Noncompete Ban: What Every Estate Planner Must Know About the FTCs New Rule and Its Impact on Estate and Succession Planning

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Noncompete Ban: What Every Estate Planner Must Know About the FTCs New Rule and Its Impact on Estate and Succession Planning

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What's The New FTC Rule

And Why Must Estate Planners Care?

Rationale, Who is Affected

- The Federal Trade Commission (FTC) estimates that about 18%, or 30 million, “workers” in the United States are subject to non-competition provisions that inhibit their taking new employment or starting their own businesses.
- It appears that such restrictions among non-highly compensated workers were widespread. Many organizations incorporated non-compete and other restrictions as standard clauses in employment and other agreements with even mid-level employees who likely had no legal representation in negotiating those agreements and may have merely signed them agreeing to restrictions without any meaningful understanding as to the potential impact on them.
- Noncompetes restrict competition, that’s bad for employees, the economy, and everyone except perhaps the business seeking the restriction.

Noncompete Agreement Ban Impacts Estate Planning

- The Federal Trade Commission (FTC) has issued a new Rule prohibiting noncompete agreements.
- It is effective 120 days after publication in the Federal Register, about September 2024.
- The rule has a far-reaching impact on estate planning. The ramifications of how small, closely held, and family businesses that have used noncompete provisions, non-solicitation, and nondisclosure agreements will now address protecting themselves and retaining key employees and contracts must change.
- The valuation of companies may be significantly affected.
- For some family and closely held businesses, the impact of succession planning could be dramatic. The family business may no longer be able to rely on restrictive provisions to retain key employees necessary to the business's future success and succession to younger family members.

Scope is Broad

- The final regulations generally prohibit non-competition agreements that prohibit or have the effect of inhibiting certain independent contractors, current and former employees, and others from competing with a former employer or contracting party.
- The new regulations are very far-reaching, and except for certain "senior executives" (a very narrow group, such as the company's president) and certain other limited exceptions, prohibit entering into or enforcing a non-competition provision even if entered before the effective date of the new regulations.
- The fact that a noncompete was specifically negotiated and paid for is irrelevant.
- New notice requirements have been enacted. Employers must advise those who otherwise could be covered by non-competition provisions that they are no longer bound by them.

An Easy Read (Not!)

- The regulation itself and the commentary provided by the FTC comprise 560 pages. See https://www.ftc.gov/system/files/ftc_gov/pdf/noncompete-rule.pdf

Immediate Action Required

Employers Must Act Now

Immediate Action Required

- Employers cannot wait for the effective date to act.
- Employers must comply with the new notice requirement to inform all workers who are no longer subject to the restrictions previously imposed on them. This must be done by the effective date of the Rule.
- Employers must analyze and determine what they can do to protect themselves from current or former workers working for the company's competitors.
- Employees who qualify as "senior executives," it may still be possible to implement restrictive agreements before the new rule's effective date. This should be evaluated immediately as noncompete restrictions cannot be implemented for anyone after the effective date (except for a limited exception on the sale of a business discussed later).

What is a Noncompete?

Its Vague, Broad, and Nettlesome

Noncompete General Definition

- A non-compete agreement restricts future employment or economic penalties for accepting other employment. It may, for example, be incorporated into an employment agreement that an employee signs to accept employment by an employer. The restrictions in these agreements limit or prohibit the employee from accepting new employment other than with the current employer or starting a competing business.

Broad or Limited Noncompete

- These types of contracts can be limited or very broad.
- For example, an employee may be restricted from accepting employment with a competitor in the same industry within 50 miles of the business location of the current employer for one year after leaving the current employer for any reason.
- Others, by their terms, are unlimited in time and distance. For example, an employee could be broadly restricted from competing in the industry throughout the continental U.S. for ten years or longer after employment terminates for any reason.
- Other than the exception for senior executives or a sale of a business it will no longer matter how broad or narrow a noncompete is, it is banned.

