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

Episode 26 -
The Trend Towards Limiting Employment Related Non-Competes, and Alternate Strategies for Employers

By Megan Monson, Amy Wiwi, Jessica Kriegsfeld

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Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an Associate in Lowenstein's Employee Benefits & Executive Compensation practice group. I'll turn it over to Megan and Amy to introduce themselves.

Megan Monson: Hi, I'm Megan Monson and I'm a Partner at Lowenstein Sandler in the same practice group as Jessica.

Amy Wiwi: I'm Amy Wiwi and I'm a Partner in the Employment Counseling & Litigation practice group at Lowenstein Sandler.

Jessica Kriegsfeld: Today's discussion will focus on some recent developments and trends in the law relating to employment related non-competition agreements. Non-competition agreements, or non-competes, if enforceable, may prohibit an employee from working for a competitor or opening a competing business. Non-competes are mostly governed by state law, but as we will discuss, there has recently been a rather dramatic federal proposed rule to regulate non-competes that could significantly limit the ability to use if it is enacted. This episode will walk through non-compete developments and trends, the federal proposed non-compete rule, and potential ideas and workarounds for employers to consider in place of non-competes in order to provide protection to a company. As always, this is not intended to be an exhaustive discussion surrounding non-competes, updates, and the status of non-competes in general. So if you are looking to understand how non-competes may be used for your workforce and the options available, we encourage you to consult with your own legal counsel. Let's jump right in. Amy, what's the purpose of a non-compete?

Amy Wiwi: The purpose of a non-compete agreement is to prevent an employee from working for or otherwise providing services to a competitive business for a specific period of time after employment ends. The justification for using this mechanism as opposed to others is typically protection of confidential information and trade secrets or client relationships. But, non-competes are easier for employers to monitor and police than narrower restrictions such as confidentiality agreements or non-solicitation provisions. Think about it, someone updates their LinkedIn where they're working and you can

inquire. It is much, much harder to determine if someone is soliciting your clients or otherwise using or disclosing your confidential information or trade secrets.

Jessica Kriegsfeld: Thanks Amy. Megan, when are non-compete agreements enforceable generally?

Megan Monson: So I'll preface this by saying a lot of what we're going to discuss today is really about the general trend in connection with non-competes, and the landscape is constantly evolving. So putting out that general caveat for everything we're talking about today. So in terms of enforcing non-competes, the approach is going to vary state by state and it's going to be due to the facts and circumstances at hand. Some states, a few that will touch on throughout this presentation, disfavor non-competes entirely, where others may allow them in more narrowed circumstances. In general, non-competes are only enforceable to the extent that they are necessary to protect the employer's legitimate interest, do not impose an undue hardship on the employee, do not harm the public, and are reasonable in time period and geographic scope. So those four criteria that I just focused on are really, I think, what courts tend to look at in determining whether a non-compete is in fact enforceable and whether it is reasonable under the circumstances.

If a court determines that a non-compete is not enforceable, a court has a number of options, they can invalidate the agreement entirely, and in some states they can blue pencil or modify the non-compete agreement. We'll get into a little bit later in the discussion the different approaches for blue penciling.

Amy Wiwi: So one thing employers are finding particularly difficult these days is trying to limit the geographic scope of a non-compete. So this case law was sort of developed in a time of brick and mortar businesses, and these days, very few businesses are limited in geography. So if one participates in the global economy and the business could be conducted anywhere in the world, it's hard to limit that geographic scope. And many states require that there be a geographic limitation in order to be enforceable.

Megan Monson: And I think that's a really interesting point, Amy, because when those statutes and the case law were enacted, you're right, that was a time prior to these worldwide sales. And I think it would be really interesting to see then how courts nowadays would really apply the geographical scope requirement to some of these businesses that are really operating throughout the world.

Amy Wiwi: Agreed. And then obviously we have a lot of states that have prohibited non-competes for certain categories of employees or all employees, like for the most part Oklahoma and North Dakota, I think California we're going to talk about a little bit in a little more detail later. The other things that are statutes are now requiring individual employees to make a certain amount of money to meet a salary threshold in order to be subject to a non-compete agreement. And so the world of non-competes is becoming narrower by the day.

