Podcast Transcript

Alternatives to Noncompetes: Current Developments in Regulating Noncompetes

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Lee: The use of noncompetes is now shifting across the country. Many states are limiting the use of noncompetes. Several states have enacted or are considering prohibitions on noncompetes. Nationally, the Federal Trade Commission is engaging in a rulemaking that could ban noncompete agreements between employers and employees. What does all of this mean for your business? Are there alternatives to noncompetes that can protect your business? To help bring all of this into focus, we've created a three-part series called Alternatives to Noncompetes. I'm Leeann Lee, and you're listening to BakerHosts.

Our first episode, Current Developments in Regulating Noncompetes, dives into the current employment, M&A, and public policy developments that are drastically scaling back on the efficacy of noncompete agreements. Our guests today are Joyce Ackerbaum Cox and John Siegal, co-leaders of BakerHostetler's Noncompete and Trade Secrets team; Margaret Isa Butler, partner in the Business Practice Group; and Labor and Employment partners, Patrick Muldowney and Jeff Vlasek. Let's listen in.

Siegal: Thank you for joining us today for the first installment in our three-part series, Alternatives to Noncompetes. The context here is that from the Federal Trade Commission and the NLRB, the FTC having noticed a proposed rule to ban noncompetes nationally, to Minnesota, which this summer enacted a statutory ban on all employment-based noncompetes, to New York, where our legislature has passed a similar bill that is awaiting the Governor's action, to the dozen or so states that have statutorily scaled back noncompetes for lower-earning employees, to judges and arbitrators across the country who are influenced by this trend, it is now obvious that noncompete agreements are becoming less effective and less accepted. So, it is time to look systematically and seriously at alternatives to noncompetes, and that is what we're here to do.

My name is John Siegal. I'm a New York-based trial lawyer who has enforced and defended against noncompetes in nearly every industry and across the country. I'm co-head of BakerHostetler's national Noncompete and Trade Secrets Practice Group, together with my partner, Joyce Ackerbaum Cox, who you'll hear from in a minute. Today, for the first session, we'll discuss current employment, M&A, and public policy developments that are drastically scaling back on the efficacy of noncompete agreements. Our panelists are Margaret Butler, a New York M&A partner; Pat Muldowney, an employment law whiz based in Orlando, Florida; and Jeff Vlasek, an employment litigator from Cleveland, Ohio. To start, Joyce, can you give us a quick update on what the FTC is considering and where it is at in its process?

Cox: Sure. My name is Joyce Ackerbaum Cox, as John said. Happy to be here with you today. As John mentioned in his introduction and as most of you all know, noncompete laws are governed by state laws, either statutes or common law, and in recent years we've seen significant actions by states either banning or limiting noncompetes. We've had previous webinars on this and some blogs and alerts, and I think for those of you particularly with national businesses or practices, know that there are different laws that pertain to different states. But what we have seen is some unprecedented action from the federal government.

So, in January of 2023, the Federal Trade Commission proposed a rule that would essentially ban noncompete agreements with very limited exceptions, and in addition it would require rescission of existing noncompetes and require employers to send notice to previous and current employees that are subject to those noncompetes. There was initially a 60-day comment period for this proposed rule, and there was an overwhelming number of responses. So the FTC extended that rule, and the comment period officially closed in April of 2023. In that three month or so time period, the FTC received an enormous amount of feedback, close to 27,000 comments, and obviously comments came in from all around, both pro and con. There were some letters from approximately 9 senators, 50 House of Representative members, as well as 18 attorneys general, all in favor of the ban, essentially arguing that this proposed bill will be best for the workforce, will help workers' compensation, will promote fairness and fair competition.

As you can imagine, on the other side, there were many businesses that were vehemently opposed to the ban, particularly because as I mentioned, there are very limited exceptions. Businesses here are particularly concerned about protecting what they consider to be their legitimate business interest, which is their confidential information, their corporate assets, etc., and again, nothing right now in the bill to protect high-level executives from leaving. A lot of the comments that we see are asking for limits based upon income or certain classes of workers as some of the state statutes currently have. So, that remains to be seen.

