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FTC Proposed Ban on Non-Competes Includes M&A Exception Comparable to California Law

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On January 5, 2023, the Federal Trade Commission ("FTC") announced a proposed regulation (the "Proposed Rule") that would ban non-compete agreements imposed against workers by employers. The Proposed Rule includes a narrow sale-of-business exception (the "Proposed Exception") that would permit a non-compete clause to be enforceable against persons holding at least a 25% ownership interest in the business entity involved in a transaction. This article discusses the Proposed Exception and compares the Proposed Exception to a similar state law exception in California for sales of businesses with regard to the enforceability of non-compete clauses. For a general discussion of the Proposed Rule by this Firm, please see here.

What Does the Proposed Exception Cover?

The Proposed Exception provides that the ban on non-compete covenants against workers would not apply to a non-compete clause 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 "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." Proposed Rule § 910.3. The Propose Rule further defines "substantial owner, substantial member, and substantial partner" to mean "an owner, member, or partner holding at least a 25 percent ownership interest in a business entity." Proposed Rule § 910.1(e).

The Notice of Proposed Rule-Making ("the Notice") explains that the Proposed Exception would only apply narrowly in the circumstances where "the seller's stake in the business is large enough that a non-compete clause may be necessary to protect the value of the business acquired by the buyer." The Notice notes that most states also treat non-compete clauses arising out of sale-of-business scenarios differently from those arising solely out of employment for the same reason. For example, each of California, North Dakota, and Oklahoma, where non-compete clauses are generally unenforceable, exempts non-compete clauses arising out of sale-of-business scenarios from their respective general rule.

The Notice further explains the proposed threshold of 25% ownership represents an appropriate balance between a threshold that may be too high or too low. For instance, when a few entrepreneurs sharing ownership of a startup sell their business, the FTC believes it is appropriate for the buyer to obtain non-compete commitments to protect the value of the goodwill of the business being sold. In such a scenario, a threshold of 51%, for example, may be too high. On the other hand, the FTC believes that the

exception should not be available when the ownership interest is minimal, for example, where a worker with a small amount of company stock sells stock back to the company as part of a stock redemption agreement when the worker's employment ends. We often see such arrangements in the context of employee incentive arrangements (other than for California-based employees) and these arrangements may not, in the view of the FTC, represent a significant enough ownership interest to permit the imposition of a non-compete covenant against a departing employee. The Notice asserts that using a defined numerical threshold, as opposed to using a term such as "substantial" owner, would "provide greater clarity to the public and facilitate compliance with the [Proposed] Rule."

What Exceptions Does California Have to its Ban on Non-Competes?

California has long prohibited the enforcement of non-compete covenants by statute. Cal. Bus. & Prof. Code § 16600. However, the statute carves out three exceptions under which a non-compete clause can be enforced (collectively, the "California Exception"):

1. one who sells the goodwill of a business, or any owner of a business entity selling all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified geographic area, so long as the buyer carries on a like business therein;

2. upon dissolution of a partnership or dissociation of a partner, such partner may agree not to carry on a similar business within a specified geographic area where the partnership business has been transacted, if the remaining partners or anyone deriving title to the business or its goodwill carry on a like business therein; and

3. a member may, upon dissolution of, or the termination of his or her interest in a limited liability company ("LLC") agree not to carry on a similar business within a specified geographic area where the LLC business has been transacted, so long as other members or anyone deriving title to the business or its goodwill carries on a like business therein. Cal. Bus. & Prof. Code §§ 16601, 16602, and 16602.5.

Specifically for the first exception, the California statute broadly defines "ownership interest" as "a partnership interest" in the case of a partnership, "a membership interest" in the case of an LLC, or a "capital stockholder" in the case of a corporation. Cal. Bus. & Prof. Code § 16601. Moreover, in relation to goodwill, California courts have pointed out that the rationale of allowing a non-compete clause in connection with a sale of a business is to prevent the seller from depriving the buyer of the full value of its acquisition, including "the sold company's 'goodwill,'" which is the "expectation of that patronage which has become an asset of the business." *NewLife Sciences, LLC v. Weinstock*, 197 Cal. App. 4th 676, 128 Cal. Rptr. 3d 538 (2011). California courts have held that, because the California Exception's purpose is to protect the buyer's interest in preserving the goodwill of the acquired corporation, the geographic scope of a noncompetition covenant must be limited to the area where the sold company carried on its business. *Strategix, Ltd. v. Infocrossing West, Inc.*, 142 Cal. App. 4th 1068, 48 Cal. Rptr. 3d 614 (2006).

How Does the Proposed Exception Compare to the California Exception?

Compared to the Proposed Exception, the California Exception is in some way broader. The Proposed Exception only applies to non-compete clauses in connection with the sale of a business by a seller who holds at least a 25% ownership interest in the business and is also selling *all* of their ownership interests, or *all* or *substantially all* of the business's assets. However, the California Exception does not have a 25% ownership threshold for a seller to qualify for the exception, and the lack of such ownership threshold often results in buyers seeking to extract non-compete obligations from a broader set of owners. In addition, the California Exception allows for a non-compete covenant when one sells the goodwill of a business, in addition to selling all its ownership interests or assets, which, as recognized by California courts, constitutes part of the full value of the acquisition. See *NewLife Sciences, LLC*, 197 Cal. App. 4th 676, 128 Cal. Rptr. 3d 538 (2011). The California Exception also allows for a non-compete covenant in the context of a dissolution of a partnership or LLC, or the disassociation of a partner or termination of a membership interest in an LLC, in each case when the other members or partners carry on the business of the partnership or LLC. This exception is frequently relied on in California, notably in the healthcare industry (for example, when a professional medical corporation buys out individual or groups of physicians), and is not reflected in the Proposed Exception.

Notably, the California Exception requires non-compete clauses to be limited in geographical area and scope of activity whereas the Proposed Exception delineates no such limitations. While both the Proposed Exception and California Exception are intended to preserve the value of a business being sold, we note that the minimum ownership threshold in the Proposed Exception would result in situations where buyers will have no practical way to restrict employees holding small ownership percentages who are nevertheless closely associated with the brand and goodwill of the business from competing with the business being sold. That is, goodwill associated with a particular employee may not be proportional to ownership percentage. With venture capital backed companies, it is not unusual that a founder would have given away a large percentage of ownership of a business—falling below the 25% threshold—in order to raise capital and incentivize others, but may continue working with the business and be closely associated with the goodwill of the business. The Proposed Exception does not appear to provide a path to use a non-compete in this instance.

The Proposed Rule, if adopted, would supersede any state statute, regulation, order, or interpretation to the extent that such statute, regulation, order, or interpretation is inconsistent with the Proposed Rule. However, the FTC also notes that greater protections at the state level would not be deemed as inconsistent and thus, would be applied. Therefore, non-compete clauses covered by the Proposed Exception would remain subject to federal antitrust law (see here for a detailed discussion), and other applicable state laws. Proposed Rule § 910.3. In the case of California, the Proposed Exception effectively means the sale-of-business exception will no longer provide a legal basis to restrict post-sale conduct of <25% equity holders, while keeping in place other California statutory and judicially-imposed limitations regarding duration, geographic scope and scope of covered conduct. Moreover, the Proposed Rule seems likely to render useless the separate exception under California law for non-compete provisions in partnership and limited liability company agreements that apply after a partner or member ceases to own an equity stake.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:

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