Jessica Kriegsfeld: Are there any other recent trends regarding employment related non-competes you wanted to mention?

Megan Monson: So I think it's really just the premise that in general, especially over the past few years, states and courts are starting to disfavor non-competes and are really narrowing the scope of who they apply to. So it's an area that's now facing, I think, a lot more scrutiny than it has in the past. And so employers who are looking to utilize non-competes in particular not just for their senior officers but for the majority of their workforce, really need to be mindful of the states that they are having employees work in and that they're doing business in and making sure that they're not running afoul of these various limitations.

Amy Wiwi: So I feel like this must be said, a lot of employers try and include a choice of law provision in an agreement and choice of forum that is outside of these jurisdictions that really disfavor non-competes. And while some states have addressed this issue directly and prohibit that choosing a choice of law where it's most favorable to the employer, our general rule of thumb is you really should use the law of the state in which the employee is performing services because the one that is most likely to apply in these states that have strong public policy against the use of non-competes.

Jessica Kriegsfeld: Speaking of the states, what are some of the key developments at a state level to keep an eye out for?

Amy Wiwi: Well, so New York's senate just passed a bill that would impose an outright ban on non-compete agreements in New York. That was June 7, 2023. Of course, the bill has not yet passed the assembly or reached Governor Kathy Hochul's desk. But this state action is really in line with recent actions by other states as well as court decisions and actions by the New York State Attorney General. For instance, there are a number of New York courts and federal judges in the southern district of New York that have indicated that non-competes are not enforceable if the individual is terminated without cause. And that's particularly interesting because there is no legal definition of cause. This is purely a matter of contract. So for those folks who don't have those types of provisions in an employment agreement otherwise, this is something the judge is going to decide at the time.

And look, employers who are terminating folks' employment, they don't always want to get into the details of why someone's employment is terminated. They don't want to make someone... They're losing their job, you don't want to make them feel even worse. Or they just don't want to raise an issue that could be controversial and have an impact on other issues like discrimination or anything else, retaliation or other things. So that's a hard thing that folks have been dealing with.

But as Megan's mentioned earlier, it's really fact specific. It has a lot to do with the facts of the individual circumstances and whether it imposes an undue burden on that person. And the New York Attorney General has initiated multiple and enforcement actions to limit non-competes for folks who do not have access to confidential information, like sandwich workers, folks who make sandwiches really cannot be prohibited from going down the street and working at another chain restaurant that makes sandwiches. And so that's been on top of mind.

Megan Monson: Really interesting developments in the trends in New York, Amy, in particular because again, I think historically employers, a lot of whom work or have offices in New York, would tend to have non-competes in their agreements and thought that that was a relatively employer favorable corporate governance and had a chance for those to be enforced. And now I think based on these recent cases and the action from the attorney general, it has really made employers think twice about including these provisions in their agreements or if they are, noting that there is now some real risk that yeah, it's going to come down to facts and circumstances, but a court may not automatically approve the terms of that non-compete and enforce it against an employee.

Amy Wiwi: Absolutely. And it depends on the term. And we'll talk a little bit more about blue penciling later, but a lot of employers rely on non-competes almost exclusively with respect to the post-employment period. And that can really be dangerous these days. So a few other states I think we wanted to mention, so Massachusetts has a statute now that requires or prohibits employers to subject to non-competes employees who are non-exempt from federal overtime law. So unless the individual is paid on a salaried basis above a certain threshold and meets the job duties test for the federal overtime law, they cannot be required to sign a noncompete. They have prohibitions

on enforcing these agreements about individuals who are terminated without cause, which is undefined here too, or if someone is laid off. And we've actually been including that kind of a revision in the agreement itself for Massachusetts because it is very explicit.

