Podcast Transcript

Alternatives to Noncompetes: Employment Law Alternatives to 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 second episode, Employment Law Alternatives to Noncompetes, dives into specific employment law tools and approaches that can serve as alternatives to noncompetes. Our guests today are Joyce Ackerbaum Cox and John Siegal, co-leaders of BakerHostetler's Noncompete and Trade Secrets team; Susan Lubow, partner in the Employee Benefits and Executive Compensation Practice Group; and Labor and Employment partners, Sabrina Shadi and Mark Temple. Let's listen in.

Cox: Thank you for joining us today for what is the second installment of our three-part series, Alternatives to Noncompetes. My name is Joyce Ackerbaum Cox. I'm an Orlando-based Labor and Employment partner, and I co-chair the firm's national Noncompete and Trade Secrets Practice Group with my partner John Siegal, who is based in New York and is a litigator who handles these matters all around the country as well.

So as I said today, if you were with us last, you heard a lot of issues and efforts to halt noncompetes and different mechanisms and measures that are being put forward by the federal and the state government. Today we're going to talk about some of the alternatives to that. We have three panelists with us, three of our esteemed partners. First, we have Mark Temple. Mark is a labor and employment litigator who is the group chair in our Houston office and litigates these matters all around the country.

We also have Sabrina Shadi. She co-leads the firm's Employment Deal team. She has previously served as the Employment Practice Group leader in L.A., where she is located, and she deals with all sorts of issues regarding employee mobility issues, particularly where the California landscape has been challenging to say the least.

And last but certainly not least, we have Susan Lubow. Susan is the co-chair of the firm's Employee Benefits and Executive Compensation Practice Group and handles all matters dealing with executive compensation and retirement plans, health plans, welfare plans, etc. So having given the introductions, I'm going to turn it over to the experts and turn it over to John to moderate for a little bit.

Siegal: Thanks, Joyce. So, the first alternative tool to noncompetes that we want to discuss is garden leave and how garden leave is different than the traditional noncompete agreement. Mark, what would you say about how garden leave compares to a traditional noncompete agreement?

Temple: Well, it is interesting. I mean, garden leave is a concept that we've, I think borrowed from Europe, particularly the U.K. It got its name because it was thought there to be a time that employees were off to be tending to their garden and a time when they couldn't work for their current employer or their potential future employer. So, because the employee was still employed by the company, they couldn't start competing since they would violate their duty of loyalty and perhaps other duties, so that is generally the concept of garden leave.

Siegal: Now, Sabrina, we've all been trained and through hard examples to know that California is different when it becomes, when it comes to employment law. What about garden leave in California? Is that enforceable, and have employers in California used it as a way to regulate the transition of employees from one company to another?

Shadi: We have successfully used garden leave in California, but you're really limited to those situations where you have an employee who is willing to agree. And often it is because they would also find it beneficial to remain employed, at least in name, to help them secure future employment and/or to continue to have income and coverage under the employer's group health benefit plan for some period of time.

Siegal: So, thanks. Susan, that leads us to you. What are the employee benefits considerations during a garden leave period?

Lubow: Yeah, so with a garden leave, because the individual is still employed, employee benefits are supposed to continue. And that typically doesn't present any issues, though I would caution that employers should look at any insurance contracts, stop loss agreements, to make sure that the agreements don't have any actively at-work requirements that could cause problems with continuing benefits during the garden leave. In general, we don't see these being an issue, but I wanted to mention it.

So again, the intent of the garden leave is that the person is still employed, so benefits continue until officially terminated. And it is at the termination of employment that you would, for instance, give a COBRA notice for termination of health coverage and consider them terminated for purposes of payment of retirement benefits.

Siegal: So with the various state statutes regulating the use of noncompetes, for instance, the New York law that is pending for the governor's action is entirely silent on the issue of garden leave. Mark, what do you see in the other new state laws regarding garden leave and whether they're treated like noncompetes or not, and are they permitted or not under these new statutes?