Right now, we understand that the vote is scheduled on the proposed rule to take place in April of 2024. If the rule is approved, it will take effect 180 days after publication. Regardless of the form, whether it is in its current form or some modified form, we can expect significant legal challenges that, there have already been a lot of people, including internally here within our group, opining on what type of legal arguments are going to be made and what challenges will be made to the rule, including whether the FTC has this rulemaking authority in the first place, whether the rule violates the major questions doctrine, as we've seen a lot of activity around whether the retroactive effect of the rule could be considered an unlawful taking. And essentially, whether this rule itself is an impermissible delegation of legislative authority.

So, there is a lot of arguments. There is going to be a lot of litigation. I guess first we have to wait to see what happens with the rule. But for now, we do have information that the FTC has hired or is using scores and scores of individuals. They have dozens of folks that are pouring through these thousands of comments, and they're apparently spending a great deal of money on it. I heard one number that they've already spent close to half a million dollars in terms of the efforts related to the bill.

So, that is where we are in the FTC ban, or the proposed FTC ban. We are keeping a close eye on it, and we will keep you all updated. I'm going to turn it over to my partner who is down the hall from me, Pat Muldowney, in Orlando. He is going to talk about some of the challenges or concerns that are being raised by the National Labor Relations Board. Pat?

Muldowney: Thank you, Joyce. So, some of you may be asking, what do noncompetes have to do with labor law? Well, according to the General Counsel of the National Labor Relations Board, Jennifer Abruzzo, a lot. This past May, the General Counsel issued to regional directors and other Board personnel a memorandum stating that the proper maintenance and enforcement of noncompete provisions in employment contracts and severance agreements violate the National Labor Relations Act, except in limited circumstances. If you're looking for that memorandum, the citation is GC or General Counsel Memorandum 23-08.

Specifically, the General Counsel wrote that noncompete provisions are overbroad because they deny employees the ability to quit or change jobs by cutting off access to other employment opportunities. She argues that this denial violates Section 7 of the Act, the National Labor Relations Act, which protects employees' rights to engage in concerted activity to improve their work conditions. Now, when we labor lawyers think of employee Section 7 rights, we historically have concentrated on employees' rights vis-à-vis the employer they're currently working for. The General Counsel, however, has expanded that. She identifies five types of activities allegedly protected under Section 7 of the Act that she claims noncompete provisions chill employees from engaging, some of which pertain to activities that occur after an employee leaves employment.

Those activities are, concertedly threatening to resign to demand better working conditions. Arguably, that may be a concerted activity. Carrying out concerted threats to resign or otherwise concertedly resigning to secure improved working conditions. Not sure how that applies necessarily once an employee leaves an employer. Concertedly asking or accepting employment with a local competitor to obtain better working conditions. Again, not the employer that we're talking, not the employer that they work for but another employer. Soliciting coworkers to go for it, to go to work for a local competitor as part of a broader course of protected concerted activity, and seeking employment, at least in part, to specifically engage in protected activity with other workers at an employer's workplace.

So, as you can see, this is a very expansive view of how noncompetes supposedly impact employees' Section 7 rights. The General Counsel argues that a desire to avoid competition from a former employee is not a legitimate business interest that could support a special circumstance defense under the NLRA. She defends this view by writing that overbroad noncompete provisions are imposed on low-wage or middle-wage workers who lack access to trade secrets or other protectable interests, kind of a theme that you'll hear from others in this presentation.

The memorandum, however, really doesn't address the tension between protection of customer, let's say customer relationships, and concerted activity directed towards coworkers. Traditionally, employers use noncompetes with, say, sales employees or others with close client contacts who have Section, and those employees may have Section 7 rights, but the employer is not attempting to impact the Section 7 rights, but they're attempting to protect the employer relationships.

So, while these employees may lack access to trade secrets, per se, there is a strong argument that customer relationships are legitimate business interests that need to be protected. Indeed, in some states such as Florida, customer relationships are specifically identified by statute as business interests properly protected by noncompete agreements. According to the General Counsel, noncompete provisions do not violate the Act if they are narrowly tailored to the special circumstances. She doesn't really give that much detail on that, but that is, she puts that out there in the memorandum.

