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Proposed FTC Ban on Non-Competes: Considerations for M&A Transactions

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Background

On January 5, 2023, the Federal Trade Commission (FTC) published a proposed rule that, if finalized and adopted, would ban nearly all employee non-competes throughout the United States and invalidate all such existing agreements (the "Proposed Rule").[1] The Proposed Rule is part of a series of actions by the Biden Administration, the FTC and the Department of Justice's Antitrust Division to address competition in labor markets, and was made public just one day after the FTC announced enforcement actions against three businesses and two individuals forcing the companies to invalidate the non-compete agreements executed by their employees.[2]

The Proposed Rule is drafted broadly enough to apply to all private employers under the purview of the FTC and their "workers", including paid and unpaid employees and independent contractors. The Proposed Rule also defines non-compete agreements quite broadly. Under the Proposed Rule, a non-compete agreement means "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person or operating a business, after the conclusion of the worker's employment with the employer." Further expanding the reach of this prohibition, the Proposed Rule would also prohibit "*de facto* non-compete clauses," which have "the effect" of prohibiting a worker from accepting work with another employer.[3]

Typically, non-compete agreements executed by sellers in connection with the sale of a business have garnered less scrutiny from agencies and courts than non-competes in the context of post-employment restrictions. The Proposed Rule, however, provides for only one narrow exception to the blanket ban on non-competes. Under the Proposed Rule, the prohibition on non-competes would not apply to non-compete clauses entered into by an individual who is a "substantial owner" of a business entity in connection with (a) the sale of a business entity or the individual otherwise disposing of all of their ownership interest in a business entity, or (b) the sale of all or substantially all

of a business entity's operating assets. As currently drafted, "substantial owner" refers only to an owner, member, or partner holding at least a 25 percent ownership interest in the business entity. Accordingly, if finalized, the Proposed Rule would limit non-competes in an M&A context to only those individuals owning 25 percent or more of the business entity in connection with the sale of the business. Such a restriction would limit the ability of buyers to prevent minority shareholders, who play a role in the business, from competing with the acquired business after the sale. This shift in dynamics could have implications across the deal-making arena, from valuations to closing conditions.

M&A Transaction and Alternatives to Non-Competes

If implemented, the Proposed Rule will have the most significant impact on M&A transactions where the employment of one or more selling principals is critical to the transaction. M&A professionals will need to think creatively about alternative arrangements to accomplish the current retention aims of seller non-compete clauses if the Proposed Rule is put in place. Below, we summarize some alternative methods to traditional seller non-compete provisions that business and legal teams should be aware of in the event the Proposed Rule is finalized and adopted:

1. Employment Agreements:
    - While non-compete provisions in employment agreements would no longer be permissible should the Proposed Rule become effective, employment agreements remain powerful tools to align incentives between key employees and buyers after the closing of a transaction. To incentivize performance and promote retention of key employees, employment agreements may provide for increased deferred compensation, the issuance of equity or payment of bonuses based on certain performance metrics of the business. The Proposed Rule will likely lead to a shift in employment agreements focused on retention from using non-competes as a "stick" to keep employees in place to more "carrots" for the employee in order to incentivize retention.
2. Grants of Rollover Equity:
    - The issuance of rollover equity to selling equityholders is not a new tool but the prevalence of, and importance of structuring, rollover equity arrangements may increase if the Proposed Rule is implemented. Rollover equity can help to align incentives between the selling shareholders and management, on the one hand, and purchasers and sponsors, on the other hand, by tying the success of the post-closing business to further compensation for selling equityholders.
3. Deferred Purchase Price Payments, Earnouts and Contingent Purchase Price Payments:
    - M&A purchasers and sponsors looking to retain the seller equityholders of a target may consider deferring a portion of the total purchase price as a means of retaining key selling equityholders. Deferred payment mechanisms can be structured in a number of ways, including by using seller financed promissory notes, earnouts or other contingent purchase price structures such as conditioning the payment of deferred purchase price upon achievement of certain financial metrics or employment through a certain date. Although an earnout or deferred purchase price structure may accomplish the purchaser's retention and competition objectives, sophisticated sellers could be reluctant to defer too much purchase price in a high-interest rate environment and will be aware of the leverage created by the Proposed Rule, if implemented, and may be reluctant to agree to such provisions, particularly if the provisions are tied to the individual's continued employment post-closing where significant consideration is earned at closing. Tax considerations will also be

paramount for such arrangements, as some sellers whose continued employment is a condition to receiving deferred consideration could see their contingent payments taxed at ordinary income rates rather than capital gains rates, further diminishing their attractiveness to sellers.

4. Joint Ventures:
    - Certain transactions may also lend themselves to be structured as joint ventures. Joint venture structures are extremely diverse and will not be appropriate alternatives for as many transactions as those listed above. In certain scenarios, however, structuring an acquisition as a joint venture may provide unique incentives for key employees by having them retain a direct interest in the post-closing business.

The breadth of the Proposed Rule, and the lack of clarity around the FTC's interpretation and prospective enforcement of the same, create the risk that the FTC could interpret the Proposed Rule broadly enough to consider certain payments made, expressly or otherwise, contingent on continued employment to be *de facto* non-compete provisions. As more information becomes available with respect to the Proposed Rule, legal advisors and companies will develop a better understanding of how certain transaction structures might be impacted by the Proposed Rule.

Looking Forward

The FTC has invited the public to submit comments on the Proposed Rule, which are due 60 days after it is published in the *Federal Register*. Although the FTC has indicated that it intends to move the rule to finalization quickly, the rulemaking process will likely take months to complete. Once the rule is finalized, enforcement of the prohibition on non-competes may begin after 180 days. Furthermore, it is likely that the Proposed Rule will face significant legal challenges, which could further delay effectiveness of the Proposed Rule for months, or even years. Together, these factors should give companies and prospective M&A purchasers enough time to determine whether they have non-compete agreements subject to the provisions of the Proposed Rule, and to consider alternatives to seller non-competes for ongoing and future M&A transactions.

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[1] Non-Compete Clause Rulemaking, FTC Federal Register Notices (Jan. 5, 2023), https://www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking.

[2] A Ban on Noncompete Agreements? FTC Uses Section 5 Against Employers and Proposes Rule to Ban Noncompete Clauses Entirely (Jan. 11, 2023), https://natlawreview.com/article/ban-noncompete-agreements-ftc-uses-section-5-against-employers-and-proposes-rule.

[3] The Proposed Rule provides two examples of *de facto* non-compete clauses: (i) where a non-disclosure agreement between an employee and a worker is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment, and (ii) where a contractual term between an employer and a worker requires the worker to pay the employer or a third party for training costs if the worker's employment terminates within a specified period of time and where the payment for the training costs is not reasonably tied to the costs the employer incurred for training the worker.