Temple: Fair, John. So, some legislators have recognized garden leave provisions as being certainly different from noncompete agreements. For example, in 2021, the Illinois Legislature expressly recognized garden leave as a distinct variance from a noncompete since they required advance notice, continued employment, and things like that. We also saw that in Oregon, the state's use of garden leave permits an employer to elect to enforce that noncompete provision for up to 12 months by agreeing to pay the employees. There is a 50% provision, 50% of their salary or 50% of their median income. So there's some intricacies in Oregon. And then moving over to Massachusetts on the other coast, that statute spells out garden leaves expressly and requires that it be paid under certain circumstances, unless there is a mutually agreed upon consideration, which we'll talk about more in a minute.

Siegal: Sabrina, how does the California statute 16600 treat garden leave, if it does?

Shadi: Yeah, California doesn't really have a special carve-out for garden leave. During a garden leave here, you're essentially relying on an employee's ongoing duty of loyalty that they owe their employer as an active employee. So if the employee decides to leave before an agreed upon garden leave period, you may have a breach of contract claim depending on the terms of that leave. You may have a tortious interference claim against the subsequent employer if they were aware that the individual had committed to remaining employed for a certain period and solicited them away, notwithstanding that knowledge. But you won't be able to enforce the noncompete post-employment.

Siegal: So in in the majority of states where of course there aren't statutes expressly dealing with garden leave, we just heard a small handful that do, Mark, is there a rule of thumb for, a rule of reason analysis, of what is and is not likely to be enforceable in terms of garden leave and the duration of garden leave?

Temple: Sure, it seems for the most part that courts have consistently found between 30 to 60 days to be reasonable, some 90. But the standard seems to be more around 30 to 60 days, including courts in New York, John. In a case involving Credit Suisse, an Illinois judge upheld a garden leave provision with, would have a 30-day clause, so that was deemed to be reasonable in Illinois. And they thought that particular time was reasonable for the employer to do what they wanted to do, that is to secure client relationships.

A Pennsylvania judge also looked at the garden leave time period and said that that was, 30 days, was adequate and reasonable. So you do have it. Interestingly, in some cases, employees aren't just required to sit idle. They are required in some cases to help transition certain duties, so that is something we can talk about more. But those are the time periods that we've seen.

Siegal: Right, because they remain an employee and their duty of, to the company requires them to do that which the company wants them to do. In drafting these things, Mark, are there any special considerations that should be factored in, in drafting garden leave provisions?

Temple: Sure, just like we do with other types of employee mobility restrictions, John, you want to spell out for the employee and the court the reasons why the restriction is reasonable. So employers should take care to identify those particular reasons that you're putting someone on garden leave and the legitimate governed interests such as business interest, employee or customer goodwill, things of that nature, as well as confidential information is something that is oftentimes specified specifically. Clarity is the key here. Like in any drafting agreement, employers should specify what is and what is not allowed during the garden leave.

One issue if you're going to have someone do particular work during the garden leave is, are you going to have employees allowed to have systems access? So, that is something that should be considered and spelled out. Finally, the other thing that should be considered and spelled out is whether or not the employer is going to reserve the right to waive the garden leave provision. Interestingly, there was an Illinois court where the employer said you can go ahead and compete. We're going to let you compete. We're not going to enforce the garden leave provision. The employee didn't take other jobs and sat out instead, and then sued the employer for collection of the garden leave payment and won. So if you're going to have a waiver or think you might waive it, you should put it in the agreement as well.

The other thing to think about is just making sure that your garden leave provision is clear and conspicuous, and it is signed by the employees. In a Massachusetts case involving Bear Stearns, the court looked at the agreement and said, well, these agreements are buried in various deferred compensation plans. The court called them stealth agreements and didn't enforce them because they were buried and also not signed by the employee.

Shadi: Sabrina, anything to add to that from a California drafting point of view?

Shadi: Actually, more of a reminder of what not to add in California. Specifically, a lot of employers over the years have tried to get employees to sign a non-California choice of law provision as a way to try to get around our local and friendly rules here. But as of 2017, California Labor Code 925 prohibits employers from requiring an employee who primarily resides and works here in California to agree to a non-California choice of law provision as a condition of their employment.

Siegal: How important, Mark, is the pay aspect of garden leave, and how important is it that the employee be paid while they're on garden leave if you want to enforce it?