Now, the Board has not taken up the General Counsel's view on noncompetes as of this time. However, last month a regional office in the, in Cincinnati, of the NLRB, filed a complaint alleging that a medical clinic and spa violated the Act by, among other things, requiring its employees to execute agreements containing noncompetes as well as customer and employee non-solicitation provisions. Among the other remedies being sought by the complaint, the complaint is seeking an order that the spa rescind those agreements and make former employees whole for monies lost as a result of their attempted enforcement.

Now, what the Board is going to do if this case comes up before it, you can't guarantee what is going to happen. But based upon the current make-up of the Board and how they've dealt with the General Counsel in recent cases, I would wager that if the case goes up to the current Board, it will adopt the General

Counsel's position, subject to review of that decision by a federal appellate court at some point.

Now the silver lining here, I don't want people to panic about all noncompetes. The silver lining here is that managerial and supervisory employees generally are not considered statutory employees under the National Labor Relations Act. So, the General Counsel's Memorandum does not apply to noncompetes used for them. Now that said, traditional post-termination restrictive covenants for non-supervisor employees may need to be substantially limited if the General Counsel's position is adopted. And again, we'll have to see how that case and other cases get litigated at the Board level. That is sort of where we are at the Board at this point. So, I'm going to turn over to Jeff and Margaret and let them address some issues here as well.

Vlasek: Great. Thanks, Pat. Again, I'm Jeff Vlasek. I'm an employment litigator in Cleveland, and, Margaret, well, you're in brighter New York, I guess. Then I am here in dismal Cleveland. So, we wanted to talk a bit about Delaware, the most exciting state in the union. But most importantly, it is very exciting for some of the recent developments in noncompete law. The Chancery Court has issued no less than six decisions in the past year. Well, I guess, October, yeah, just about the past year. And we're going to kind of briefly cover all of them in this little brief snippet of time. But just quick ground foundation before I flip it to Margaret to talk about *Kodiak*, the most exciting case.

Again, Delaware is a crux for so much of this because so many companies are founded there, or they have choice of law provisions that direct noncompete, non-solicitation agreements to turn to Delaware law for interpretation and enforcement. And again, prior to, really, this past year, it's been a question of, is it going to be enforced? And more importantly, Delaware had a blue-pencil ability to kind of modify things to make them enforceable. But, quite frankly, in the past 12 months, that hasn't really been the case. So, Margaret, I guess, you want to take it with *Kodiak*? That is probably the best place to start.

Butler: Absolutely. Thanks, Jeff. And I'm Margaret Butler. I'm an M&A partner in our New York office.

The *Kodiak* case, *Kodiak Building Partners LLC v. Adams*, really shook up deal practice world because it called into question a lot of practices that had become common in negotiating transactions. In that case, which was a sale of a business context, so two sophisticated parties, one was buying a business, another was selling a business. The seller sold their roof truss producing business, Northwest Building Components, to a more diversified company, Kodiak Building Partners, LLC. The sellers, as is customary, entered into non-competition covenants with the buyer of the business. In the deal world, we've always believed that that is in accordance with public policy, because you want to protect the interest that the buyer is paying for. So, we haven't really worried too much about those other than, of course, to make them reasonable and attempt to make them compliant with law.

In the case at issue, in *Kodiak*, the seller breached his non-competition covenant almost immediately when he took a position with another roof truss producer just 24 miles away. So, from a substantive perspective, this is exactly what you're trying to protect against when you buy a business. You don't want the seller to go off and compete against you immediately. However, the Delaware Chancery Court struck down the noncompete and declined to blue-pencil it, so the person here, Mr. Adams, was able to compete. And the Court said that this is because the noncompete was just too broadly defined. They said the business and the territory, which are some of the normal terms we try to define in these provisions, were geared towards the entire business of the acquirer, which was more diversified geographically and had 19 subsidiaries. And Delaware Chancery Court reminded us that these noncompetes should be targeted to the business of the seller. And in this case the seller had only one line of business, production of roof trusses, and they operated in Idaho, Washington, and Montana, not nationwide or in the many states that the buyer operated in. So, the Delaware Chancery Court struck down the provision, did not blue-pencil it, and Mr. Adams was free to compete.

