Enforcement is on the Rise Against Non-Compete Agreements. Is Your Business Ready?
Sam Gandhi, Jim Lowe, and Terri Reuter
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Sam Gandhi:
One in five workers in the U.S. has signed a non-compete agreement. Companies use these contracts to protect their trade secrets, reduce employee turnover, and improve their business leverage. Detractors, though, say the non-competes decrease wages and are burdensome to workers. There is now increasing private litigation against non-competes. Some states are passing limits on their use, and federal labor and antitrust regulators are on the alert.

James Lowe:
State laws on non-competes may only make such agreements unenforceable, whereas if the agreement violates the antitrust laws it may result in very serious financial penalties.

Sam Gandhi:
That's Jim Lowe, a partner in Sidley's Antitrust and Competition practice.

Teresa Reuter:
We're seeing two unrelated areas of law come together and so, you're going going to need the advice of your employment lawyers and your antitrust lawyers at the same time.

Sam Gandhi:
And that's Teresa (Terri) Reuter, a partner in the firm's Labor, Employment, and Immigration practice. In today's podcast we'll discuss how non-compete agreements are utilized, and what employers should know to protect their businesses.

From the international law firm, Sidley Austin, this is *The Sidley Podcast* where we tackle cutting edge issues in the law and put them in perspective for business people today. I'm Sam Gandhi.

Hello, and welcome to this edition of *The Sidley Podcast*, episode number 39. Terri, Jim, great to have you on the podcast today.

Teresa Reuter:
Pleasure to be here, Sam.

James Lowe:
Sam, thanks so much.

Sam Gandhi:
You have covered…Kathy Hochul vetoed a bill last month that would ban the use of non-compete agreements for all workers in her state. This was after business groups had warned such a measure would push jobs out of New York, according to *The Wall Street Journal*. Terri, give us your high-level take on this, and for those who haven't had ever to consider these agreements, what are they and how have they historically been received?

Teresa Reuter:
So, let's start with just talking about what non-competes are. Employers use non-compete agreements to prevent employees from working for competitors when they're employed, and for a period after their employment terminates.

Now, these typically have been governed by state laws, and whether the nature of the employment termination, whether as an employee I leave the employer or as an employer you fire me, whether that affects whether the non-compete is enforceable really depends on the law. But frequently no matter how you leave the relationship, you're prevented from going to a competitor.

There types of provisions are also frequently paired with other types of provisions that protect companies' and employers' confidential information, and other business investments. And those types of provisions are non-use, non-disclosure of confidential information clauses, and then provisions that prevent employees from soliciting other employees of the company, customers, or potential customers.

Non-competes historically have been disfavored because, of course, contract law is supposed to support a robust business environment in

which competition is encouraged. So all non-competes must have an end point after employment. And depending on who the employee is, what work they did for a company, this could be as short as three months after employment, or in some cases up to two years or longer, and it's all facts specific.

Now, thinking back a little bit, non-competes have really proliferated in recent years. Right now about 20 percent of U.S. workers are bound by non-compete clauses and employment agreements, and 98 percent so, the vast majority of private employers require executives and managers to sign non-compete agreements as a condition of employment, and this is all according to the U.S. Government Accountability Office.

With this proliferation, governments have responded in kind so that half the nation's states have an active legislation limiting non-compete clauses in some form. Some states like Minnesota and California, among others, have banned them altogether so they are not permitted for those folks that are based in Silicon Valley. California has had this restriction in place for more than a century and it frequently holds itself out there as an example as how businesses can thrive even absence of these employment-based non-competes.

Employers counter these arguments and say, we need them to protect our legitimate business investments and our interest. So, the New York ban, for example, that you just mentioned that was vetoed by the governor, was opposed by large banks and corporations that rely heavily on non-competes to prevent top and frequently highly-paid employees from unfairly competing in the marketplace. And that would mean taking strategies and know-how to direct competitors, and using them immediately.

Now, industry groups such as The Business Council of New York State also opposed broad restrictions on non-competes, and they argue that companies generally use them for legitimate reasons, and that the courts already set limits on when and how the contracts can be enforced, and we see that a lot. Every time we talk to employers about non-compete enforcement we have to say, it's not a guarantee on enforceability.

Critics, of course, counter all of these arguments and they say, non-competes prevent the free movement of labor which is bad for businesses

and employees, and place an unfair burden on workers, including those who work low-waged and low-skilled jobs.