Temple: Well, remember, we're in a court of equity always when looking at these agreements, so the amount of pay can be viewed by many courts as being very important. So as the employers are trying to find ways to tip the scales in the employer's favor, the more pay is the better as far as courts are concerned.

Siegal: And have courts identified any public policy factors that come into play when requiring a notice period that essentially does require an employee to remain an employee for a decent interval after their resignation? What factors have courts looked at in that regard?

Temple: Sure. In one case in Massachusetts, a judge there found that requiring the individual to continue in an at-will employment relationship was actually against public policy and not enforceable. We saw something similar in Pennsylvania, but there the judge refused to enforce the provision, finding that the garden leave violated the 13th Amendment to the United States Constitution because it actually sought to compel personal services.

Siegal: So, I think a takeaway here, from what you all have been saying, is if you draft it carefully with a reasonably short period of time, provide for compensation, do the other things you've advised, a garden leave is more likely to be enforceable than a noncompete. But what are the downsides, if any, of using garden leave as an alternative to a traditional noncompete agreement?

Temple: Sure, because you're paying the employee. So, the first downside is the significant costs. Oftentimes these employees are higher-level employees. And John, as you know, in your business, the financial services industry is an industry that uses these garden leave provisions. So, there can be a significant cost associated with having someone on garden leave.

Siegal: Mm-hmm.

Temple: Secondly, they're typically shorter, as we said. So when you're looking at a garden leave compared to a noncompete, you have a shorter period of time, so the restrictions are less. And last, if you're again having the employee help transition their work or their job during that garden leave period, you have to carefully consider what exactly that you're going to have, allow them access to, because again, they're likely going to a competitor, which is why you're concerned in the first place.

Siegal: Alright, thanks for that. We're going to move on from garden leave now and talk about other post-employment restrictions. Joyce, you want to take it from here?

Cox: Sure, thank you. So, Mark, I'll throw the first one to you. Let's talk about customer non-solicit provisions. Are they a viable alternative to our traditional noncompete agreements?

Temple: Sure. In most instances, Joyce, they are. So, courts generally recognize that customer non-solicitation agreements are, by the nature of what they are, less restrictive since they still allow the employee to immediately start work, usually in the same industry in the same geographic area.

Like many of these restrictions, it just all depends upon where you're physically located. In New York, as John mentioned, there's a bill that was recently passed by the legislature banning noncompetes, but that bill doesn't apply to contracts prohibiting the solicitation of clients learned about during that employee's employment. Looking over in Oklahoma, a state where pure noncompetes are unenforceable, non-solicitation agreements are in fact enforceable there. And then looking at Rhode Island, we saw that the noncompete agreement prohibition for low wage earners there doesn't apply to non-solicitation agreements. So, you have a little bit of a patchwork as you look at different states and how they're handling it.

So something interesting to note, last week you talked about the FTC's comments and what is going on there. But the proposed rule which essentially bans noncompetes provides that the definition of a noncompete does not include customer non-solicitation agreements because they don't physically prevent a worker from seeking or accepting employment. But again, you got to be careful because before we celebrate that FTC is not going after it, what the FTC has said is if the non-solicitation agreement is so broad that it effectively looks like a noncompete and acts like a noncompete, we're going to treat it as a noncompete.

Cox: Yeah, that de facto language is a little bit concerning in the FTC proposed rule, but those are good points. How about you, Sabrina? What do we see regarding customer non-solicitation agreements in California? Could that be a viable option since very other few other things are?

Shadi: Sorry to say, but no dice. California treats them essentially as equivalent to a noncompete, so that wouldn't really be a viable alternative here. I would note however, though, that of course we do have trade secret protections here, and so to the extent that somebody engaged in unlawful activity such as use of trade secrets to solicit customers, then you would have an avenue to put a stop to that.

Cox: So, I think an important takeaway is make sure, again, you know what state you're dealing with and whether that state considers non-solicits as part of noncompetes by definition or treats them differently and how that is treated differently. Moving on, let's talk about paid noncompetes. How does paying someone to sit out affect the enforceability of what would otherwise be a traditional noncompete restriction? Mark, you want to take that?