FTC Definition

- *"Non-compete clause means:*
- *(1) A term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from:*
- *(i) seeking or accepting work in the United States with a different person where such work would begin after the conclusion of the employment that includes the term or condition; or*
- *(ii) operating a business in the United States after the conclusion of the employment that includes the term or condition.*
- *(2) For the purposes of this part 910, term or condition of employment includes, but is not limited to, a contractual term or workplace policy, whether written or oral."*

FTC Rule Can Encompass NDAs and Non-Solicitation Agreements

- Restrictions on an employee's ability to disclose or use confidential information relating to their employment might be so broad and restrictive that they could make it difficult for such an employee to secure employment elsewhere. Similarly, non-solicitation agreements may inhibit competing with the former employer. Thus, banning non-compete agreements is even broader than just non-compete provisions. The FTC pronouncement clarifies that other contractual arrangements with a similar effect as a noncompete are also prohibited. Consider the practical implications of this broad definition on employers evaluating large numbers of past employment and independent contractor agreements to identify which have restrictions that will require compliance with the notification provisions.
- The Rule also prohibits "*…an agreement that extinguishes a person's obligation to provide promised compensation or to pay benefits due to a worker seeking or accepting other work or starting a business after they leave their job. One example of such an agreement is a forfeiture-for-competition*

FTC Rule Can Encompass Forfeiture Arrangements

- The Rule also prohibits "…*an agreement that extinguishes a person's obligation to provide promised compensation or to pay benefits due to a worker seeking or accepting other work or starting a business after they leave their job. One example of such an agreement is a forfeiture-for-competition clause…imposes adverse financial consequences on a former employee as a result of the termination of an employment relationship, expressly conditioned on the employee seeking or accepting other work or starting a business…*"

Example: Family Business Succession

FTC Rule May Dramatically Impact Some

Impact on Family Business Succession Planning Case Study

- **Example**: A family manufacturing business begins planning its succession and estate planning in mid-2025. Anticipating the reduction in the estate tax exemption, the founder of the business wants to make gifts of business interests into an irrevocable trust to avoid future estate taxes that could undermine his or her ability to bequeath the business to his or her children and grandchildren.
- As part of that estate tax planning process, the estate planning attorney recommends that the client formulate a business succession plan. That is vital, as merely avoiding estate taxes if no management succession plan is in place, is unlikely to facilitate the business's survival.
- Two of the founder’s four children and one grandchild work in the business. The founder does not feel that the children are ready to run the business and believes that two key employees can help transition the business to the children and serve the long-term needs of the business when the current owner, as the founder, retires, dies or is incapacitated.

Impact on Family Business Succession Planning Case Study

- He suggests that the key employees be offered more generous employment agreements, bonus arrangements, and profit sharing if they commit to remain with the business following the death, disability, or retirement of the founder. Specifically, the owner would like to entice and bind the key employees to remain with the company for at least five years after the owner has to cease involvement to help two children in the business mature and gain business acumen.
- The Founder is more than willing to offer what he or she believes is an above-market compensation package for the security of knowing he or she can secure the business transition.
- But if the key employees assume this role, the owner needs to provide them with extra training and access to critical confidential information.

Impact on Family Business Succession Planning Case Study

- The owner requests that the attorney include a non-disclosure agreement (NDA) and non-compete provisions so that once that extra training and confidential information is provided, neither of the two key employees can use that information to set up a competing business, thereby undermining the company and hopes to transition it to the next generation.
- In the past, the key employees would have hired their own attorney to review and negotiate bargained-for employment agreements. That would have been a good deal for everyone.
- However, the attorney informs that noncomplete agreements, and possibly even the nondisclosure provisions, may not be enforceable because of the new FTC rule. So now the dilemma is how can the founder and employees, all of whom want to enter into a deal to benefit everyone, secure the arrangement for the founder and the business? It may not be possible.

Impact on Family Business Succession Planning Case Study

- Although it might be that highly compensated executives with independent legal representation should be able to negotiate to receive generously pay packages in exchange for agreeing not to compete, it appears that the freedom to contract, even in such circumstances, is no longer allowed.
- Business succession planning, perhaps the key component of an estate plan for many family businesses, will be more difficult to achieve.
- While providing some equity to the key employees and leveraging the restrictions based on their equity sale may be feasible, it is unclear whether that exception (discussed below) will suffice.
- Might nondisclosure agreements, non-solicitation agreements and a future incentive compensation package provide some protection?
- But will those provisions in aggregate have the affect of a noncompete and hence themselves be unenforceable?