A number of takeaways here. Of course, being, don't rely on the ability to blue-pencil, and make sure that the noncompete provision you include in your documents is narrowly tailored and reasonable and would be enforceable by a court. Interestingly though, we understood this to be the law in Delaware, of course, that you couldn't have these overly broad noncompetes. But the Court here relied on cases from the employment context, which historically we viewed as different from the sale of the business context. So, it really was a little bit of a surprise to the deal world, and it is what's triggered us to look at more cases over the past year which Delaware Chancery has delivered. It is definitely moving in that direction.

Another thing to point out is in the sale of the business context, often we have the person agreeing to the noncompete waive their right to challenge it for reasonableness, and we've always assumed that is okay because these are sophisticated parties transacting for a significant amount of money. But that isn't really going to work in these cases. Delaware is saying that for public policy reasons, it has to look beyond that. And so, *Kodiak* got us focused on this, and maybe, Jeff, I don't know if you have more to say on *Kodiak* or if you want to go on to the next case in this line?

Vlasek: Yeah. No, so I don't have nearly as much to say about *Kodiak* as you did, and I think for the purposes of time, I'm going to skip ahead a little bit. Obviously, in the materials you see the *Ainslie* decision that came out a few weeks, I guess a couple months after *Kodiak*, kind of relied on some of the similar principles. And in fact, I believe it cites *Kodiak* in its ruling, that a four-year noncompete was too broad.

The one that I did want to talk about a little more in detail, which came out in February of just this year, is *HighTower Holding v. Gibson*. There again, this is a little more employment focused. So, the defendant there, Mr. Gibson, was a partner in a financial advisory firm that HighTower acquired. And in connection with that transaction, he was given a standard protective agreement that included noncompetes and non-solicitations, and they all had Delaware as the choice of law provision for any dispute. After the transaction was closed, of course, what does Mr. Gibson do? Well, he runs off, and he quits and starts his own firm. But importantly, he started his own firm in Alabama, where Mr. Gibson lives and where Mr. Gibson works, because he does not live in Delaware, and he does not really transact any business in Delaware. And so, the court took that into account, which to some degree was a bit of a surprise.

The court denied HighTower's request for a preliminary injunction and found it was insufficient to, there were insufficient facts to uphold a Delaware choice of law provision and specifically applied the more rigid Alabama standard. And it said, quote, the entire purpose of this applicable analysis is to prevent parties from contracting around the law of a default state by importing the law of a more contractarian state, unless the second state also has a compelling interest. In other words, you can't just circumvent whatever particular state you happen to be in, California, by saying, well, Delaware law is going to apply here. So, in other words, you have to look at precision in your drafting. You cannot simply rely on sort of a default that Delaware law is going to apply under this particular circumstance.

The other one I wanted to touch on briefly before we kind of wrap up with a couple of other points, *Frontline Technologies Parent v. Murphy*. I won't get into the, to the nitty-gritty in that particular case, but again, a precision of drafting is what is important there. In that particular case, Frontline Group was the entity that was the employer, but Frontline Parent was the entity that was named in the noncompete. And the court specifically said, you agreed to a noncompete with Frontline Parent, not Frontline Group, so we're not going to just basically give you carte blanche to say, well, Frontline is one entity. No, you knew what you agreed to. We're not going to blue-pencil this and make it better for you. You have to draft your documents carefully, and you have to pay attention to the state that these individuals are working in and particular entities that you are trying to prevent them from competing with.

Now, Margaret, I know we've got two cases left to touch on. I don't know if you want to say any other words about *Intertek*, or anything in particular on that, or I can jump to *Centurion*.

Butler: No, I would just, I would chime in on *Frontline*. I think it is interesting also because this was a private equity firm, right? And these firms do tend to view their subsidiaries as part of their business, and they do grant equity interest in one entity, and they operate in a different entity. And so, I think this case has real implications for how we think about these agreements in the private equity context.

Vlasek: Agreed, I agree definitely. Yeah, the only other case I wanted to touch on a little more detail was *Centurion Service Group v. Wilensky*. Again, another state law-focused case where in this particular circumstance we had an individual who had a noncompete that lasted two years beyond his employment. It was broad, anywhere in the United States, and it was competitive to Centurion's business. But more importantly, it was competitive if Centurion was going to, quote, planning to design, develop, sell, or provide. In other words, it was future looking. You, the individual, had to imagine, well, what, would Centurion be involved in this particular industry? If so, I probably can't work there. And the court said no, that is too broad. You need to be more specific in terms of what you are going to prevent this individual from doing.

