Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 37 –
From the FTC to State Laws: The Evolution of Non-Compete Agreements

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JUNE 2024

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Megan Monson: Welcome to the latest episode of Just Compensation. I'm Megan Monson, a partner in Lowenstein Sandler's Executive Compensation, Employment and Benefits Practice Group. I'm joined today by two of my colleagues in my practice group, my partner Amy Wiwi.

Amy Wiwi: I'm so happy to be here today.

Megan Monson: And we're also joined by Amy Schwind, counsel in our group.

Amy Schwind: Thank you for having us.

Megan Monson: Thank you both so much for joining us today. Today's discussion is a follow-up to a prior conversation we had with respect to employment related non-competition agreements and recent developments in the law. As this is a constantly evolving area of the law and something that many employers are focused on, we wanted to continue the discussion and primarily focus on recent changes and trends over the past six months. The Federal Trade Commission recently voted to ban post-employment non-competition clauses, and as a result, this discussion will focus on the implications of that ruling and other recent non-compete developments at the state level. As always, this is not intended to be an exhaustive discussion surrounding all non-compete updates, and so if you were looking to understand how non-competes may be used for your workforce and the options available, we encourage you to consult with your legal counsel. Jumping right in, in terms of non-competes, one of the hottest topics right now is the FTC approval of the non-compete ban on April 23rd, 2024, that would apply nationwide. What are the key takeaways of this ruling?

Amy Schwind: Sure. So as of the effective date of this final rule, which right now is slated for September 4th of this year, so just a few months, post-employment non-compete clauses will be banned for all workers and that includes employees and independent contractors with a limited exception for existing non-compete agreements already entered into with senior executives. And the term senior executive is defined, and it's defined to narrowly, it has to be a worker with a total annual compensation of at least approximately $151,000, and they also have to be in a policymaking position. And so

that is going to be narrowly construed to include only business entity's president, chief executive officer, or the equivalent, or any other officer of the business entity who has policymaking authority or any other person similar to an officer with policymaking authority. And so interestingly, according to the FTC, it does not include the head of a division within a business if their decision-making authority is limited to their division.

Amy Wiwi: That was surprising and that was something that the FTC clarified in its recent webinar that had helped or anyone who wanted to watch, but we had been expecting that to include folks who are running certain parts of a business, and it will not.

Amy Schwind: Yep, exactly. As Amy did mention, the FTC hosted an online compliance webinar on May 14th to provide information on how to comply with the final rule, and that webinar is available for viewing on the FTC's website. So after the effective date of the final rule, an employer may not enter into a non-compete agreement with any worker, even a senior executive, so essentially only existing agreements with senior executives will be grandfathered in. Employers are also required to send a notice by the effective date, so by what's currently scheduled for September 4th to workers who are not senior executives informing them that any non-compete they may have signed will not be and cannot legally be enforced against them. Also in their webinar, the FTC did clarify that the final rule does not require formal rescission of an agreement that contains non-compete, so any formal legal modification to the agreement itself, but it does require the notice.

Amy Wiwi: I was going to say the notice does not need to be formal either, that it can be a bulk email sent to all of your employees who are not senior executives to let them know that that provision of any agreement they have signed is not going to be enforceable.

Megan Monson: Is there any sort of penalty or ramification for failing to provide that notice?

Amy Wiwi: So while there's no penalty in the FTC's non-compete rule for failing to provide this notice, they certainly have enforcement authority and they can enforce that compliance with that rule.

Megan Monson: So it sounds like then for employers who have employees who are not senior executives and whose non-compete agreements would no longer be enforceable, it would be prudent for them to either undertake a review to determine who has signed these agreements to send this notice, or as you suggested, Amy, send a mass email to all employees if they don't have the bandwidth to go forward and do that in an individualized exercise to determine who has these type of agreements in place.

Amy Wiwi: That's correct.

Megan Monson: So from a practical standpoint, what does the FTC non-compete ban mean for businesses?

Amy Wiwi: Well, for right now, we are advising employers to just hold tight and continue on with the status quo for the time being. However, when they are looking at this issue, they should determine whether individuals have other agreements in place that will help them to protect their legitimate business interests, so NDAs, non-solicits, those kinds of things. And they may want to look at their processes for access to confidential information. There are a lot of different ways that employers can protect their legitimate business interests that do not involve non-competes, and those are always good things to look at while we're waiting to see whether this will go into effect and when. So while they should continue on with the status quo for now, they may want to

start looking at different ways that they can protect those interests so that they have things in place once we know what is going to happen.