Now, supporters of the New York proposal thought it would spur innovation and help the state compete with California for talent and new startups, and that's particularly in the tech sector.

So, you have a variety of opinions on whether New York's proposal was good or bad for business.

Sam Gandhi:
Terri, let me clarify one question for you. When you talk about non-competes that are being banned, you're talking about non-competes that even during the non-competition period the employee is being paid, right, to not compete? Or is it any type of non-compete?

Teresa Reuter:
Any type of non-compete. So, the employee would not necessarily be entitled to severance or other payment during that period. So, it's basically saying, you have a skillset and know-how and you cannot go to a direct competitor and use that skillset and know-how in your field for some period. If you don't have the opportunity to work in another field, you might not have pay during that time.

Sam Gandhi:
Jim, what do you make of that? From the employer's perspective, what are your thoughts in terms of the case against these agreements?

Jim Lowe:
For many companies non-competes are the easiest way to reduce the risk that employees will leave and take trade secrets or customers or competitively-sensitive information to a direct competitor. So, without non-competes for employees who have access to that sort of sensitive information or customer relationships, employers will have more limited ways to prevent competitive harm to them or to their information. And non-disclosure agreements and perhaps limited cooling off periods may still be available, though there are some states that limit even those, but those are more difficult to enforce and may not be as effective.

The proposed changes, and there are going to be more of them, the New York law has been vetoed for now, but almost certainly is going to pass in a different form later this year, will require employers and employment lawyers like Terri to be creative in developing ways of protecting the legitimate issues that non-competes were designed for.

Sam Gandhi:
And so, Terri, on a practical level, how do those agreements actually work? If I'm an employer, how does that actually relate to my business?

Teresa Reuter:
It's very business and industry specific, but generally speaking what you'll see is at the start of employment, or upon promotion, or opportunity to participate in an incentive program, the employee will be asked to sign an agreement that will contain a non-compete provision.

Now, I mentioned earlier there are also other types of provisions that frequently are paired, the non-solicitation, non-disclosure, and those also will be in there and are intended to protect the same type of information and business investment. Depending on employer's practice, where it's located, where the employee is located, and many other factors, once an employee signs onto this agreement — that contains non-compete and maybe these other provisions — that employee will be subject to those provisions, and it could be the case that they might not really assess the employee for many years until that employee terminates.

Now, across all industries these agreements are frequently used with folks who have significant contact with customers and other major sources of revenue for the business. The classic example is sales employees. So, sales employees will frequently be prohibited from going to a direct competitor, you can't sell widgets at ABC corp if you used to be employed by ACME corp for a year, and that would typically apply in the same territory as they sold before. So, if I had a series of states that I covered before, it would typically cover that state.

And the idea is that I'm going to have a competitive advantage working with my prior employer's products, data, pricing list, etc., if I go to a direct competitor and do the same exact thing.

Now, in other cases it's less clear whether businesses are going to reap great protection from non-competes, and that's when businesses have all employees or lower-level or lower-paid employees who are less likely to leverage their skill, knowledge, any confidential information they had access to, in a way that will really offer a competitive advantage to their new employer.

And what we're seeing, you know, what New York was saying in some groups that were in favor, for example, of the New York proposal is, it's unfair to require or allow those folks to be subject to non-competes. Given this question of what's fair, whether employees are fairly prevented from going to a direct competitor, that's where the regulators are stepping in to try to basically draw boundaries and say, here's what we think is fair, here's what we think isn't.

So, this scrutiny that we're going to talk about and that Jim's going to talk about, too, from this antitrust angle, is not going away, it is here with us to stay. There's a general consensus of the expansion of the use of non-competes with lower-level and lower-paid employees is what's prompting this movement in state legislators to step up, and this federal proposal that Jim is going to talk about. New York's Governor actually talked about that in terms of trying to find a compromise for some New York legislation.

What happens when government steps in is frequently they're going farther than businesses would like in trying to protect workers, and so, you'll see when we talk about our federal proposal, it's a complete ban, and what was proposed in New York also was a complete ban.

Sam Gandhi:
Jim, to Terri's last point, how is enforcement factored into the arena of these non-compete agreements? What's the government looking at doing?