And much like *HighTower*, the individual and *Centurion*, let's see, he, Centurion was an Illinois LLC. The former employee was an Illinois resident. The employment agreement was executed in Illinois. The alleged breach occurred in Illinois, and the competitive business was headquartered in Illinois. So again, the court said no, you can't look and just say default, go back to Delaware. Five out of five, you're in Illinois, and that is the law that we're going to apply, which again is not the same as Delaware.

I wanted to make sure we got enough time to turn it over to John, so, because I know he's got plenty of stuff to say about New York, so.

Siegal: Yeah. Thanks, Jeff. Thanks, Margaret. So, in Delaware, the uncertainty is the evolving case law. In New York, the uncertainty is that a bill has passed both houses of the legislature that would make New York a state like California, or now Minnesota this summer, which enacted a bill this summer, that would prohibit all noncompete agreements. The governor, Governor Hochul, has until the end of the year to act on the bill, signing it, vetoing it, pocket vetoing it, negotiating a compromise bill with the legislature.

Here is the only thing I'm going to say with certainty. Anyone who tells you what is going to, that they know what is going to happen in New York this year with noncompetes, does not know. No one knows, including the legislators and including the Governor's staff, who are charged with responsibility for this. It is really up in the air. Now the bill as passed by the legislature does not include an exception for sale of business noncompetes. It would, as written, prohibit sale of business noncompetes in New York, unlike California, unlike Minnesota, and unlike even the proposed FTC rule. Now that was not an advertent decision by the legislature. They just didn't deal with it. And I think, bearing in mind that what I just told you that nobody knows what is going to happen, I think it is highly unlikely that a bill is going to be signed by the governor in the M&A capital of the western world that doesn't provide for seller noncompetes in an M&A context. But right now, it is not in the bill.

Secondly, unlike a lot of states, 12 in the last 4 or 5 years that have enacted noncompete restrictions on an income scale, there is no income threshold in this bill. This bill as written, if enacted, would prohibit JPMorgan Chase from having a noncompete that would prohibit its CEO from going and running Citibank the next day. It has, it would apply to people with stock ownership. It would apply to $1,000,000-plus employees. There is certainly discussion about an income threshold, not clear what, if anything, will happen.

The one prediction I will make that I feel fairly confident in, is that if there is an income threshold in a bill passed in New York, it will be an income threshold substantially higher than in any other state. Right now, the highest threshold, I believe, is Washington state at $100,000, although Colorado, you can sometimes go up to, I think it is like $120,000. That those people below that are exempted. If there is an income threshold in New York, I expect it will be much higher than New York City Partnership, which is a coalition of big business CEOs in the city, is lobbying for a $250,000 threshold. So, you'd have to think that is kind of a floor on any negotiations with the legislature, if such negotiations occur.

It is totally up in the air where New York will land, whether New York will enact something before the FTC acts in April, and if so, what it will be. If and when something happens, we will be back to you immediately with an update. But right now, it is just pure uncertainty. And with that, which is not how lawyers like to talk, but that is the reality of the environment we're operating in. Let me, Joyce, kick it over to you to close out, and Joyce?

Cox: Thank you, John, and thank you to the rest of our panelists, Pat, Margaret, and Jeff. Thank you for joining us. We've outlined a number of, I guess, problems, obstacles, potential issues that are arising in this world. Hopefully, you will join us next. We start to talk about maybe some potential solutions or alternatives. We will talk about specifically the employment law tools that you might want to consider to use as alternatives to noncompetes.

Lee: Thank you, John, Joyce, Margaret, Patrick, and Jeff. If you have any questions for them, their contact information is in the show notes. Please join us next time for Part 2, Employment Law Alternatives to Noncompetes. Partners John Siegal, Joyce Ackerbaum Cox, Susan Lubow, Sabrina Shadi, and Mark Temple will discuss specific employment law tools and approaches that can serve as alternatives to noncompetes. As always, thanks for listening to BakerHosts.