Amy Schwind: And to be clear, the FTC has been upfront that if it is a garden-variety, non-solicit or confidentiality, or non-disclosure agreement, that that would not be considered a non-compete under the final rule because they don't function to prevent a worker from seeking or accepting other work or starting a business.

Amy Wiwi: And garden-variety is something that we could spend hours talking about. But look, if this final rule goes into effect in September, it will forever change the landscape of restrictive covenants in this country and employers will have to make some significant changes. So the authority of the FTC to issue this rule is the subject of a number of federal lawsuits. There have been motions for stays of the effective date of the rule, which would halt its application while the litigation proceeds, and the Northern District of Texas is expected to issue a decision on this by July 3rd. So if it does go into effect in its current form, you really need to keep your interests in mind when developing new agreements, making sure that folks who had non-compete agreements also had these other protective provisions.

And there is one exception in the rule for the right of a buyer to impose a non-compete pursuant to a bona fide sale of a business entity or of the person's ownership interest in a business entity, or all or substantially all of business entity's operating assets. So we aren't looking at a world in which you buy a business and then need to worry about not being able to enforce this provision. The other things that we'll talk about as far as steps that an employer can take are around compensation and other things that we can condition upon certain things that do not involve a non-compete.

Megan Monson: Aside from the FTC ruling, can you advise us of any other noteworthy state non-compete updates over the past six months?

Amy Schwind: Yeah. So there has been a lot of activity in various states aside from the FTC at the federal level. In California, so California has long held that post-employment non-competes in the employment context are void under their business and professions code. And that includes post-employment, non-solicits of clients. Two new laws became effective January 1st in California to essentially bolster this long-standing prohibition and give teeth by imposing certain penalties. By February 14th of this year, employers were supposed to notify current employees and former employees who were employed after January 1st, 2022, whose contracts included non-compete clause that any non-compete clause they may have signed is void. And there are other various aspects to the new laws as well. It's ultimately unclear how courts in other states will handle challenges to non-compete agreements alleged to violate these California laws, but employers based in California or that have employees in California should certainly take note.

In New York, there was a lot of publicity at the end of last year surrounding a proposed blanket ban on non-competes in New York State. In late December 2023, New York's governor vetoed that landmark bill, but reintroduction with some modifications is expected, and the governor has expressed support for a ban that would permit non-competes only for highly compensated employees. So we are keeping a close eye on that and we will definitely see where that goes in New York state. In New York City, the New York City Council has been very busy proposing three bills that would potentially restrict non-competes at various levels. One is an expansive bill that would impose a ban on non-competes with workers generally, and that bill has no senior executive exemption. A separate bill would ban non-competes for low wage workers, and a third bill would ban non-competes with freelance workers unless the hiring party compensates with a mutually agreed amount.

So these bills are not law yet, they would to be passed by the rest of the New York City Council and approved by the mayor, so we are also keeping a close eye on these as well. In Washington state, there have been recent amendments to their existing non-compete law that go into effect in June of this year. They expand the definition of a non-competition covenant. They also limit the existing sale of business carve-out, so if you are a Washington employer or have employees in Washington, this is definitely something to take note of. In states that have pay thresholds for imposing non-competes and non-solicits, those thresholds may have risen as of January 1st of this year.

For example, Colorado's threshold increased to around $124,000 on January 1st, so this is definitely something to be mindful of as well. There are also bills restricting the use of non-compete provisions in various states that are pending, including Iowa, Maine, Michigan, New Jersey and Oklahoma to name a few. And we've also seen courts that are becoming increasingly unwilling to correct facially, overbroad, non-compete provisions. For example, the Delaware Chancery Court, which historically has been more friendly to non-competes, we've seen them becoming stricter, particularly in the sale of business context, so that's also something to keep in mind.

Megan Monson: Amy, I think it's really helpful to hear about all of these state law updates because it just goes to emphasize, I think, the emerging trend that across the board non-competes are getting scrutinized further and it's becoming more difficult if at all in some locations to have a non-compete and especially now while we're waiting to see what's going to happen with the FTC rule, and if it goes into effect later this year, it's still prudent to comply with all of the state law requirements that are applicable to your workforce.