Temple: Sure, Joyce. So as we mentioned before, any time you pay an employee for being off of work, it is going to help the court sitting in equity, so same situation here for a paid noncompete. It really helps. We saw in Massachusetts, for example, paid noncompetes are a viable option for employers because you have that language in the statute that talks about other mutually agreed upon consideration. And that can be some type of payment or benefits or stock options, things of that nature. So, that is the place where we've certainly seen it.

Also, courts in New York have upheld noncompetes with the so-called what we call safety net provisions. And safety nets are clauses which provide for payment if the employee is unable to find alternative employment. We saw in the *Lumex* case there in New York that a judge upheld a six-month restrictive covenant in large part because the employee continued to receive his full compensation, including benefits. We also saw a different case in New York, where this one involved Estee Lauder, where the court upheld a restrictive covenant containing a sitting out clause, finding that the former executive was entitled to his full salary during the period as well as full benefits. So, those were factors the courts deemed to be very important and weighing in favor of the employer on a paid noncompete.

Cox: I'm going to go out on the limb and guess where California ends up on this. Sabrina, do paid noncompetes in California get you around the otherwise restriction of no noncompetes or non-solicitations allowed?

Shadi: No. If you're talking a post-termination covenant not to compete, then the payment will not be relevant.

Cox: Will not be permitted in California? We're not surprised. Okay, so moving on. We talked about garden leave. What are some other approaches that an employer might use, especially in the context of, say, an acquisition where there are certainly concerns about if you're the purchaser getting the benefit of the bargain and having the seller sit out or not immediately compete against you? Sabrina, can you talk about that?

Shadi: I finally have something positive to say here. California law actually has a statutory exception which allows owners of the business who are selling their ownership interest and/or the goodwill in their business to enter a noncompete with the buyer who carries on a like business.

There are definitely nuances, which I'm sure will come as no surprise to anyone, about how this exception is applied. So I would be sure to consult with counsel and look at the latest case law to determine whether the exception can be relied on, particularly in situations where maybe the seller is not a majority owner or there is a question about whether the goodwill of the business is really part of the relevant transaction.

Cox: That's an important, at least we know that there is a glimmer of hope in the sale of business in California. So, we're going to move on. We'll talk a little bit. Susan, maybe I'll direct this question to you. Other than garden leave, what other types of alternative compensation arrangements do you see that can deter unfair competition?

Lubow: Sure. So, companies look to a wide array of compensation structures designed to delay payment of certain post-employment benefits in order to enforce various restrictions on these former employees. These arrangements include equity or equity-based compensation, long term incentive plans, deferred compensations, severance arrangements, bonus payments designed to place conditions on receipt such as a required notice provisions for departing employees or requirements to transition employees. Most often, these arrangements are through quote, forfeiture for competition clauses, conditioning payments on employee compliance with restrictive covenants in order to receive the compensation.

These programs are attractive because they can be a powerful incentive not to engage in unfair competition and can be enforced without filing a lawsuit. Historically, these arrangements have enjoyed less scrutiny as to their reasonableness, with courts applying what is called the employee choice doctrine, reasoning that the restrictions do not impose a per se bar on employees working for a competitor but only impose financial consequences on doing so.

So, in addition to forfeiture for competition clauses, companies have historically used clawback provisions requiring repayment of compensation already paid after certain specific events. Again, it varies by state law whether clawback provisions are now even allowed. And in addition, there's the traditional bad boy clauses imposing forfeitures or clawbacks on specific acts, such as disclosing confidential information or disparaging the company.

Cox: And under that situation, you're going to have to go to court anyway in a clawback situation, because I don't imagine employees are voluntarily…

Lubow: Yes.

Cox: …turning that money back over.

Lubow: Yep.

Cox: Yeah. Well, considering the current environment against noncompetes, which we've talked about, what is the current state of these forfeiture for competition provisions in compensation arrangements?

Lubow: Yeah, so the FTC's proposed ban on non-competition clauses does not specifically address forfeiture for clause provisions. However, the FTC ban covers not only express non-competition clauses, but provisions that have the effect of a noncompete. In addition, as discussed in Part 1 of the webinar, because multiple states have adopted significant restrictions on noncompete clauses, as we've heard today, and some courts have declined to follow the employee choice doctrine, we can expect to see forfeiture for competition restrictions in all types of compensation arrangements to undergo a heightened level of scrutiny, whether such clauses are reasonable or whether they are considered a de facto noncompete.

