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Employment

Changes Brewing for Enforceability of Non-Compete Provisions

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Due to centuries of common law jurisprudence and periodic legislative adjustments, courts in most American jurisdictions typically uphold reasonable non-competition agreements related to employment matters. There are a handful of outlier jurisdictions (California, most notably), however, where non-competes are flatly banned.

Like most states, New York has developed rules that protect employers' legitimate interests and employees from unreasonable restrictions on their ability to earn a living. So, New York non-competes are enforceable if necessary – but not more than necessary – to protect employers' legitimate business interests rather than impose an undue hardship on the employee. Raw prevention of competition is not a legitimate business interest, but protecting trade secrets, confidential information and close client relationships built on the employer's time and dime can provide the basis for enforceable non-competes.

Until recently, the rules seemed settled. Now, however, the New York State legislature has passed a bill that would ban virtually all employment-related non-competes (New York Bill or Bill), and the Federal Trade Commission (FTC) has announced its intention to promulgate a rule broadly banning non-competes (Proposed Rule or Rule). Those proposals represent a fundamental shift in the law governing restrictive covenants in New York.

This article analyzes the New York Bill and the Proposed Rule; raises questions about their implications; and explores how they might impact different aspects of non-compete agreements. It highlights the potential impact of these changes on the enforceability of non-competes, including their effect on various agreements and legal relationships.

See "What Fund Managers Should Know About the FTC's Proposed Ban on Non-Compete Provisions" (Jun. 1, 2023).

Non-Compete Restrictions in the New York Bill

The New York Bill states, "[n]o employer or its agent, or the officer or agent of any corporation, partnership, limited liability company, or other entity shall seek, require, demand or accept a non-compete agreement from any covered individual."[1]

A "covered individual" is broadly defined as a "person who, whether or not employed under a contract of employment, performs work or services for another person on such terms and conditions that they are, in relation to that other person, in a position of economic dependence on, and under an obligation to perform duties for, that other person."

The New York Bill also broadly defines a "non-compete agreement" as "any agreement, or clause contained in any agreement, between an employer and a covered individual that prohibits or restricts such covered individual from obtaining employment, after the conclusion of employment with the employer included as a party to the agreement".

There are some express exclusions from the definition of a non-compete agreement. An agreement establishing a fixed term of service or an agreement that "prohibits disclosure of trade secrets, disclosure of confidential and proprietary client information, or solicitation of clients of the employer that the covered individual learned about during employment" are not prohibited – "provided that such agreement does not otherwise restrict competition in violation of this section."

For instance, although an agreement forbidding an employee from taking or using an employer's trade secrets would presumably be enforceable, a far-reaching non-compete imposed strictly to protect an employer's trade secrets may be prohibited. Similarly, an employment agreement that binds an employee for a set period would not, in itself, be a prohibited non-compete; and an employer might still be able to seek damages caused by breach of that agreement. However, seeking an injunction prohibiting an employee from going to work for a competitor for an unexpired term would likely be prohibited.[2]

See "Procedures for Fund Managers to Safeguard Trade Secrets From Rogue Employees" (Jul. 21, 2016).

The New York Bill creates a cause of action that covered persons may bring against any "employers or persons" who violate its provisions, under which the court will have the power to void any forbidden non-compete agreement and order "all appropriate relief," including enjoining the conduct of any person or employer, and awarding lost compensation, damages, reasonable attorneys' fees and costs – but the court must award liquidated damages (which cannot exceed $10,000).

In addition, without reference to any "covered individual" or "a relationship that places a person in a position of economic dependence on, and under an obligation to perform duties for, another person," the New York Bill separately provides that "[e]very contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." That language is a verbatim copy of California's statutory provision that has been interpreted as (among other things) prohibiting non-competes.[3]

Notably, the New York Bill is not retroactive. Instead, it applies only to contracts entered or modified after the 13th day after the Bill becomes law.

Although there are some questions about the New York Bill's effect, one thing is clear: it prohibits all employment-based non-competes without exception.

See "How NY-Based Investment Managers Can Craft Enforceable Non-Competes That Do Not Provide for Post-Employment Compensation" (Nov. 19, 2019).

Questions Raised by the New York Bill

What Else Is Prohibited?

Having taken care of employment-related non-competes in other sections of the New York Bill, it is unclear what the legislature intended by importing the California statute into New York law wholesale. This section of the Bill would apply to "any contract" – not merely contracts between covered persons and employers. Was the adoption of the California statute verbatim intended to forbid all the agreements (not only employment non-competes) that have been held to be prohibited by the California statute?

What About Non-Competes as to the Sale of a Business?

