***Private Equity Pathways* - Navigating Restrictive Covenants in Private Equity**
Speakers: Nick Stawasz and Tracey Diamond
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Nick Stawasz:

Hi. Welcome to our *PE Pathways* podcast series where experienced deal makers share their thoughts on current private equity and M&A trends and developments. Today we are going to discuss restrictive covenant agreements. My name is Nick Stawasz, a partner in the Private Equity group, and I'm joined by my fellow partner from our Labor & Employment practice and podcast veteran Tracey Diamond.

Tracey Diamond:

Nice to see you, Nick, and to hear your voice and thank you for having me join you today. Just as a quick plug, in addition to my labor and employment practice, I am the co-host of the podcast Hiring to Firing where we take TV shows and movies and use them as jumping off points to talk about HR and employment law issues. So check us out anywhere you get your podcasts. But anyway, let's talk about PE and restrictive covenant agreements.

Nick Stawasz:

Tracey, thank you for joining me today. So I want to start off talking about the recent proposed FTC rule that did not go into effect and with that rule not going into effect. Does that mean employers can be more aggressive with the terms they're seeking in non-competes and other restrictive covenants?

Tracey Diamond:

The short answer to that is no, that it's not just business as usual because the FTC ban didn't go into effect, although it is sort of business as usual because business as usual meant before the FTC rule was being contemplated that there were all sorts of other state law considerations. Before I get to that though, I just want to mention in light of the election and the new administration coming in, I do think that the FTC ban itself is probably dead in the water. Although it may not be the end of the FTC's interest in this, I think it is probably less likely. Don't you agree, Nick?

Nick Stawasz:

I think so on this particular issue, although I think still possibility remains that the FTC may pursue individual enforcement actions or perhaps another government agency might as well. I think the other consideration too for our clients to be mindful of is certainly this FTC proposed rule got a lot of press and publicity and raised awareness amongst employees and perhaps

plaintiffs counsel for employees. So those employees may be more inclined to bring their own individual claims than perhaps they would've been before.

Tracey Diamond:

It's such an interesting context right now because after the US Supreme Court decision last year combined with more company-friendly administration coming in the U.S. Supreme Court decision than I'm talking about not giving Chevron deference to agency decisions anymore. I do think that agencies in general are going to have a harder time putting these regulations in place, but that doesn't mean that it's just have every employee sign a restricted covenant agreement because the states are all over the place when it comes to statutes and common law restrictions on restrictive covenants. So really important to know the states in which you are doing business and whether or not there are any restrictions under state law.

Nick Stawasz:

I'd like to talk about that a little bit Tracey if we can because I think so many companies these days are operating in a number of different states. Certainly the pandemic increased the potential for employers to hire a lot of remote workers from states that maybe they were not hiring before. And with the prevalence of four restrictive covenant agreements being used by employers, does state law vary with respect to those restrictive covenants or are there any particularities that employers should be mindful of as they are hiring employees across the country?

Tracey Diamond:

Yeah, this is not an area where it's a one-size-fits-all solution anymore by far. And employers that are still using sort of old templates and having every employee sign the same restrictive covenant agreement likely are violating state law. So really important that you dust off those agreements and take a hard look at the state laws in which you're doing business and the state laws range all over the place. So on one extreme, we see currently four states where non-compete provisions are completely banned. Those are California, Oklahoma, North Dakota and Minnesota. On the opposite side of the spectrum, we see states where it's a little bit more on the employer-friendly side. Florida is a good example of that where the burden of proof is on the employee to show that the restrictive covenant agreement shouldn't be enforced rather than the burden as it is in so many other states being on the employer to show that the restrictive covenant agreement should be enforced.

And then there's all sorts of states in the middle and various different ways that the states have found to tackle this issue. One example is Massachusetts. In Massachusetts there's limitations on which employees can sign and under what circumstances you can enforce those agreements, but it's also requires by state statute that an employer provide either garden leave or some other mutually agreed upon consideration if they're going to enforce the non-compete. Then there's these other categories of states, Illinois and Colorado are good examples of them where there are salary thresholds. So you can only have employees that are earning over a certain amount of money per year, sign a non-compete agreement, and you also have to provide advanced notice, in Colorado, the notice has to actually be in a separate document and it includes some specific language.

