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ANTITRUST TRADE AND PRACTICE

Transaction-Related Noncompete Agreements Face FTC Fire


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The Federal Trade Commission (FTC) has filed at least three administrative complaints in the last year challenging transaction-related noncompete agreements. These actions have important ramifications that antitrust and M&A practitioners must be aware of when drafting such agreements.

Noncompete agreements are quite common and generally enforceable so long as they are reasonable in scope and necessary to protect a legitimate business interest. Yet the FTC alleged that noncompete agreements entered into as part of three separate transactions violated the antitrust laws—namely the FTC and Clayton Acts. Of note, a senior representative at the FTC wrote that while many practitioners assume noncompete agreements are enforceable when they are ancillary to a legitimate business transaction, the FTC nonetheless will evaluate non-compete agreements to ensure they are not overly broad. The FTC's most recent challenges show that no agreements are immune from scrutiny even when a deal is closed or the transaction value is relatively small.

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'In the Matter of DTE Energy'

The first of the FTC's recent challenges to non-compete agreements was filed in August 2019 against DTE Energy, Enbridge and Nexus Gas Transmission. Complaint, In the Matter of DTE Energy, No. 1910068 (F.T.C. filed Aug. 2019). Nexus Gas Transmission, a joint venture between DTE Energy and Enbridge, sought to acquire Generation Pipeline from North Coast Gas Transmission (NCGT) and its majority stakeholders. The FTC alleged the parties' noncompete agreement substantially lessened competition in violation of the FTC and Clayton Acts but did not otherwise challenge the underlying transaction on the merits.

The noncompete agreement at issue restricted NCGT's ability to compete with the combined entity post-transaction. Specifically, the agreement prohibited NCGT from operating part of its 280-mile long natural gas pipeline in the Toledo, Ohio area. The FTC alleged that NCGT's pipeline, which spans 13 counties in Ohio, competed with Generation's 23-mile long pipeline for customers in Toledo, Ohio, including parts of Lucas, Wood and Ottawa counties. The noncompete agreement barred NCGT from competing in part of these three counties for three years following the transaction. While a three-year noncompete agreement is likely to be viewed as reasonable with respect to its duration, it must also be necessary to protect a legitimate business interest and reasonable in geographic scope.

Here, the FTC alleged that Nexus Gas Transmission was not protecting a legitimate business interest and the agreement was overly broad. The FTC argued that "a mere general desire to be free from competition is not a legitimate business interest" and the non-compete agreement did not protect any recognized business interests such as "intellectual property, goodwill, or a customer relationship." The FTC went on to say that even if the non-compete did protect a legitimate business interest, it was unreasonably broad because it restricted NCGT's ability to compete "for any opportunity" in the Toledo, Ohio area. Ultimately, the parties settled and the FTC approved a consent agreement in which the parties' agreed to eliminate the non-compete agreement. No other remedy or divestiture was required as the noncompete agreement was the FTC's only focus, and the transaction closed in September 2019.

'In the Matter of Axon Enterprise'

In January, the FTC filed a second administrative complaint regarding a noncompete—this time against Axon Enterprises and Safariland. The FTC alleged both that the transaction at issue and the non-compete and nonsolicitation agreements entered into as part of the transaction violated the antitrust laws. Complaint, In the Matter of Axon Enterprise, No. 1810162 (F.T.C. filed Jan. 3, 2020). Axon acquired VieVu from Safariland in May 2018 in a deal valued at about $7 million. The transaction was not HSR-reportable and had already closed when the FTC filed suit. Pre-merger, both parties manufactured and supplied body-worn cameras and digital evidence management systems to large, metropolitan police departments. Safariland continues to manufacture equipment for law enforcement, public safety, military and recreational markets and agreed to supply certain products to Axon post-merger.

As part of the transaction, the parties agreed to several non-compete and nonsolicitation agreements that the FTC alleged were overly broad and did not protect a legitimate business interest. The parties agreed not to solicit the other's clients for ten years and the other's employees for eleven years. The parties also agreed that Safariland would not compete for Axon's customers for ten years nor would it compete for products and services that Axon supplied and in industries where Axon was active. Safariland agreed not to engage in product lines for body-worn video, in-car video, digital evidence management and enterprise records management globally for 10 years and agreed not to compete in the industries for conducted electrical weapons, body-worn cameras, fleet or vehicle cameras, surveillance room cameras and digital evidence management globally for twelve years. In contrast to Nexus Gas Transmission's three-year noncompete agreement, the non-competes at issue here were much broader in time and geographic scope.

> Practitioners and transacting parties should draft transaction agreements carefully so that they can avoid an FTC challenge.