Unlike California law, which provides a carveout for non-competes imposed as to the sale of a business, the New York Bill does not contain an exception for such non-competes. Did the New York legislature intend to wipe out the lenience its courts generally have afforded non-competes designed to protect buyers of businesses from unfair competition by sellers?

Would Notice or Garden Leave Provisions Be Enforceable?

Some employers require employees to agree to give advance notice of their resignation, during which the employees are required to perform transition services. Similarly, "garden leave" provisions require employees to give advance notice of their intention to resign, and they remain employed (and on the payroll) throughout the notice period. However, they typically do not have any duties. Under both forms, employees cannot move on to a new employer until the notice period expires. Such provisions certainly restrain employees from quitting and starting work elsewhere immediately, so the question is whether the New York Bill would forbid such provisions.

Would Forfeiture-for-Competition Provisions Be Enforceable?

Under the "employee choice" doctrine, courts in New York view forfeiture-for-competition provisions not as restrictive covenants but as financial disincentives that come into play where employees lose unvested or unpaid forms of compensation if they choose to quit and go to work for a

competitor. Under that doctrine, forfeiture-for-competition provisions are not reviewed for reasonableness. Did the legislature intend to prohibit these previously sanctioned forfeiture-for-competition provisions?

See "Restrictive Covenant Laws at the Federal and State Level Increase Challenges of Enforcing Non-Compete Agreements (Part Two of Two)" (Oct. 19, 2021).

What About Agreements Prohibiting the Solicitation of Employees?

It is unclear whether the New York Bill would prohibit an agreement not to solicit fellow employees to work elsewhere. On the one hand (tracking the language of one part of the Bill), an agreement by employee "A" not to solicit other employees arguably does not prohibit or restrict employee A from obtaining employment. On the other hand (tracking the language of another part of the Bill), a covenant not to solicit fellow employees may be viewed as a contract by which anyone is restrained from engaging in a lawful profession, trade, or business. Notably, the California statute which the New York legislature adopted, apparently has been held to prohibit non-solicits of employees.

Does the Bill Cover Alternative Legal Relationships?

The Bill covers agreements between employees and employers and is likely meant to cover independent contractors. But what about other legal relationships? For instance, some firms embed non-competes in limited partnership agreements entered by their senior professionals, with the idea that courts give parties to such agreements wide latitude to order their rights and obligations as they see fit.

When applying the Bill's terms, however, would courts focus on substance not form by holding that such LPs are covered persons who are economically beholden to the partnership for whom they perform services, and such partnership agreements are non-competes that restrain LPs from engaging in their profession? Interestingly, unlike the Bill, California law expressly allows a partnership agreement and a LLC agreement to contain a non-compete for as long as the partnership or LLC carries on its business.

See "How to Evaluate Portfolio Companies for Independent Contractor Misclassification Liability" (Jun. 18, 2019).

Prohibition of Non-Competes in the FTC's Proposed Rule

The Proposed Rule is broadly drafted and aims to deter employers from entering, maintaining or asserting the enforceability of non-compete clauses.

The Proposed Rule declares as follows:

> It is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker; maintain with a worker a non-compete clause; or represent to a worker that the worker is subject to a non-compete clause where the employer has no good faith basis to believe that the worker is subject to an enforceable non-compete clause.

Thus, the Proposed Rule not only bans non-compete clauses on a going-forward basis but also prohibits the "maintaining" of those clauses. To that end, the Proposed Rule imposes an affirmative obligation on employers to immediately rescind any outstanding non-compete clauses; and to reach out and provide direct, written notice to all current and former employees with non-compete clauses that those clauses are no longer in effect. The employees are free to work anywhere they like, including for a competitor of the employer. Thus, the Rule would be retroactive and invalidate any non-compete clauses already in place.

The Proposed Rule makes clear that it applies to anyone "who works, whether paid or unpaid, for an employer," including "an employee, individual classified as an independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a client or customer."

The Proposed Rule defines a "non-compete clause" as "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."

And it encompasses de facto non-compete clauses that "h[ave] the effect of prohibiting 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." That includes [a] non-disclosure agreement between an employer and a worker that is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer."

Unlike the New York Bill, the Proposed Rule has an express carveout for:

> a non-compete clause that is entered into by a person who is selling a business entity or otherwise disposing of all of the person's ownership interest in the business entity, or by a person who is selling all or substantially all of a business entity's operating assets, when the person restricted by the non-compete clause is a substantial owner of, or substantial member or substantial partner in, the business entity at the time the person enters into the non-compete clause.