They have to have additional consideration. So the statute talks about paying someone 50% of their salary during the period of the non-compete as sufficient consideration. But we've seen a lot of other things offered as considerations such as equity interests or other bonuses. It is yet to be seen whether these will be sufficient. There's not a lot of court action on these yet, but I'm sure we will see that. And many other states that have statutes on this topic, they require that Massachusetts be the choice of law and that the choice of forum must be in the county where the individual lives in Massachusetts. So it is getting ever more difficult in Massachusetts and elsewhere to enforce these types of agreements.

Megan Monson: I think Amy mean that just really highlights the importance of if you're entering into agreements, especially now with anybody in particular that you're really concerned about that could be competing because they have access to trade secrets or confidential information, making sure that you're reviewing with your legal counsel the applicable state laws that you would be subject to and making sure that you're complying with the various requirements so you don't have an inadvertent football in failing to have enforceable noncompete simply by not following the statutory requirements.

Amy Wiwi: Absolutely.

Megan Monson: Another state that comes up frequently in the topic of non-competes is California. And just in general, employment related non-competes in California are unenforceable as a matter of public policy. And while there are limited exceptions that we're not really going to focus on today, I just wanted to put that out there because that is something kind of at the forefront of a lot of people's minds and are things to be aware of if you have a workforce in California.

Amy Wiwi: I can tell you, a lot of folks are not aware that these are not enforceable in California, and they use their regular old form that they've used for employees in other jurisdictions. And then they come to me after the person has left and I have to explain to them, "You absolutely, positively cannot enforce this agreement against this person in California." So I always find it... This is what we do all the time. We talk about non-competes every day. But yeah, it is really important to check state laws on these issues when you are entering into agreements with folks.

So we have some other states that really prohibit non-competes. California was the first, but Oklahoma has a statute that specifically allows employees who have non-compete agreements to engage in a competitive business as long as they don't directly solicit the established customers of the former employer. So North Dakota has a blanket ban on non-competes except in the sale of the goodwill of a business or the dissolution of a business or some disassociation of a partner or member of a business. And that is really important because you should be figuring out other ways that you can protect your confidential information or client relationships. And Minnesota recently passed a law prohibiting the use of non-competes as of July 1, 2023, except in connection with the sale of a business and also dissolution of the business. So this statute does not regulate confidentiality and non-solicitation provisions, but prohibits employers from using a law other than Minnesota as choice of law.

Jessica Kriegsfeld: So if a non-compete doesn't follow these state rules, sometimes courts will be willing to deem parts of the agreement enforceable while deeming other parts

unenforceable, a practice that's called blue penciling. What are the state trends around blue penciling?

Megan Monson: Yes, that's a great question, Jessica. I would say that many states permit but do not require courts to blue pencil, and it's ultimately left up to the discretion of the court to determine if they think a non-compete is overly broad or unreasonable in terms of scope and duration and whether or not they want to "blue pencil." I'll say that the courts that in general do blue pencil, the approach can also vary by state. Some may just strike provisions that they view are overly broad or problematic. Some will allow the court to alter the terms of the non-compete to narrow the scope. So again, I think that really strikes on the point that Amy made earlier, the importance of looking at what a specific state's law is and what their practice is. Because this is all really relevant when you're determining what is the right scope of the non-compete and trying to maximize both the protection that a company can get, but also with the competing dynamic of trying to maximize the enforceability. And I think that's really where the blue penciling can come in, to understand what courts are typically doing in that state and whether they will possibly modify it if it's overly broad or whether they will strike it down.

There are some states, but a limited number, that are required to blue pencil overly broad agreements. And on the flip side, there are also a handful of states that do not permit courts to blue pencil non-competes, and that if a non-compete is found to be overly broad, it's just invalidated entirely.

Amy Wiwi: Yeah. On the point you made about courts having different approaches, so there are a good number of court decisions in which the court refuses to rewrite the agreement and will in fact... They won't change the stated terms, so they won't reduce the duration or redefine the geographic scope. And particularly this occurs when an employer is viewed as having been sort of overreaching. So in those instances, as Megan said, they will strike those provisions entirely. And so we caution against employers using very broad provisions when relying on blue penciling because these days, employers are much better served by narrowly defining not just the time and distance but also the prohibited activity of the non-compete. So that makes it much more likely that a court would modify the terms and render that provision enforceable instead of saying, "Nope, this non-compete is too long. It's gone."