Amy Schwind: Absolutely.

Megan Monson: So we've touched on this a little bit throughout our discussion, but if you could talk a little bit about what employers can do to protect themselves given the landscape around non-competes, I think that would be very helpful for companies who are trying to understand what this means from a practical standpoint and what they can do to protect the company.

Amy Wiwi: So you want to stay informed. Federal activity could have significant far-reaching implications on how employers may protect their legitimate business interests, including confidential information, customer relationships and other goodwill. Obviously, the state laws vary significantly, so check on the status of non-competes in any jurisdiction which you have employees. And look, there are ways that you can keep someone from providing services to another entity such as garden leave. This has really been expressly approved by the FTC, but the individual would have to really receive proportional portion of their total compensation so that depending on how your compensation is structured, could include some bonus amounts or other things that you wouldn't normally consider as part of a garden leave. So typically, garden leaves don't last as long as companies like non-competes to last, but you would consider it essentially paying for the non-compete agreement while it is in effect. The employee must remain employed by the employer during that period of time, so as the employer, the individual certainly can be prohibited from engaging in competitive business during the period of employment.

There are other ways to incentivize folks to stay, so depending on how you have your compensation structured, different compensation could be payable at a later date only if you remain employed. There are a lot of different ways that you can structure things so that folks are giving something up if they leave. Companies should really look at what they have in place and consider whether these other, at this point its belt and suspenders, but if that could really help them protect their interests in case of

some sort of widespread change, such as the FTC rule going into effect, understand that there are many, many different ways that you can work on your culture. I mean, I've even heard some folks who are talking about potentially moving particularly sensitive jobs to other countries that it force non-competes.

So there are a lot of different ways that you can protect yourself, limiting access to confidential information to those who need to know it for purposes of their position or purposes of the work that they're doing for you, invention assignment agreements so that if an individual has a really good idea, they don't just take it with them and start a competing business. You would want to keep track of those brilliant ideas by having regular check-ins or having individuals write an email to their manager every week with their ideas about how to improve the business or other things along those lines. So really monitoring relationships with customers, ensuring there's not one single point of contact that represents the company in any customer or investor relationship.

So we would be very happy to chat in detail with anyone who would like, or talk to your legal counsel about different ways to protect your business, and that will vary based on positions and the type of business that you're in. I think employers really like non-competes because it's much easier to prove and doesn't typically involve subpoenaing clients to establish solicitation or disclosure of confidential information or other things along those lines. What somebody updates their LinkedIn profile, you can see they're working at a competitor. So I think there are going to be ways that we develop with our clients how to really protect their information without making it necessary to have litigation in order to set all these kinds of disputes, but there is not going to be a one-size-fits-all approach to any of this.

Megan Monson: And one thing I'll say to caution companies who are planning to solely rely on the sale of a business exception for allowing non-competes either in states that currently prohibit non-competes or if and when the FTC rule goes into effect to just be mindful of the Delaware Chancery Court decision that Amy mentioned, and so that the non-compete that you have in the sale of business should still be appropriately tailored to the business being purchased, reasonable in time, duration and scope because there is risk that if you present something overly broad and overly aggressive, that could be struck down. So just being mindful of the business that you're trying to protect and what level of non-compete is needed to adequately protect the company from a business standpoint.

Amy Wiwi: That's great. Thanks, Megan.

Megan Monson: Thank you so much Amy and Amy. This has been a really useful and worthwhile discussion. It's important for employers to consider these recent trends relating to post-employment non-compete agreements to assure that any non-compete agreements they have are enforceable to the extent permitted by applicable law and to provide the employer with the adequate protection they need. As we've mentioned numerous times throughout this episode, the laws regarding non-compete agreements at both the state and federal level are ever-changing. This episode is intended to be a high-level overview of recent developments but is by no means an exhaustive discussion of all considerations that may apply to your agreements and your particular business. So as Amy mentioned, it's not a one-size-fits-all approach, and we encourage you to consult with counsel about your existing non-compete agreements and before entering into any new non-compete agreements. Thank you for joining us today. We look forward to having you back for our next episode of just Compensation.

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