EMPLOYMENT BRIEFING

Non-compete clauses: proposed reforms on both sides of the pond

On 12 May 2023, the government announced its intention to limit the length of non-compete restrictions in employment agreements to three months following the termination of employment (the UK proposal). This move is intended to assist with the government's aim of ensuring that the economy remains competitive. The government has stated that the ability for employees to freely change jobs is central to a competitive economy and that non-compete restrictions hinder innovation while suppressing wages. The UK proposal follows a similar proposal by the US Federal Trade Commission, which announced on 5 January 2023 that it is planning to introduce a near complete ban on non-compete clauses in the US (the US proposal).

If the UK and US proposals are passed into law, they will significantly alter the enforceability of non-compete restrictions in these jurisdictions (*see box "Global context"*). Employers will need to rely on other tools to try and protect their business interests, primarily garden leave in the UK and other restrictive covenants in both the UK and the US. There are some particular issues that financial sponsors in private equity transactions will need to consider.

The UK proposal does not apply to other post-termination restrictions, such as non-solicitation and non-dealing restrictions, or confidentiality obligations, which will remain subject to the existing rules and could be enforceable for periods of longer than three months. While the US proposal applies only to non-compete restrictions, other types of post-termination restrictions could breach the ban if they are sufficiently broad.

Wider workplace agreements

The UK proposal is intended to apply only to employee and worker contracts, and should not affect non-compete provisions in wider workplace agreements, such as shareholder or partnership agreements. The US proposal, on the other hand, may capture non-compete restrictions in wider workplace agreements.

Management equity incentives. Management incentivisation is a central concept for financial sponsors to align the objectives of investors with those of their management teams. Management individuals participating in the incentive pool are customarily subject to restrictive covenants, which typically include a non-compete restriction.

The UK proposal does not expressly mention non-compete restrictions in the context of management incentive programmes. Further detail on its precise scope is required to properly assess whether, where a shareholding or a grant of equity to an employee is deemed to be incidental to the employment relationship, any non-compete restrictions in the relevant equity documents would be caught by the UK proposal. If they are caught, the duration of non-compete clauses in these documents would be limited to three months following the termination of employment.

Non-compete restrictions in an agreement that documents a significant shareholding of a founder or key management member, particularly where they hold a stake in the ordinary shares or strip equity of the business, are more likely to continue to be enforceable for longer than three months, provided that the restrictions adhere to existing common law principles; that is, they are reasonable in time and geographical scope.

The risk for financial sponsors regarding the enforceability of non-compete restrictions in the context of equity incentive programmes is greater where grants of equity under a management incentive plan (MIP) or other long-term incentive plan (LTIP) are made to a larger number of junior employees who own a small shareholding in a business as a result of their employment. In these cases, there may be a valid argument that non-compete restrictions in the MIP or LTIP documents are within the scope of the UK proposal and so would be limited to three months. If the UK proposal goes ahead, financial sponsors will need to consider the length of non-compete restrictions in the context of equity arrangements for junior employees who receive equity grants solely as a result of their employment.

While the UK proposal is limited to employment contracts, the US proposal applies to anyone who works for an employer and there is no carve-out for equity arrangements. This means that the US proposal would capture non-compete restrictions contained in MIP or LTIP documents, irrespective of whether the employee is a founder with a significant shareholding or a junior employee who has been granted equity only as a result of their employment.

M&A transactions. In M&A transactions, it is typical for purchase agreements to contain restrictive covenants, including non-compete restrictions for non-financial sponsor sellers. These restrictions are distinct from those contained in employment agreements as their purpose is to limit the ability of a seller to dispose of an existing business and then join or establish a competing business. English courts have long accepted that restrictive covenants in purchase agreements are required to protect a buyer and acknowledge that the parties are usually regarded as having equal bargaining power (*Herbert Morris Ltd v Saxelby [1916] 1 AC 688, Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd [1894] AC 535 and Rush Hair Ltd v Gibson-Forbes and another [2016] EWHC 2589; see News brief "Restrictive covenants in commercial contracts: cutting to the chase", www.practicallaw.com/0-636-2151*).