The FTC challenged the parties' noncompete and non-solicitation agreements alleging they were unreasonable restraints of trade. The FTC argued that customers were harmed from the lack of "potential or actual competition by Respondent Safariland." Similar to its prior complaint, the FTC alleged that the parties were not protecting a legitimate business interest as "a mere general desire to be free from competition is not a legitimate business interest." And even if there was a legitimate business interest, the FTC argued that the agreements were too long to reasonably protect such interest. In support of these arguments, the FTC quoted unhelpful language from the parties' documents, which referenced the intense price competition between the merging parties. In particular, Axon's CEO referred to the twelve-year non-compete as a "hidden jewel in the deal." The parties ultimately settled the FTC's claims regarding the noncompete and nonsolicitation agreements and agreed to eliminate the agreements at issue. The FTC's challenge to the transaction itself remains pending, and the administrative trial is scheduled to begin in October 2020.

'In the Matter of Altria Group'

Most recently, the FTC filed a complaint against Altria Group and Juul Labs (JLI) alleging the parties unlawfully agreed to restrict competition in their purchase agreement. Complaint, In the Matter of Altria Group., No. 1910075 (F.T.C. filed Apr. 1, 2020). Altria, a leading tobacco company, purchased a 35% minority stake in JLI. As part of the transaction, Altria agreed not to compete with JLI in the U.S. market for closed-system electronic cigarettes. Altria also agreed to provide a variety of support functions and license its intellectual property to JLI and appoint members to JLI's board of directors. As in Axon, the Altria/JLI transaction was not HSR-reportable, but the FTC nonetheless took issue with the transaction's non-compete agreement.

The FTC alleged that the parties' agreed-upon conduct harmed competition in violation of the Sherman, Clayton and FTC Acts. It argued that the transaction eliminated current and future competition with respect to price, innovation, and shelf space in the market for closed-system electronic cigarettes. In defining the market, the FTC argued that traditional cigarettes and open-system electronic cigarettes were not substitutable for the parties' closed-system products. The FTC further argued that Altria had no intention of exiting the market absent the transaction even though it issued a press release in which Altria said it was exiting the marketplace due to concerns that pod-based systems and non-traditional flavors could contribute to increased use by young persons. The FTC's complaint focused more on the transaction's effects as a whole and did not specifically claim that the non-compete agreement lacked a legitimate business interest or was not reasonable in time or geographic scope. The FTC's complaint was filed on April 1, and neither Altria or JLI has responded.

Moving Forward Despite FTC Scrutiny

The FTC's recent challenges show that no transaction agreements are immune from scrutiny, and all five FTC commissioners appear to agree that enforcement of noncompete agreements is necessary. The FTC is likely to continue investigating noncompete agreements even where the value of the transaction is relatively small or the transaction has already closed. The five FTC commissioners unanimously voted to issue each of the aforementioned administrative complaints, which is particularly noteworthy as the FTC commissioners have split along party lines in many other recent decisions. Their unanimity shows this is not a bipartisan issue that is likely to change based on a change of administration. A FTC senior representative provided the following guidance to parties' seeking to avoid an FTC challenge: "In considering the scope of these types of restrictions, consider what you are trying to protect or guard against, why you need that protection, and the scope of the protection you actually need (as opposed to want), given the value invested in the transaction."

As with any noncompete agreement, the parties must be able to show that it is reasonable in scope. The FTC did not challenge the duration of the parties' noncompete agreement in DTE Energy, suggesting that a three-year noncompete is likely to be reasonable so long as it also reasonably (and minimally) restricts competition within a geographic and product market. In all of the complaints addressed above, competition was restricted absolutely within the FTC's defined market. While parties can challenge the FTC's market definition, they should endeavor to limit competition only in products or geographic areas where absolutely necessary. And it would help if the parties face aggressive or numerous competitors in the areas where they agree to restrict competition, which would limit the likelihood of anticompetitive effects and FTC scrutiny.

Parties should also be sure to document the legitimate business interest for their noncompete agreements. In Altria, the FTC alleged that the parties could not show "the transaction resulted in cognizable efficiencies sufficient to outweigh the competitive harm caused by Altria's agreement to exit the relevant market." It also noted in the Axon complaint that the parties could not demonstrate efficiencies that would offset the transaction's anticompetitive effect. And the case was further complicated by evidence from Axon's president that Axon did not consider potential efficiencies in evaluating the transaction. If the parties' documents show that an agreed-upon noncompete is necessary to realize cognizable efficiencies, they may be able to show a legitimate business interest that alleviates the FTC's concerns. And even where cognizable synergies cannot be proven, it is important that parties' documents do not suggest an unlawful or anticompetitive reason for having a non-compete agreement.

We have seen aggressive antitrust enforcement in recent years and the FTC's scrutiny of noncompete agreements is likely to continue. In approving the DTE Energy consent order, Commissioner Wilson wrote in concurrence, "the commission will continue to scrutinize non-compete agreements to ensure that they are no broader than necessary to protect the legitimate interests of the parties." Commissioners Chopra and Slaughter more emphatically argued in a joint concurrence that "too many firms impose noncompete clauses to avoid the discipline of a functioning marketplace," and "the FTC should always be skeptical of non-compete agreements that unnecessarily suppress competition." As such, practitioners and transacting parties should draft transaction agreements carefully so that they can avoid an FTC challenge.