Jessica Kriegsfeld: There's been some discussions surrounding a rule put forth by the Federal Trade Commission as it relates to post-employment non-competes. Can you explain the rule, the proposed terms, and the potential impact?

Amy Wiwi: Yes. So President Biden issued in July 2021, an executive order on promoting competition in the American economy. So in this order, among many other requests and proposals on related topics to various agencies and departments, President Biden encouraged the chair of the Federal Trade Commission to work with others to exercise the FTCs statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility. So it was obvious what President Biden was looking for, so the FTC proposed early this year a very broad rule that would prohibit for all workers, so not just employees, but independent contractors and unpaid workers. And it would also require employers to affirmatively rescind any existing non-competes within a period of time after the rule becomes effective. So as we typically see in state legislation, there is a carve out in the case of the sale of a business, but this rule requires that that individual with the non-compete actually own at least 25% of the business being sold. So that's a significant change from the way states have typically handled it, and it's much more restrictive than we are used to in the area.

The proposed rule does not or would not be prohibitive of non-solicitation and other confidentiality provisions, but would strike down any such provisions that are defacto non-competes, emphasize the need for employers to narrow the scope of these other provisions as well. So just because there's not a statute prohibiting such a clause doesn't mean that a court wouldn't strike an offending provision as well. We do not know what will happen yet. The FTC was looking for comments on things like just really alternative options, so whether something other than a categorical ban, so maybe different categories of workers or some sort of rebuttable presumptions based on certain terms of the agreements. And it will be interesting to see how those came in and how the FTC responds to them. And I guess we'll see, right? The comment period is closed and we shall see what happens.

Jessica Kriegsfeld: Are there any legal challenges expected if the FTC moves to make the rule final?

Amy Wiwi: So, we've seen some in the talk up to today. But we would expect folks would bring up certain legal doctrine. We're not going to get into the nitty gritty of administrative law, but the FTC indicates in its proposed rule that it has authority pursuant to Sections 5 and 6G of the Federal Trade Commission Act. Section 5 declares unfair methods of competition unlawful. And Section 6G grants the FTC authority to make rules and regulations for the purpose of carrying out the provisions of that subjector. But we would expect to see some challenges that the FTC lacks the authority to engage in role making on this topic.

We also expect that we'll see challenges on the basis of the major questions doctrine, which is a principle of statutory interpretation where courts will presume that Congress delegate to executive agencies things that will have major economic or political significance. And then we've also seen a little buzz about that the FTC's action is an impermissible delegation of authority under the non-delegation doctrine. So under this doctrine, the Congress cannot delegate its legislative powers to other entities, and so the prohibition typically involves Congress delegating its powers to administrative agencies or private organizations. But that is to be seen as well. We will see what happens next.

Megan Monson: Yeah, I think, Amy, everything that you were just talking about with the FTC proposal just really seems to highlight the theme that we've had throughout the discussion today is really I think the general, again, trends towards narrowing the scope of non-competes across the board. And so I think it will really be interesting to see if the FTC proposal goes into a final form and what that looks like, because that definitely is going to have an impact across the board. And I'll add that throughout I know we've focused on kind of a couple of key states that we've seen updates in, and that list that we've spoken about is not exhaustive. There are a number of other states that have specific rules about non-competes. So again, it's just making sure that you're consulting with counsel and/or reviewing the applicable state laws to make sure that you're not running afoul of any requirements.

Jessica Kriegsfeld: What are some ideas and examples to enhance employer protections without using non-compete agreements?

Megan Monson: Yeah, that's a great question, Jessica. We've been talking a lot about, okay, how can we make the non-compete enforceable, but there are the scenarios where it may not be a possibility under state law, or what other things can an employer do to really try to provide it some protection against really the use of confidential information or trade secrets, which at the heart of all of this is really what companies are trying to protect. So some of the things that companies can utilize as tools in their toolbox are putting employees on garden leave for a period of time so that they're basically paying them to sit out. And so from the employee's perspective, they're receiving some sort of compensation, and at the same time, the company is getting that protection by paying

them to sit out so that they're not competing, especially for a time that's in close proximity to when they've left, so that they really have all the confidential information and the business information about the company fresh in their mind.