Jim Lowe:
Historically restrictions on employee movement data, non-competes, or agreements between employers not to solicit or hire each other's employees have largely been a matter of employment and contract law in the area that Terri works in. A few states, as Terri mentioned, and most notably California, historically had strict limits on such agreements, but generally they were viewed as enforceable if not wildly unreasonable. And

so, that was the status quo for many, many years. However, that has started to change.

Employment restrictions including non-competes and non-solicits started to be a focus of interest to the Antitrust Division of the Department of Justice when it investigated an alleged no-hire agreement among West Coast tech firms in the early 2000s. That investigation resulted in the DOJ bringing civil cases against a number of those firms in 2010, and following on from those cases, in 2016 the DOJ and the Federal Trade Commission (FTC) issued guidelines stating that certain types of no-hire, also known as no-poach agreements would potentially be subject to criminal prosecution as effectively price-fixing agreements.

In the last three years DOJ has brought a number of criminal no-poach cases, though they have so far been unsuccessful, resulting in either dismissal or in acquittals. Nonetheless, DOJ has stated that it will continue to bring them along with civil cases where appropriate, and we are aware of a number of grand juries that are open investigating these sorts of agreements.

The DOJ has also brought cases alleging wage fixing among employers, which again relates to employee movement and wage freedom. It's also important to note that to be subject to an allegation of an illegal agreement regarding wages or hiring under the antitrust laws, the firms involved do not need to compete downstream, they just need to compete for the same type of employees.

For example, firms may need the same type of engineers even though they use them to design very different downstream products, but they still compete for those engineers and therefore are considered competitors under the antitrust laws for purposes of the labor market.

Both the DOJ and the Federal Trade Commission and a number of state Attorneys General also continue to focus on non-compete agreements, particularly those involving, as Terri said, lower-wage employees. And both have challenged agreements and filed briefs in support of plaintiffs in some of the private cases challenging non-competes, non-solicits, and no-poach agreements.

More recently under the direction of President Biden, the Federal Trade Commission is exploring a national ban on companies that would require workers to sign the agreements. So, in January of last year the Federal Trade Commission issued a proposed rule to ban all non-compete agreements regardless of type or level of employment. That has resulted in a deluge of comments on the proposed rules, and the FTC after it digests those comments, is expected to vote later this year on a final version of its proposed nationwide brand.

There is question as to the FTC's authority to issue such a rule, and the Chamber of Commerce and other business groups have said that the rule exceeds the agency's authority and therefore if they issue a rule it is likely to face legal challenges.

It's also important to note that this is not limited to just enforcement by the DOJ and the FTC. Both the DOJ and FTC have entered into agreements with the Department of Labor, and DOJ with the National Labor Relations Board (NLRB) to address all forms of employment restrictions, and the antitrust agency's new merger guidelines highlight that the impact of transactions on labor may be a factor in merger investigations and merger enforcement.

Additionally, the General Counsel of the National Labor Relations Board [Jennifer Abruzzo] in May 2023 issued a memo asserting that employee non-competes violate the National Labor Relations Act, and she has separately asserted that customer non-solicit agreements may also violate the act.

So, there are a number of agencies involved here, Sam, and we expect that the focus at the federal level will continue and expand.

Sam Gandhi:
Let me ask you both, what does the federal government think of what a non-compete actually is? Is it any restriction on competing after you're terminated? Is there any kind of guidance that the government has issued in terms of what type of restriction would be permissible?

Jim Lowe:

Well, I think just from the point of view of the FTC's rule, the FTC's rule as drafted currently is extraordinarily broad and would effectively stop all types of non-competes regardless of their purpose or intent or their scope from being enforceable. Again, whether that rule will survive is an open question at this point. But certainly that's the FTC's view.

The DOJ has not spoken as much on non-competes so, that's a little less clear what the scope of their concern is, and the NLRB's statement is relatively limited and is not sufficiently defined at this point to know if it reaches the scope of the FTC rule.

But Terri, I don't know where the states are on all of this.

Teresa Reuter:
At the state level generally speaking, we're seeing non-competes. So, a prohibition on working for a competitor business, taking another position is getting the most scrutiny, and then some states legislate on non-solicits, customer non-solicits, and to a lesser extent employee non-solicits, and at times they legislate on those but provide a lower level of scrutiny and a greater level of variability as to what is permissible.

And so, I think you're going to continue to see that tiered approach where the prohibition on working for a competitor, because you're preventing people potentially from earning a living during that time, is going to see the greatest scrutiny. And then the other types of provisions we talked about, these other types of restrictive covenants are going to get a lesser level of scrutiny and be more permissible. That's where we see this going.

