FTC Noncompete Ban Could Harm Buyers And Sellers In M&A

Law360

February 10, 2023

Adam Gersh and Mariel Giletto

This article originally ran in Law360 on February 10, 2023. All rights reserved.

As federal and state governments consider limiting or prohibiting employee noncompetition agreements or other restrictive covenants, the significant and detrimental impact these reform efforts will have on mergers and acquisitions is often overlooked.

To be clear, most reform efforts aim to limit or ban employers from forcing employees to sign agreements restricting their post-employment competitive activities. The Federal Trade Commission's recently proposed rule banning noncompetition agreements is garnering the most attention due to its far-reaching affects.

Although the proposed noncompete ban exempts certain owners selling a business, even if the restrictions may be otherwise forbidden for nonowner employees, that's not the end of the story. Erosion of protections from competition will be factored into the purchase price by buyers evaluating the value of an entity and by sellers looking to maximize the value of their enterprise.

Historically, noncompetition agreements and other restrictive covenants in M&A transactions are subject to less scrutiny because the sellers are paid for the restrictions as part of the sale of the business — especially among sophisticated buyers and sellers — and it is understood that buyers should be permitted to safeguard the value of the purchased business.

Buyers of businesses often rely on restrictive covenants as a crucial mechanism to protect the business that they just purchased. Restrictive covenants such as noncompetition, nonsolicitation and nondisclosure obligations preserve the value of goodwill purchased and offer assurances that the buyer will not face immediate competition from a former owner or key employee.

Without the full benefit of all necessary protections, a former owner or key employee could open a competitive business or work for a competitor immediately after the sale, thereby significantly diluting the value of the business just purchased.

Competition from former workers is especially a risk in service industry businesses that are dependent on the employees, or in businesses where relational selling is a key driver of business development, as this can influence the price that buyers pay and the proceeds that sellers receive.

The FTC's proposed ban seems to recognize the value of noncompetes in M&A transactions, as its proposed rule notes "non-compete clauses between the seller and buyer of a business may be [different because] they may help protect the value of the business acquired by the buyer." Unfortunately, the FTC's proposed rule only exempts a noncompete agreement entered into by a buyer with an individual who owns at least a 25% ownership stake in the seller's business prior to the sale.

Although the FTC's proposed rule leaves confidentiality and nonsolicitation agreements — as long as they do not effectively operate as noncompetition agreements — in place, those limited protections may not be enough for buyers of businesses.

This narrow exemption for the sale of a business fails to recognize that restrictive covenants are the norm in many industries, especially in small- to middle-market transactions, where the companies being sold are often owned by a number of individuals who fall below the 25% threshold of the proposed rule.

And the amount of equity owned by an individual is not necessarily correlated to the value that individual brings to an organization, which may be based more on their level of involvement in the business or relationships they may maintain.

Further, key employees often have significant institutional knowledge and relationships that drive the profitability of the organization, but they may not meet the ownership threshold of the proposed rule. In fact, in many instances, those key employees have no or nominal ownership interest. Locking key employees into employment agreements that include noncompete restrictions is often, from a buyer's perspective, critical to consummating the purchase.

This is also critical from a seller's perspective as it helps justify a higher selling price. Permitting key employees with valuable information to compete with a buyer immediately after closing could significantly dilute the value the business, which could not just drive down the purchase price, but also deter some buyers.

Finally, the proposed rule would invalidate certain restrictive covenants made as part of transactions that concluded before the rule takes effect. Retroactive application is potentially devastating to a buyer who relied upon those restrictive covenants for the reasons addressed above. If the restrictive covenant is eliminated, sellers and both former and current key employees would be permitted to directly compete with a buyer, even after the buyer factored the value of the restrictive covenants into its pricing of the deal.

The FTC's proposed rule is certain to face opposition from stakeholders during the comment period, as well as legal challenges if it is adopted as proposed. The proposed rule is open for public comment until March 10.

It seems probable that any ban will not become immediately effective, as it is likely to face challenges in court even if it does overcome the public objections. However, companies would be wise to start evaluating the implications of the proposed ban.

Companies should proactively develop policies and procedures to help reduce the risk of misuse of confidential information and trade secrets, especially if they are looking toward selling their business in the near future. This might include limiting the disclosure of unnecessary information to investors and employees.

Companies should also retain a log of all restrictive covenants they have in place for both former and current employees and owners. In the event of a ban, the currently proposed rule requires employers to notify these individuals that their agreements are no longer effective.

Further, companies would be well served by examining existing restrictive covenants to determine whether a nonsolicitation agreement or other covenant could be deemed a de facto noncompete clause under the proposed rule. Companies should consider revising those agreements to limit the employment restrictions while adding stronger protections for confidential information.

Even though the proposed rule is not an immediate concern, businesses should also be wary of overreaching with their noncompetition agreements and, instead, should focus on using them to retain value.

The FTC has already begun taking enforcement action against businesses it alleges are imposing noncompetition agreements on employees when the business has no protectable interest. The FTC contends this overreaching by employers is anti-competitive activity.

Companies with unenforceable noncompetition agreements face operational and valuation risks, but some of these can be mitigated by appropriately tailoring restrictions.

Businesses, whether they are buyers or sellers, should consider alternatives to noncompete clauses, including nondisclosure agreements focused on protecting sensitive information and trade secrets, agreements prohibiting solicitation of customers or referral sources, or golden handcuff plans.

Business should also consider potentially requiring individual sellers, who are the biggest competition threat, to acquire rollover equity in the buyer or operating subsidiary in order to bind these sellers to a continued duty of loyalty. While the definition and application of the duty of loyalty is state specific, it generally requires the owners and directors of the company to place the company and the shareholders' interests before any of their own.

ATTORNEYS MENTIONED

Adam Gersh

Mariel Giletto