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How FTC's Noncompete Rule May Affect Exec Comp Packages

By **Meredith O'Leary** (May 10, 2024, 5:40 PM EDT)


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On April 23, the Federal Trade Commission issued its final rule imposing a nationwide ban on employers from using post-employment noncompetes with current and former workers.[1]

Other than narrow exceptions for existing noncompetes with senior executives,[2] noncompetes entered into in connection with a bona fide sale of a business, noncompetes in franchisor-franchisee relationships and noncompetes imposed by nonprofits, the rule bans all new post-employment noncompetes, invalidates all existing post-employment noncompetes, and prohibits the enforcement of any post-employment noncompetes.

Under the rule, employers must inform all workers subject to post-employment noncompetes — other than existing agreements with senior executives — that such provisions are no longer valid.

The rule takes effect 120 days following its May 7 publication in the Federal Register, making its effective date Sept. 4. Several lawsuits have already been filed challenging the rule, which could delay the implementation of the rule until a final determination has been made regarding its enforceability.

Executive Compensation: What Remains Unchanged

While the rule will certainly have a dramatic impact on executive compensation arrangements, employers should first keep in mind what has not changed.

Permitted Forfeitures and Clawbacks

Forfeiture or clawback conditions of payments and compensatory awards that are not based on the violation of a post-employment noncompete or do not otherwise punish a worker for working for a competitor will not be affected by the rule.

Employers can still provide for forfeiture or clawback of payments and compensatory awards upon violation of other post-employment restrictive covenants — e.g., confidentiality, nonsolicits — and certain terminations of employment, such as termination for cause.

Similarly, forfeiture or clawback conditions of payments and compensatory awards that are based on the violation of a noncompete during the worker's term of employment will not be affected by the rule.

Such provisions remain enforceable, subject to applicable state law.

Permitted Vesting and Payment Requirements

Typical time- and performance- based vesting provisions in compensatory arrangements will not be affected by the rule. Requiring a worker to earn a payment or award based on continued service to the employer or company performance metrics will not be affected by the rule.

Similarly, requiring a worker to be employed by and in good standing with the employer on the payment or vesting date to receive payment will not be affected by the rule.

Existing Arrangements With Senior Executives

Arrangements with senior executives in place as of the effective date of the rule will also not be affected by the rule. This includes employment agreements, and equity, incentive, nonqualified deferred compensation arrangements and the like, that include post-employment noncompete provisions.

However, note that the rule does not appear to permit amending or extending such arrangements to circumvent the rule on a going-forward basis.

Executive Compensation: What Will Change

After understanding what has not changed, employers will need to take stock of how their companies currently structure executive compensation and how they may need to restructure it in the event the rule goes into effect as currently contemplated.

Severance Arrangements

Severance in employment agreements is typically conditioned on worker's compliance with certain post-employment restrictive covenants, including noncompete covenants to the extent permitted by applicable state law.

Employers should review existing agreements with severance to determine what obligations the employer and employee will be bound by absent such noncompetes. Going forward, the payment of severance cannot be conditioned upon compliance with a post-employment noncompete.

Prohibited Forfeitures and Clawbacks

In many incentive and other compensatory arrangements, workers forfeit earned or future benefits upon violation of post-employment restrictive covenants. This is particularly the case in situations where workers continue to hold equity or equity-like interests post-termination.

To the extent such existing restrictive covenants include a noncompete — or other provisions that function as a de facto noncompete — violation of such a provision can no longer be a basis for post-termination clawback or forfeiture.

Prohibited Arrangements in Connection With Equity Ownership

There is no exception to the rule for workers who are also classified as shareholders or self-employed

partners for tax or other purposes, other than in the context of a sale of a business.

Workers who hold equity, including significant equity, in their employer or its affiliates are covered by the rule, even if their working relationship is ancillary to the investment relationship, such as a founder-employee.

Such individuals cannot be bound by noncompetes following their termination of employment, even if nonworker investors are bound by such provisions.

280G Exclusions Based on Post-Employment Noncompetes

Historically, employers subject to Section 280G of the Internal Revenue Code — the so-called golden parachute provisions — that are not able to engage in the shareholder waiver and approval process, often exclude compensation paid to disqualified individuals in consideration of a post-employment noncompete from 280G amounts as reasonable compensation for services rendered after a change in control.[3]

Such exclusion would not be available with respect to arrangements prohibited by the rule.

Expected Trends

If implemented, employers may have less "stick" to compel workers to remain employed and may need to use more "carrot" to incentivize workers to not take their expertise to competitors. As such, we expect a move toward:

- Entering into post-employment noncompete arrangements with senior executives prior to the implementation of the rule;
- Longer, time-based vesting periods;
- More cliff-based vesting or otherwise requiring workers to be employed at payment to earn a benefit and forfeiture of benefit upon terminations prior to such time;
- More buyouts as replacement compensation for forfeited equity and incentive compensation for new hires as a result of the above;
- Garden leave replacing severance;
- More equity compensation, based on efforts to assert that shareholder-workers are not investing in the employer or its affiliates in their employment capacity and so such investments and their terms are not covered by the rule; and/or arrangements that allow the sale of equity or equity-like interests in connection with termination of employment to qualify as a bona fide sale of a business.