Sam Gandhi:
You're listening to *The Sidley Podcast*. We're speaking with Sidley Partners Jim Lowe and Terri Reuter about the parameters of non-compete agreement, how they're implemented, and the regulatory considerations for businesses.

So, last year the FTC and the Department of Labor signed what is called an MOU or Memorandum Of Understanding, to join forces to combat anti-competitive practices in the labor market. And some contend those agencies may use this joint effort to bolster their enforcement by identifying additional cases for each agency to pursue.

And so, Terri, there's obviously a lot of legal overlap between antitrust issues and labor and employment issues. What should businesses know about this important intersection?

Teresa Reuter:
This is an area where we're seeing two previously more or less unrelated areas of law come together and so, you're going to continue to need the advice of your employment lawyers and your antitrust lawyers at the same time, and aligned on the same principles.

So, this is an area where Jim and I have usually partnered on it more than we have in the past as regulation and scrutiny has been stronger. Jim mentioned earlier that more than half the states impose restrictions of some kind on restrictive covenants and non-competes, and we're seeing those more attorneys general (AGs) use their power to tell the enforcement and our use of no hired and non-competition agreements under state antitrust and state employment laws.

Where we see these issues come up where both of our guidance is frequently needed is in corporate transactions, and in particularly carve-outs. So, where businesses are going to either buy a part of another business or they're going to sell off a portion of their business, and frequently in that transaction document there will be an agreement among the parties that said, okay, you're not going to solicit certain groups of my employees and I'm not going to solicit certain groups of your employees.

And inevitably in those contracts there's questions about whether the non-solicitation applies, whether it's enforceable, whether a no-hire would be enforceable, and the reason we see that in carve-outs more than just in a full sale of a business is that when you're doing a carve-out you're spitting off employees and you're making a decision about whether they are in scope to the carve-out business or out of scope, and there's always a little bit of ambiguity there.

When looking at those contractual provisions, they often have tail periods of 18 months or two years, and so, Jim and I frequently will be on a deal team, and then they will come back 18 months later and we'll have to revisit with the parties: what was intended, what happened here? And so, you're

really going to want your antitrust and employment team on those matters and thinking about those issues with you.

Sam Gandhi:
Jim, I want to follow up with you on this. Your thoughts on the synergy between antitrust and employment from the antitrust perspective.

Jim Lowe:
You know, Sam, I've been an antitrust lawyer for more than 30 years and it's only in the last five or six years that I've interacted with employment lawyers including Terri. It just wasn't a factor for a long period of time in antitrust. Historically HR professionals needed only to speak with labor and employment lawyers, and then as Terri said, that's really changed.

HR professionals and executives in companies generally, and certainly in-house counsel, need to be conscious that agreements with employees and with other employers that restrict employees that may have been acceptable in the past may now create both employment law and antitrust risk. The latter of which can be exceedingly costly to the company since antitrust litigation involves extensive discovery and expert testimony and can result in treble damages where there's an unfavorable verdict.

The FTC's foray into non-competes in the last year highlights how labor is now a focus of competition in consumer protection law. Incidentally, this is true not only in the U.S., but also in Europe and the UK as well — so this is not a solely U.S. phenomenon — of both enforcers at the European Commission (EC) level and in the UK have indicated an interest in these sorts of labor issues.

So, HR professionals and their in-house counsel need to be conscious that restrictions on employees that might have passed muster under their relevant state law currently, may run afoul with federal law, and understand the implications of all potential legals risks and their consequences. For example, state laws on non-competes may only make such agreements unenforceable, whereas if the agreement violates the antitrust laws it may result in very serious financial penalties for the company.

Teresa Reuter:

Sam, I'd like to add one more thing. On the topic of penalties, California also is getting in the business of penalizing companies who use illegal non-competes so, we're seeing that at the federal and also state level.

Sam Gandhi:
As we wrap up the podcast, this question is for both of you which is, what's on the minds of your clients and what are the issues on these types of agreements are they posing to you?

Teresa Reuter:
I would say two issues dominate clients as questions on non-competes right now. The first regards, how do I manage a restrictive covenant agreement when my employees are geographically disbursed? This question has been more important since the pandemic and generally speaking the expansion of remote work, including for smaller businesses and start-ups.