Exception For Senior Executives

Must be In Force Before Effective Date

Who is a Senior Executives

- The FTC estimates fewer than 1% of employees are in this category.
- This exception is only for agreements in force before the effective date so businesses that wish to bind key persons must do so immediately.
- The FTC defines "senior executive" as employees earning more than $151,164 in a "policy-making position." A "*Policy-making position means a business entity's president, chief executive officer or the equivalent, any other officer of a business entity who has policy-making authority, or any other natural person who has policy-making authority for the business entity similar to an officer with policy-making authority. An officer of a subsidiary or affiliate of a business entity that is part of a common enterprise who has policy-making authority for the common enterprise may be deemed to have a policy-making position for purposes of this paragraph. A natural person who does not have policy-making authority over a common enterprise may not be deemed to have a policy-making position even if the person has policy-making authority over a subsidiary or affiliate of a business entity that is part of the common enterprise*." that the business may have tried to restrict to protect itself.

What is the policy-making authority?

- *“Policy-making authority means final authority to make policy decisions that control significant aspects of a business entity or common enterprise and does not include authority limited to advising or exerting influence over such policy decisions or having final authority to make policy decisions for only a subsidiary of or affiliate of a common enterprise*.”
- These definitions are vague which may make determining the status of an employee as being a senior executive difficult. But also, the nature of the definition could exclude important key persons.

Can Non-disclosure, Non-Solicitation, and Deferred Compensation Substitute For the Now Prohibited Noncompete?

Maybe!

NDAs and Non-Solicitation Agreements Can Still be Valid, But…

- The FTC's new rules restricting or prohibiting noncompete agreements do not expressly prohibit employee non-solicitation arrangements, confidentiality or non-disclosure arrangements, or customer non-solicitation arrangements.
- But, the new rules state that other forms of restrictive covenants, such as the above, are prohibited **if the functional effect is the same as a non-compete** provision.
- A non-disclosure arrangement or non-solicitation agreement can function similarly to a non-compete if these ancillary arrangements encompass such a broad amount of data that they serve to restrict employees from other employment or starting a business after terminating their employment with the current employer. If they serve to prevent a worker from working for another employer in the same industry, they are analogous to a prohibited non-compete agreement and are, therefore, also restricted. So, recasting a non-compete agreement as other types of restrictions will not permit avoiding the new rules.

Use Other Restrictions Judiciously

- The new Rule could be problematic for closely held and family businesses. Non-completes will be eliminated, which may have been the most important restriction. The business may be able to use non-solicitation and confidentiality restrictions to some extent, but those will have less teeth than in the past. There may be deferred compensation structures that do not pay out and may be tied to the company's performance to give the current company a position to succeed.
- Thus, restrictions are still permissible, but to be permissible a non-disclosure or non-solicitation restriction would have to pass muster under the above standard. It could not penalize a worker for seeking or accepting other work or starting a business after they leave their job. This will be a facts and circumstances test that will have to be evaluated carefully. These restrictions to be permissible could not "function similarly to non-competes." To be valid these restrictions could not "constitute an unfair method of competition." Restrictions could not "prevent a worker from seeking or accepting other work or starting a business after they leave their job."

Structuring NDAs and NSAs Post Rule

- A limit against calling named customers may be safer than prohibiting the calling of any client of the former employer. There should also be a time frame, e.g. five years or whatever is appropriate to the particular situation. Likely, the more tailored the non-disclosure and non-solicitation restriction the more likely it will pass muster under the new Rule.
- Proprietary information from the company, copyrighted materials, etc., should still be able to be restricted. The FTC is concerned that it is not a level playing field. But if it is sufficiently narrow, these other types of restrictions are allowed.
- The final rule will not prevent adopting garden-variety NDAs, but it will prevent overbroad NDAs that seek to prevent an employee from accepting business. That may mean you cannot disclose proprietary information but can go to customers of former employers. Is soliciting a former customer disclosing confidential information? All of this is a fact-specific inquiry.