Garden Leave

While the preamble to the rule seems to explicitly permit garden leave arrangements — where a worker continues in employment during the period that would otherwise be the severance period and can therefore be prohibited from competing during such employment[4] — such arrangements can present

issues.

For example, while workers on garden leave can be excluded from active duties, the workplace and employer systems, garden leave arrangements can face enforceability issues and are typically shorter than traditional severance periods.

Additionally, from a liability perspective, employment-related claims can arise during the garden leave period.

Finally, under the terms of an employer's benefit plans, the worker may be eligible for benefits at active employee cost during garden leave or may become disqualified from such plans as a result of a reduction in hours.

If an employer implements garden leave arrangements, it should review its benefit plans to ensure the intended treatment under such plans for such workers — retirement benefit accrual, accrual of paid time off, earning of incentive compensation, vesting, commission plans, etc. — and compliance with the rule.

Equity Investments

As described above, there is no exception to the rule for workers who are also classified as shareholders or self-employed partners for tax or other purposes.

Additionally, most worker-based equity programs are premised on the exchange of equity grants or the opportunity to invest in employer equity for the worker's services.[5]

Nonetheless, we anticipate some employers may attempt to structure equity and equity-based programs as investment-based, rather than employment-based in an attempt to enforce restrictive covenants — including noncompetes — without reference to employment status.

Presumably, such restrictive covenants would need to apply to all investors, which may be administratively difficult. Any such arrangements should be carefully structured with legal and tax advisers.

Sale of Business Exception

The rule does not apply to post-employment noncompetes entered into pursuant to a bona fide sale of "a business entity, of the person's ownership interest in a business entity, or of all of or substantially all of a business entity's operating assets."[6]

Under the rule, there is no threshold ownership requirement or proceeds required to be received for a noncompete to be enforced, so long as the sale is a bona fide sale.

While the FTC clearly contemplated the rule applying to traditional corporate change in control sale transactions, the language also appears to cover a divestiture of an individual of all of their interest in an entity, even if such divestiture would not, in and of itself, constitute a traditional change in control transaction.

As such, it appears that if a post-employment noncompete was a condition to a worker selling their

ownership interest in a business entity, which could presumably occur upon the end of an employment relationship, it would be enforceable under the rule.

As such, a call right, or a put option, of all of a worker's equity upon termination of employment may meet this requirement and could constitute a bona fide sale sufficient to support a post-employment noncompete under this exception.

Next Steps

Given the rule is subject to challenge and noncompetes are not prohibited until the rule goes into effect, many companies have made the decision — at least in the short term — to continue to operate in the ordinary course, including continuing to enter into employment noncompete agreements.

Nonetheless, companies may wish to consider executive compensation arrangements with an eye toward the fact that any payments or benefits given in consideration of a post-employment noncompete may remain even if the benefit of that bargain is eliminated.

Companies could also identify senior executives, and audit existing arrangements and review the scope of existing restrictive covenants and forfeiture provisions included therein.

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[1] The Rule defines a "worker" as "a natural person who works or who previously worked, whether paid or unpaid, without regard to the worker's title or the worker's status under any other State or Federal laws, including, but not limited to, whether the workers is an employee, independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a person."

[2] The Rule defines a "senior executive" as a worker who has a "policy-making position" with "policy-making authority" and receives total annual compensation of at least $151,164 during the preceding year on an annualized basis.

[3] Under the 280G regulations, to be excluded, the disqualified individual must demonstrate by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood the agreement will be enforced.

[4] The FTC is specific on this point.

> [T]he Commission notes that an agreement whereby the worker is still employed and receiving the same total annual compensation and benefits on a pro rata basis would not be a non-compete clause under the definition, because such an agreement is not a post-employment restriction. Instead, the worker continues to be employed, even though the worker's job duties or access to colleagues or the workplace may be significantly or entirely curtailed. Furthermore, where a worker does not meet a condition to earn a particular aspect of their expected compensation, like a prerequisite for a bonus, the Commission would still consider the arrangement "garden leave" that

is not a non-compete clause under this final rule even if the employer did not pay the bonus or other expected compensation.

[5] For example, the profits interests safe harbor requires such grants be in exchange for the provision of services, the Rule 701 exemption to the Securities Act of 1933 is based on the provision of personal services for the interests, and Section 83(b) elections are typically premised upon the provision of future services as a substantial risk of forfeiture.

[6] "A bona fide sale is one made in good faith as opposed to, for example, a transaction whose sole purpose is to evade the final rule. In general, the Commission considers a bona fide sale to be one that is made between two independent parties at arm's length, and in which the seller has a reasonable opportunity to negotiate the terms of the sale."