See "Trending Issues in Employment Law for Private Fund Managers: Non-Compete Agreements, Intellectual Property, Whistleblowers and Cybersecurity" (Nov. 17, 2016); and "Steps Fund Managers Can Take in Light of NY Attorney General's View That Certain Non-Compete Clauses Are Unconscionable" (Sep. 22, 2016).

Questions Raised by the Proposed Rule

How Would an NDA Violate the Rule?

The Proposed Rule warns that an overbroad non-disclosure agreement (NDA) could constitute an invalid de facto non-compete clause – but how? In the commentary accompanying the publication of the Proposed Rule, the FTC pointed by example to a case where a California court struck down an NDA as an unenforceable non-compete where the NDA defined "confidential information" as any information that is "usable in" or "relates to" the securities industry, which the court concluded effectively prevented the plaintiff from working in the securities industry after his employment ended.[4] If that is the measure, an NDA must be very broad to be a de facto non-compete clause.

Are Notice or Garden Leave Provisions Enforceable?

The language of the Proposed Rule is intriguing in this regard. By specifying that actual and de facto non-compete clauses are agreements that prohibit or have the effect of prohibiting employment after a worker's employment with the employer, the Rule suggests that there may be room for enforcement of notice provisions or garden leave. Those provisions impose obligations during an employee's employment, not after.

Would the Proposed Rule Ban the Non-Solicitation of Clients or Employees?

It seems unlikely. The Proposed Rule focuses on agreements that prevent employment. In its commentary the FTC explains:

> In addition to non-compete clauses, employers and workers enter many other types of covenants that restrict what a worker may do after the worker leaves their job, including, among others, NDAs; non-solicitation agreements; and [training repayment agreements]. The definition of non-compete clause would generally not include these types of covenants because these covenants generally do not prevent a worker from seeking or accepting work with a person or operating a business after the conclusion of the worker's employment with the employer.

The FTC warns that when a covenant is drawn so broadly as to prevent employment, it would constitute a prohibited de facto non-compete clause.

See "Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Fund Manager Employment Agreements" (Nov. 23, 2011).

Would Forfeiture-for-Competition Provisions be Enforceable?

Neither the Proposed Rule nor the commentary deals with forfeiture-for-competition provisions. If the criterion under the Rule is whether the agreement at issue prevents employment, however, then forfeiture-for-competition provisions may be safe. Those provisions do not prevent the worker's

employment for a competitor; they only cause forfeiture of unvested or deferred forms of compensation if the employee chooses to work for a competitor.

Does the Proposed Rule Cover Alternative Legal Relationships?

Yes. The Rule applies to non-compete clauses between employers and workers; and defines "employer" (by cross-reference to 15 U.S.C. § 57b-1(a)(6)) as "any natural person, partnership, corporation, association, or other legal entity." It would not appear that non-competes embedded in partnership or LLC agreements would be immune from the Proposed Rule's prescriptions. In addition, the express carveout provided associated with the sale of a "business entity" – defined as "a partnership, corporation, association, limited liability company, or other legal entity, or a division or subsidiary thereof" – implies that absent the carveout, the Proposed Rule would apply to partnerships, LLCs or any legal entity.

It remains to be seen whether New York Governor Kathy Hochul will sign the New York Bill, veto it, or send it back to the legislature requesting changes. And the FTC apparently will not be voting on a non-compete ban until April 2024. However, although there are questions about their scope, if these proposals become law in their current form (and remain law despite undoubted legal challenges in the courts), employment-based non-competes will be banned entirely, no matter how highly compensated or highly titled an employee may be, and no matter how sensitive the confidential information they possess. Such a change would be startling in jurisdictions like New York, where reasonable and reasonably necessary non-competes have long been enforceable to protect legitimate business interests.

For coverage of other employment issues, see "Legal and Practical Impact on Fund Managers of New Federal Law Ending Forced Arbitration of Sexual Harassment and Assault Claims" (May 10, 2022).

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[1] Bill No. S3100A § 1 (promulgating new N.Y. Labor L. § 191-d(2)), 2023-24 Legis. Sess. (N.Y. 2023).

[2] Under current law, "where an employee refuses to render services to an employer in violation of an existing contract, and the services are unique or extraordinary, an injunction may issue to prevent the employee from furnishing those services to another person for the duration of the contract." *American Broadcasting Companies, Inc. v. Wolf*, 52 N.Y.2d 394, 402-03 (1981). The rule's utility

is low, however, because very few employees are deemed to be "unique," which is typically limited to popular and extraordinarily talented artistic performers or athletes.

[3] *See* Cal. Bus. & Prof. Code § 16600 ("every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.").

[4] *Brown v. TGS Mgmt. Co., LLC*, 57 Cal. App. 5th 303 (Cal. Ct. App. 2020).