In the UK, non-compete restrictions contained in purchase agreements are therefore typically more onerous than those contained in employment agreements, often lasting for one to two years after closing. In the US, many states similarly apply a more lenient standard to restrictive covenants that are entered into in the context of a sale of a business, rather than in an employment context, and it is typical for restrictions to apply for up to five years after closing.

In financial sponsor structures, it is common that some of the sellers are involved in the management of the target business and it is customary to structure a transaction so that these owner-managers continue in their existing role following completion. As

part of this, these owner-managers typically receive new employment agreements that contain non-compete restrictions. These non-compete restrictions would be captured by both the UK and US proposals. However, non-compete restrictions in the purchase agreement are not expected to be captured by either set of proposals.

It is anticipated that there will be good arguments that non-compete restrictions in purchase agreements are separate and distinct from those restrictions that are subject to the UK and US proposals on the basis that they typically run from the date of completion, rather than the date that the employment terminates, and are intended to protect the goodwill in the business being sold. Financial sponsors should carefully monitor how legislation and the courts address this issue.

The US proposal includes a limited exception for non-compete restrictions that are entered into in connection with the sale of a business by an owner, member or partner that holds at least a 25% ownership interest in the respective business entity. It is notable, however, that the recent legislation passed in New York, unlike the US proposal and the existing laws in California, Oklahoma, North Dakota and Minnesota, does not contain a sale of business exception (*see box "Global context"*). Business groups in New York are lobbying the governor to reject or limit the bill in various ways, including to incorporate a sale of business exception.

Immediate actions

The exact timeline of when the UK and the US proposals will come into effect is unclear. In the UK, in the absence of draft legislation, it is uncertain at this stage whether the UK proposal would have retroactive effect and, if so, how this would work, and there is no indication of how existing non-competes will be dealt with. The US proposal would apply retroactively. A vote on whether to enact it is not expected until April 2024.

As further clarity on the timeline of the UK and US proposals is awaited, it will be prudent for financial sponsors to review:

- Existing employment contracts to identify where non-compete restrictions exist and, in the UK, where their length exceeds three months.
- Existing equity documents to identify where non-compete restrictions exist and, in the UK, where their length exceeds three months.
- Purchase agreements from previous and upcoming transactions to assess how the non-compete restrictions align with restrictive covenants in new employment agreements for sellers that will be carrying on as managers.

Financial sponsors can get ahead of potential issues by reviewing existing non-compete

Global context

Non-compete restrictions have long been recognised as an important instrument for employers to protect their business interests (*see feature article "Employee restrictive covenants: enforcement, challenge and trends", www.practicallaw.com/w-024-8474*).

UK and EU position

The government estimates that approximately five million employees are subject to non-compete restrictions in the UK, where post-termination non-compete restrictions are generally enforceable only if they protect a legitimate business interest and apply no further than is reasonably necessary to protect that interest. Non-compete restrictions also need to be appropriately limited by duration and geographical scope.

Legislation governing non-compete clauses in the EU tends to be more favourable to employees. The typical approach is that, for a non-compete to be enforceable, employees need to be compensated for the post-termination period of restraint. The European Commission has also confirmed that it is looking at ways to improve the enforcement of non-poaching agreements in the employment context.

US position

The Federal Trade Commission (FTC) estimates that one-fifth of all Americans, which amounts to over 30 million people, are bound by non-compete restrictions. The FTC claims that non-compete restrictions suppress wages, hamper innovation and block entrepreneurs from starting new businesses.

Several US states have already instituted complete bans on non-compete clauses or significant limitations on their use, such as being able to stop employees from working for competitors only in capacities that are sufficiently similar to the role that they had with the former employer and requiring additional payments in the event that an employer seeks to enforce non-compete restrictions if the employee is terminated without cause. California, North Dakota and Oklahoma are among those states that have strictly forbidden post-employment non-compete clauses for many years, and Minnesota has recently joined them. New York recently passed a bill banning non-compete clauses altogether, although the governor has not yet signed the bill to make the ban effective.