Really it runs the gamut and you really need to know your states and know where your employees are sitting and what the state laws are that are applicable to it. Given all that, Nick, since we have the FTC sort of in the background, we have the NLRB also sort of in the background making noise about restrictive covenants and then we have all these different state laws and non-competes. What about the sale of a business? Is that an exception to sort of this general concern about whether or not a restrictive covenant agreement would be enforceable against an employee?

Nick Stawasz:

So the answer to that is yes and no. Any type of non-compete entered into in the connection with the sale of the business, it still to be reasonable both in terms of its scope and its duration and it needs to have a legitimate reason, purpose for existing. So I think we typically see up to a five-year non-compete.

Tracey Diamond:

Which is way bigger than what you'll see in the normal employment context where you normally will see one to two years at most.

Nick Stawasz:

Post-employment. Correct? Yes. So depending upon the duration of an employee's employment, if any a non-compete entered into a connection with a sale of a business could go on for longer, potentially significantly longer. Oftentimes we'll see those non-competes. The duration of them vary depending upon the individual and the proceeds they're receiving in connection with the sale. But again, they also need to be reasonable in terms of their scope and what they are covering. It generally is viewed as being reasonable if it's limited to the business being acquired at the time of closing. So, you are looking at the business that is being acquired, not your business to the extent it differs, not what happens after the fact, but rather what are you acquiring at that point in time. And as part of that, where is that business operating?

If they are not operating in 40 of the 50 states, then arguably by extending it to those additional states where they're not operating, the enforceability of that restrictive covenant agreement is going to be put into question and more subject to challenge. So we're talking reasonableness in terms of the restrictions you're imposing on them in terms of what they can do, where they can do it, and for how long a particular individual cannot engage in that activity.

Tracey Diamond:

And that's one area where the regular sort of basic we should have covenant agreement in the employment context differs a little bit too. So while it's that same sort of concept of it needs to be reasonable in terms of time and place, what we're seeing in more and more states is the concept of reasonableness being interpreted to mean only the type of work that the employee did for the company as opposed to not working for a competitor in any capacity. And oftentimes we'll hear the example of, well, this non-compete is overbroad because you're not allowing this employee to work even as a janitor in the competing business as opposed to limiting it to the

type of work they did for their employer. Whereas what you're saying, Nick, is in the sale of the business that you really have to know what the businesses that you're acquiring and make sure that it's limited to the acquiring business, not to the business that you may have been doing previously. Right?

Nick Stawasz:

That's correct, Tracey. And I think the risk too is if it's subject to challenge and it goes before a court, that court might instead of blue penciling that provision to make it compliant with the law may just throw out the entire agreement and the entire restrictions. And so that particular buyer in that instance, an employer doesn't get the protection they initially sought because it was so broad, the court just ultimately said, we're throwing this whole provision out rather than limiting it to what would be enforceable.

Tracey Diamond:

Yeah, I'm glad you brought that up because I'm also seeing the blue pencil rule in some states being interpreted itself very narrowly where a court will delete language but will not add to language. So if the agreement isn't word smithed in a way where it would allow the court to delete certain words in order to make the covenant more narrow and therefore enforceable in the court's mind, the court will, like we just said throughout the entire agreement rather than blue pencil it.

Nick Stawasz:

I think another consideration too, we're dealing with these types of non-competes is the location of them. So for instance, you wouldn't want to place these non-competes in the employment agreement, rather you'd ideally have it in the purchase agreement or in a separate agreement that makes reference to the purchase agreement and the consideration being provided on account of the purchase agreement. To tie them together, you really need to make sure that these restrictive covenants, whatever context they're in, employment sale of the business are very distinct and it's clear in what setting that particular individual is entering into that particular agreement.

Tracey Diamond:

In the absence of a business sale non-compete, and with all of these ever-changing laws around employment non-competes, what are some ways do you think that an employer can protect itself against former employees competing against them?

Nick Stawasz:

I think there's a number of different avenues that an employer can go through to get that coverage. Certainly non-solicitation provisions are one way, both non-solicitation of employees to prevent an individual from luring key employees away from the business or non-solicitation of customers, so leaving the business and then going after your customers and taking them away and thereby harming the business. Now, in doing so, one needs to be mindful of state laws. For

instance, in California, non-solicitation provision of a customer would be illegal and unenforceable, but nevertheless, that is one avenue, certainly confidentiality provisions to the extent you have a strong NDA in place to limit what an individual can do with that confidential information, and there are other obligations with respect to it. Those can all be useful methods of protecting the goodwill that one's acquired in the business.