Structuring NDAs and NSAs Post Rule

- The FTC may consider the particular industry and the actual geographic area. For example, if the prior employer was in a rural area and most potential customers used that prior employer, the restriction could be tantamount to a non-compete as it might prevent the restricted employee from finding any later employment.
- Note that the FTC was concerned about the burdens the employer is putting on the employee, and that must be considered. The FTC may well enforce the Rule to send a message to employers not to try to circumvent the Rule by using redesigned non-disclosures and non-solicitations to accomplish a similar result to a noncompete.
- Clearly, any restrictions will require more thought and effort to ensure that they do not arise to the level of a functional noncompete. A critical issue is where the FTC will draw the line.

Impact of Violation; Drafting Tip

- But what if the line is crossed and the other restriction is improper? Some argue that that will not give rise to a private cause of action. The FTC can pursue an injunction or fines.
- Practitioners might consider crafting savings language, that if a new restriction is overly broad such that it violates the Rule it will be constrained so that it does not. However, savings language may not avoid a violation the FTC may still penalize.

Family Dynamics

New Considerations

New Considerations about Hiring Family Post FTC Rule

- The prevalence of sibling rivalries and other negative family dynamics is well known. What will the impact of the new ban on noncompete agreements and other restrictions be on the dysfunctional family business client? Suppose nondisclosure and non-solicitation restrictions cannot be enforced. Might some family businesses have to evaluate differently whether a particular family member or in-law should even be permitted to join the business? Might the family dispute with parties unbound by restrictions motivate a disgruntled family member to leave and set up a competing business, whereas in the past, they could not have?

Sale of Business Exception

May Not Provide Broad Exception

Sale of Business Exception

- If an employee sells their business interests in a real bona fide sale, the restrictions on noncomplete agreements will not apply. Perhaps the concept is that if you are receiving a fair or bona fide price for your business interests, restricting you from competing is part of the price you pay to get that buyout. This exception can also apply if there is a sale of all or substantially all of a business entity's operating assets.
- Initially, the proposed FTC exception for certain non-competes between a business's seller and buyer applied only to a substantial owner with at least 25% ownership interest in the business entity being sold. Based on comments, the Commission adopted an exception for the bona fide sale of a business without requiring that the seller have at least a 25% ownership interest. Section 910.3(a): "Exception for Persons Selling a Business Entity."

Sale of Business Exception

- 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. This concept may make it difficult to structure an employee to have equity used to justify imposing a non-compete. With the elimination of the 25% equity requirement, is there any de minimus amount that is too small to support a non-compete? Would non-voting equity interests suffice?
- The FTC considers a bona fide sale to be 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. So-called "springing" non-competes and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale because, in each case, the worker has no goodwill that they are exchanging for the non-compete or knowledge of or ability to negotiate the terms or conditions of the sale at the time.

Notice Requirements

Act Now

Requirement to Notify Employees

- The FTC enacted comprehensive informational requirements to ensure that their employers notify affected employees of the new rules and that non-competes are no longer enforceable.
- This requirement could create a substantial administrative burden that must be complied with by the effective date of the legislation.
- The employee who entered into a non-compete arrangement must be given "clear and conspicuous notice" that the non-compete arrangement will not be, and cannot be, enforced.
- The notice the employer must give must: (1) identify the employee who entered into the non-compete arrangement; (2) be written and hand-delivered to the employee, or by mail at the employee's last known personal street address, or by email to the employee's current work email address or last known personal email address, or by text message at the employee's cellular telephone number.

Requirement to Notify Employees

- The FTC has provided sample language employers should probably track in their notice to assure compliance.
- Make a list of all persons who might be covered by non-compete provisions, including certain independent contractors. Second, err on the side of caution by advising virtually every former employee (which may include an independent contractor) that any non-competition that applies or might apply to him or her cannot and will not be enforced.
- Consider the practical implications of the notice requirement. There does not appear to be any time restriction. So if a business had boilerplate noncompete provisions that lasted for a long duration, that business may have to go through decades of historical records to identify potentially affected employees and independent contractors.