Another tool that companies might utilize is having some sort of deferred payments or golden handcuffs. And so there's kind of that carrot approach that people are going to comply with the covenants that they have agreed upon because there's payments that they're going to receive in the future. And if they don't comply with covenants that they may have or obligations they may have, they're not going to get those future payments.

Amy Wiwi: Like their bonus plans and other things like that, where it's a condition in the plan that an individual not engage in certain conduct.

Megan Monson: You're exactly right, Amy. And so it might be something where you've left with some sort of deferred vested equity that you could receive future payout for, but you would forfeit it, the right to future payments if you violate any of the covenants. So really from the individual's perspective, there's an economic consequence for most of us, that's really kind of how you get at the heart of trying to deter people because they're going to be the ones potentially harmed by the action they're doing. And related to that, sometimes we see employers utilizing clawbacks as well. So it kind of takes it a further step that not only are they cutting off the right to future payments, but if that person's received payments in the past after they've left or related to their equity, they have to pay that money back to the company. And again, that could be a really large deterrent for some people. Now, we're not going to get into the scope of the logistics and challenges with trying to claw back funds, which in and of itself can be challenging. But again, that's kind of another thing that employers can build into their contracts to really try to mitigate against employees leaving the company and, again, competing or taking their confidential information elsewhere.

Amy Wiwi: Agreed. I think really employers need to take a hard look at what they're actually trying to protect by way of these agreements. A lot of employers think, because I mentioned earlier, it's the easiest to police, they rely almost exclusively on non-competes to protect their confidential information and client relationships. So this is not sufficient in this environment. We need to treat our confidential information as confidential. You have to limit the access to individuals who need to use that information in the course of their job and provide trainings to folks on how to deal with confidential information. Policies on the treatment of confidential information are rarely read by employees. And there isn't anything that you can do to put the toothpaste back in the tube once that kind of in information is disclosed or used. And if you're trying to protect your client relationships, you really need to develop and nurture those relationships so that one person is not the face of the company, but one of several points of contact. So if that's a company relationship, you have to make sure that you are nurturing that from a company perspective, then the individual isn't only familiar with that one person at the company.

And as we mentioned earlier, sort of non-solicitation covenants, they can be really effective, but they are also of limited utility if over broad. So what we have typically been recommending is that non-solicitation covenants should be limited to those clients or customers with whom the employee had direct contact on behalf of the company or about whom or which they have had access to confidential information. And confidentiality covenants really cannot limit an individual's right to use information in the public domain or things that don't really have economic value to the company for not being known outside. So those should be carefully tailored as well to ensure that your backup plan is effective in the event the non-compete is not enforceable. So those courts that are not comfortable with non-competes or less and

less inclined these days to enforce them, it's also possible that they may invalidate these other types of provisions.

So I think employers just need to take a hard look at the reason they use these and it should be a belt and suspenders approach, not relying on one contract clause to protect everything they've built. So there is a lot of variation among different states and other things, and it wouldn't be the most awful thing to have some sort of uniform approach in the United States, but we shall see how the FTC adjusts its proposed rule based on the comments it received. So we'll keep an eye on that.

Jessica Kriegsfeld: It's important for employers to consider these recent trends relating to post-employment non-compete agreements to ensure that the non-compete agreements are enforceable and provide the employer with adequate protection. As mentioned, the laws regarding non-compete agreements, both at the state and federal level, are ever-changing. This episode is intended to be a high level overview of recent developments and trends, but is by no means an exhaustive discussion of all considerations that may apply to your agreements. We encourage you to consult with counsel about your existing non-compete agreements and before entering into any new non-compete agreements. Thanks for joining us today. We look forward to having you back for another episode of Just Compensation.

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