Tracey Diamond:

I would say on the trade secret confidentiality piece as well, not only should you document that properly in terms of having an employee or a purchaser sign the NDA, but make sure that you're keeping your trade secrets secret and you're doing it in a way that you've also, so in other words, having a policy in place that makes it really clear how important it is to the company that their trade secrets are not used or disclosed other than under certain limited circumstances. And then walk the walk. Don't just talk the talk, make sure that those trade secrets are password protected, that if they're in paper files, that they're under lock and key, and that you can show policies where your rank and file are aware of the fact that these are important sort of the secret sauce of the company and they are not to leave the company premises.

And then when an important employee leaves, it's also a good idea to be doing forensics to see what, if anything, that employee did take with them so that you can, if necessary, support a claim for misappropriation of trade secrets since that area has become even more important than ever in terms of a tool in your tool chest in light of the fact that non-competes are less effective tools than they used to be in some places.

Nick Stawasz:

I think one other pathway too, Tracey, certainly non-disparagement clauses, I think we more typically see those in the context of an employee separation agreement and less so upfront in the form of a restrictive covenant agreement. But that's certainly another valuable provision that employers can utilize to again, protect their name and their image and their business post-separation and going forward, because is in some instances, you're not going to be in a position to enter into a separation agreement with a particular employee when they leave, whether they don't want to sign it or the terms are such that it just doesn't come to fruition. So getting those non-disparagement clauses initially together with the other restrictive covenants can be a useful tool as well.

Tracey Diamond:

So Nick, on the non-disparagement, the one cautionary note I would mention, and this only applies to non-supervisor employees to the extent that you have non-supervisor signing a non-disparagement agreement in the employment context, that the National Labor Relations Board did come out with a decision a year or two ago now, and their jurisdiction is only with regard to non-supervisor employees, but they held that non-disparagement agreement is overbroad with regard to that group. If it's anything above the standard for just plain old defamation, which would be a common law claim, whether it's in an agreement or not, just sort of a little note of caution, there are non-disparagement agreements. The other area in terms of tools in a company's tool chest for this issue in light of the issues with non-compete agreements is the concept of a forfeiture for competition clause. And we see those a lot in the equity award

agreements where an employee or executive is agreeing that if they violate a non-compete or other form of restrictive covenant, that they're going to have to give back or not be able to receive certain equity awards that are otherwise promised to them.

And those seem to be a little bit easier to enforce than straight on employment-based non-compete agreement because the concept here is you are a high-level executive, you know what you're getting into, you may be willing to forego that form of compensation in order to have the benefit of competing. It's a bit more of a tit for tat and less of a inability to engage in any kind of livelihood just by virtue of having signed the document. Nick, what about in the PE context? Is there anything sort of specific to private equity that investors should be aware of?

Nick Stawasz:

Sure, Tracey. I think one of the things certainly, and we talked about it a little bit earlier, is there's really no one size fits all. A lot of private equity-owned portfolio companies pursue a roll-up strategy where they're doing a number of add-on acquisitions, and certainly they have their preferred form of documents and agreements that they use, and I think it's really important that those agreements be tailored accordingly for each transaction, whether that is the geographic scope that you're pursuing for the restrictive governance or that is the duration. It's important to have those conversations with counsel, discuss it and to make appropriate decisions to tailor and craft those agreements accordingly for that particular acquisition and those individuals signing it, they'll have the most likely success of enforceability going forward if you tailor it and it's, again, not one size fits all.

Tracey Diamond:

That makes a lot of sense. I also think from the portfolio company point of view, a lot of times I'm seeing PE firms buy a portfolio company and then not really taking the time afterwards to take a look at the forms and the agreements that that portfolio company is using, which may need some updating. That would be a good time to do that housekeeping and put some thought into what you want that workforce to be agreeing to.

Nick Stawasz:

Absolutely, Tracey. It's an ever-changing environment now, particularly with respect to non-competes at the federal and state level, so it's crucial that companies are working closely with their council on these matters. Well, Tracey, thank you for joining me today on *PE Pathways*. I really appreciate your participation and really enjoyed the conversation this afternoon.

Tracey Diamond:

Thanks for having me. It was nice to talk to you about these issues.

Nick Stawasz:

And I'd also like to thank our audience for joining us today. Certainly if you have any questions or comments, feel free to email us and hope you can join future episodes of our *PE Pathways* series.