Cox: Can you provide any examples of a situation where one of these forfeiture for competition provisions was determined to be unreasonable or invalidated by a court?

Lubow: Yeah, so in *Ainslie v. Cantor Fitzgerald*, the Delaware Chancery Court invalidated restrictive covenants in a limited partnership agreement that provided for a payout of deferred compensation and capital accounts over a period of four years. The restrictive covenants included a one-year noncompete and a two-year non-solicitation provision, and then in addition there was part of the partnership agreement. The limited partner will be deemed to breach a restricted covenant only when the partner's managing general partner makes a good faith determination that the partner has done so.

The amounts at issue ranged from $100,000 all the way up to $5 million, and involved 6 former limited partners. So in that case, the court refused to apply the more lenient review afforded by employee choice doctrine, finding that the forfeiture for clause provisions were unreasonable and unenforceable.

First, they held that the geographic scope, which was a worldwide scope, was unreasonable under the circumstances. Second, they said it was unreasonable in scope of whom the covenants protected, in part because the competitive activities also extended to affiliated entities of Cantor Fitzgerald. And then third, the agreement's definition of prohibited solicitation included acting in concert with an attempt to quote, solicit or induce, or influence a consultant to terminate other business arrangements with Cantor Fitzgerald and inducing a customer employee to adversely interact with again, a Cantor Fitzgerald affiliate.

So my understanding is this case has been appealed to the Delaware Supreme Court, and I believe that oral arguments are actually set for next week. And so the case has obviously gotten a lot of attention, including the filing of an amicus brief by various business organizations, including the U.S. and Delaware Chambers of Commerce. These groups urge the reversal of the lower court decision, arguing that the Delaware Supreme Court should recognize the significance of the business interests and that the forfeiture for clause provisions protect, as well as the benefits that such provisions provide to employers and employees, giving employees an economic incentive to align their interest to those of their former employer. So, it'll be interesting to see what happens in that case.

Cox: It will be interesting, and along the lines of what we were saying, it is along the trend of perhaps Delaware courts not being as friendly to businesses as they may have previously been in years past. And also some drafting tips, right, to make sure that your provisions are always as narrowly tailored as they can be.

So, it looks like probably a lot of employers might be interested in going this route of kind of something that affects their benefits. What should companies be aware of, or what should they review in connection with executive compensation agreements generally, Susan?

Lubow: Yeah. So, it is similar to what has already been talked about. In light of the recent trends, you need to look at your current and future executive comp arrangements. And to have a best chance for these forfeiture for competition provisions being upheld, you need to make sure that the provisions are sufficiently narrow in scope geographically in duration. You need to have a defensible rationale between the amount of compensation lost and the amount of damage that could be done to the company for competing. I know one factor that the court in *Ainslie* considered was the very high dollar amount for some of the forfeitures.

Also, employers cannot rely on blue-pencil provisions to make them reasonable, so you can't just strike out the part that's objectionable. And in addition, in general, it doesn't seem like employers can rely on a quote, stipulation of reasonableness to insulate them. And then finally, I would just say that employers should focus on the carrots rather than the sticks by using comp policies that encourage employees to remain employed, such as retention bonuses, stay bonuses, or other discretionary bonuses, as well as equity grants with extended vesting schedule. Just in general, you want to make your employees want to stay there, so.

Siegal: Susan, thank you. And Mark and Sabrina, thank you for your comments and your instructions today and this insightful discussion. Please join us next, where we'll discuss intellectual property alternatives to noncompetes and IP protections that you can utilize as alternatives to noncompete. Thanks, everyone.

Lee: Thank you, John, Joyce, Susan, Sabrina, and Mark. If you have any questions for them, their contact information is in the show notes. Please join us next time for Part 3, Intellectual Property Alternatives to Noncompetes. Partners John Siegel, Joyce Ackerbaum Cox, Lisa Collins, and Christina Moser will discuss specific intellectual property tools and approaches that can serve as alternatives to noncompetes. As always, thanks for listening to BakerHosts.