing/incoming employees
- Software solutions for identifying and tracking trade secrets and suspicious activity
  - See CrowdStrike



*“A board of directors who are dogs enforcing a policy”*

# Trade Secret Protections: Digital Sandboxing

- Limiting systems access via a virtual private network (VPN)
- Implementing multifactor authentication
- Blocking or limiting USB port access on company computers
- Blocking certain sites or implementing sandboxed browser
- Limit employee access to only documents and data needed for their role
- Label docs/folders as confidential



# Trade Secret Protections: On/Outboarding

- Specific discussion and identification of company policy
- Offer letters
- Confidentiality, non-disclosure, and return of property agreements
- Outboarding doc re: materials to return
- Forensic examinations and account/device review
  - In-house review must be extremely careful if done at all
  - Loss/change of metadata can be critical



*“Someone being fired from a job but they are happy about it”*

Questions?

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**Thank you for attending!**

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