So, it used to be the case that we would see those businesses centered on one or two locations, but now we're seeing employers take advantage of the national labor pool and are hiring anywhere, and that means they could be subject to the state laws of dozens of states rather than one or two. And they want to know, can I fit all of these provisions in one form and use it for everyone, all my employees? Do I need to have different state-specific forms?

And the answer to those questions is going to depend heavily on the sophistication of your back-office business functions, your legal and HR department, how many employees you have, who you want to have non-competes. So, there's lots of questions about developing a system that works for your business, and is bespoke to your business.

Sam Gandhi:
So, can I interrupt you for a second? Technically, couldn't an employee kind of turn that back on you saying that in fact, given that this is national this actually applies in states like California and other places in which it's banned and so, therefore it's banned?

Teresa Reuter:

Well, if the FTC's rule comes into play, yes. This will be a whole new ball game, and Jim and I will be very busy talking to companies about reworking their agreements. But until the rule becomes final, and frankly we do expect it to be subject to legal challenges depending on what it says. Right now we're still in the patchwork of state-driven regulations on non-competes, and that's a real headache for employers, no doubt. Although many would say, I'd much rather deal with the patchwork than deal with the complete ban.

The other issue we talk about regularly is getting ahead of that ban and whether we can do anything to anticipate what will happen. It's really tough because the complete ban was a little bit farther than I think folks thought the FTC would go. I think just like what happened in New York, what we talked about in the beginning, there's a sense that non-competes are particularly useful for highly-paid folks who have really sensitive and competitively advantageous information.

And so, I think there's an expectation that at least in some locations they'll continue to be permissible, but it's all subject to what the FTC does so, we'll have to wait and see.

Sam Gandhi:
Jim, to sum up with you, what are your clients telling you from the antitrust standpoint?

Jim Lowe:
As Terri said, we're seeing this a lot in transactions and in two respects, one of which is the question of where a company wants to have limitations on, for example, employee movement after a transaction, or whether they want to enforce existing employee agreements, and we do a lot of advising on what is likely enforceable and acceptable under both employment and antitrust law. So, we see that a lot.

Increasingly these questions are arising in due diligence in transactions as well because sophisticated buyers want to make sure they're not buying themselves liability if the target is a participant in agreements that may prove to be illegal either now or in the future, and so, we're asking a lot of due diligence questions about those topics.

We're also seeing this in compliance training. Labor markets, as we've said, are increasingly the focus of antitrust, and companies now need to include their HR professionals in their antitrust compliance training that they should be doing in any event. And they need to train those professionals on how to identify conduct that could create an antitrust risk.

Also, companies need to see if they, in fact, have agreements that could run afoul of the law, not just in non-compete agreements — as Terri talked about in preparing for the potential FTC rule — but also non-solicit and no-poach agreements with other employers. And they need to do some asking around and auditing to see if those agreements exist, and we've been involved in some of those efforts as well.

It's also important to remember in this context that under the antitrust laws, the definition of an agreement is very broad. It can include literally a wink or a nod or a note on a napkin at a dinner, and also can include what we might call gentlemen's agreements between executives. Those sorts of agreements have been the basis of some of these criminal no-poach agreements that the DOJ has brought so far.

And no-hire, no-solicit, non-competes all create both enforcement risk and private litigation risk, and so, companies really need to take steps through compliance training and auditing to limit those risks, and if they discover that they're parties to agreements that may cause trouble, to work quickly to limit that risk, either by restructuring agreements or by eliminating them entirely.

Those are the sorts of things on the antitrust side that we're seeing, and as Terri said, we work very closely with her and her colleagues, particularly on the transactional side to make sure we've covered all angles as those issues arise.

Sam Gandhi:
We've been speaking with Sidley thought leaders, Jim Lowe and Terri Reuter about the antitrust matters that often figure into employment law and how they're advising clients in these areas.

Jim, Terri, it's been a great look at the landscape regarding non-compete agreements. Thanks for sharing your insights on the podcast.

Jim Lowe:
Thanks for having us.

Teresa Reuter:
Thanks, Sam.

Sam Gandhi:
You've been listening to *The Sidley Podcast*. I'm Sam Gandhi. Our executive producer is John Metaxas, and our managing editor is Karen Tucker. Listen to more episodes at sidley.com/sidleypodcast and subscribe on Apple Podcasts or wherever you get your podcasts.