In addition, the General Counsel of the National Labor Relations Board issued a memorandum on 30 May 2023 criticising the use of non-compete clauses with non-supervisory employees (*www.nlrb.gov/news-outreach/news-story/nlrb-general-counsel-issues-memo-on-non-competes-violating-the-national*).

restrictions, especially for junior employees who have been granted equity only as a result of their employment, in order to consider whether these restrictions can effectively be relied on or if they need amending.

Practical considerations

While financial sponsors can continue to rely on non-compete restrictions in employment contracts and other contractual arrangements in the usual way for now, the UK and US proposals give rise to the need to consider other options that are available to keep employees from joining a competing business shortly after they leave.

Garden leave. Many employment agreements in the UK include the ability to require an employee to stay away from work during their notice period, but to remain an employee and to honour their obligations to the employer, including not to work for anyone else. The UK proposal does not alter the rules on garden leave in the UK, meaning that employers may wish to rely on it to prevent key employees from joining competitors. This will be the most practical way in the UK to keep employees from joining a competitor for longer than three months after the termination of employment once the UK proposal is implemented.

In the US, the concept of garden leave is not common and US courts have been reluctant to enforce garden leave provisions. For example, several US courts have held that enforcing garden leave provisions requires the courts to order an employee to continue an employment relationship against their will (*Smiths Group plc v Frisbie, 2013 WL 268988, D Minn Jan 24, 2013; Bear, Stearns & Co Inc v Sharon, 550 F Supp 2d 174, 178, D Mass 2008*). Another US court has held that enforcing a garden leave provision would be fundamentally unfair to an employee's private banking clients as it would deprive them of their choice of financial adviser (*Bear Stearns & Co Inc v McCarron, 2008 WL 2016897, Mass Super Ct Suffolk Co, Mar 5, 2008*).

A US court may also view a garden leave provision as a non-compete restriction or, to the extent that the employee is relieved of all job duties, constructive discharge. Therefore, financial sponsors in the US should rely on one of the other alternatives discussed below to ensure that they are adequately protected. In addition, extending notice periods to increase the period of garden leave will result in an added expense, so ultimately this will be a balancing exercise where the cost of paying an employee on garden leave is weighed against the detriment that the business would suffer if that employee joined a competing business.

Other restrictive covenants. The UK and US proposals do not cut across or hinder other restrictive covenants, which can continue to be longer than three months. Employers should review and, where necessary, strengthen other post-employment restrictions, such as non-dealing, non-solicitation and confidentiality clauses, to ensure that these restrictions provide sufficient protection in the event that the UK and US proposals limit or eliminate non-compete restrictions. Employers must be careful when amending any such restrictive covenants to ensure that they comply with applicable laws and do not become non-compete restrictions in all but name, which may render them subject to the new rules and potentially limited in the same manner.

Forum shopping. Employers may wish to consider relying on the rules in other jurisdictions, where permitted, that provide more favourable treatment of non-compete restrictions. For example, in Germany non-compete restrictions may be enforceable for up to 24 months in return for ongoing payment, while in Italy they may extend to as long as three to five years. The choice of law analysis often depends on the underlying facts and the public policy of the forum court. The decision to forum shop requires careful consideration of, and local advice on, the wider implications of relying on the laws of a foreign jurisdiction, which may be less favourable to employers in other contexts, and the ability to enforce a restriction if it offends the public policy in the jurisdiction of enforcement. For example, certain states in the US may not necessarily honour a contractual choice of law provision of another state and may instead require the applicable law to be that of the state in which the employee works or resides.

Next steps

If passed into law, both the UK and US proposals would significantly hinder the ability of financial sponsors to protect their business interests. While waiting for clarification on when and how the reforms are implemented, financial sponsors can begin reviewing existing employment contracts, equity documents and purchase agreements to assess their current non-compete restrictions and evaluate whether these restrictions can be relied on effectively or require amending.

Employers should also consider the UK and US proposals when drafting new non-compete restrictions. Over-reliance on non-compete clauses should be avoided; instead, financial sponsors should ensure that they use the full spectrum of tools at their disposal to protect their business interests, particularly garden leave in the UK and the use of other restrictive covenants in the UK and the US.

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The UK and US proposals are at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1156211/non-compete-government-response.pdf; and www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking.