Which Agreements Require Notice?

- Must identify not only noncomplete arrangements, but also non-disclosure, non-solicitation, and other restrictions.
- Consider that noncompete agreements may not be labeled prominently as such in a contract. Once agreements that contain provisions that may not be prohibited are identified, the employee's status as a senior executive, or not, will have to be ascertained.
- Might this then require a review of every agreement by counsel?
- As an alternative, should a broad brush approach of notifying any former employer or consultant/contractor be taken?

Mechanics of Identifying Affected Employees

- Another aspect of the notice requirement will include the process the employer must go through. Are all historic personnel records digitized? If digitized, have they been OCRd so that they can be searched, or must that be undertaken first to facilitate keyword searches of older historical documents? What if the employer has not digitized all historic employment records? Will old paper files have to be manually reviewed? It would seem so. How will the employer’s document retention policy affect this process? If old contracts past some date have been destroyed, there may be no means to identify agreements before that date. It would seem that whatever is done, employers should consider documenting the process they go through to demonstrate reasonableness in their efforts to comply with the new rule.

Consequences of Not Complying with FTC Regulations

Penalties and More

Consequences of Not Complying with FTC Regulations

- Undoubtedly, some companies will not advise their former employees that they are no longer bound by the restrictive non-compete provisions that have applied to them. Moreover, some companies may threaten to enforce them, causing former and current employees not to take action for the company's failure to comply with the new regulations. A company may do so if it acts in good faith.
- However, failure to comply with FTC requirements can be costly. The FTC has the authority to impose fines on companies that do not comply with its rules. In addition, the FTC can seek an injunction forcing a company to comply. The company may suffer civil penalties and have reputation losses as well. But, certainly, some will not voluntarily comply. Some have already sought to prevent the regulations from taking effect.

Professional Practices

Significant Impact

Consideration for Professional Practices

- The American Bar Association in Model Rule 5.6 prohibits lawyers from enforcing a non-compete except in connection with retirement.
- "*Rule 5.6: Restrictions on Right to Practice*
- *Share: Law Firms And Associations*
- *A lawyer shall not participate in offering or making:*
- *(a) a partnership, shareholders, operating, employment, or other similar type of agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement; or*
- *(b) an agreement in which a restriction on the lawyer's right to practice is part of the settlement of a client controversy.*"
- Lawyers cannot generally be bound by a noncompete even before the new Rule.

Consideration for Professional Practices

- The non-compete restrictions are new for other professional practices and will have a broad impact. CPA and brokerage firms that have limited competition, such as trying to prevent practitioners that leave from contacting prior clients of the firm they left, may no longer be able to be restricted.
- Professional practices will have to consider the impact of the FTC rule.
- In many CPA firms, if a partner retires and has to sell equity back in the firm, will that permit the attachment of a non-compete? But is that equivalent of equity and the sale of a business? Will those non-competes be upheld? What about the position of a non-equity partner in a professional practice? No non-compete should apply to that position as there is no equity to sell to support the exception to the non-compete. Will some of those characterized as a "partner" really be treated as mere employees for the purposes of the rule, thereby prohibiting the application of the sale of equity exception? For owners who are functionally like employees, even if they have some control and equity, the term "worker" may encompass them, and the restrictions on non-competes will apply.

Conclusion and Additional Information

Sub-Title

Conclusion

- While the FTC's restrictions or prohibition on the use of non-compete, non-disclosure, and non-solicitation agreements certainly will help many employees, the impact on many closely held and family businesses could be negative and dramatic. In particular, business owners must evaluate how these new rules may adversely affect succession planning. Consideration should be given to how these new rules will affect the valuation of companies for tax and non-tax purposes.
- Practitioners should consider notifying clients of these rules, especially the importance of acting before the effective date as to senior executives and notice requirements.
- Practitioners will have to grapple with the impact of these rules on their own practices.
- Finally, practitioners will now have to juggle pre-2026 estate planning, CTA compliance, recently issued GST regs, FTC rule and more!

Additional information

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