EMERGING AND MID-SIZED MANAGERS: PREPARING FOR THE FTC'S PROPOSAL TO ELIMINATE NON-COMPETES

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US Asset Management and Investment Funds Alert

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On 5 January 2023, the Federal Trade Commission (the FTC) published a proposed rule (the "Proposed Rule") that would broadly ban companies from entering into noncompete agreements with their workers, rescind substantially all existing noncompete agreements, and require notifying all current and former employees of such rescission.[1] The FTC claims authority for the Proposed Rule under Section 5 of the Federal Trade Commission Act, which allows the agency to police unfair methods of competition. The Proposed Rule would preempt all state laws that permit noncompete provisions.

If enacted in substantially its proposed form, the Proposed Rule would impact almost every industry in the United States including the private equity industry, and particularly on emerging and mid-market fund sponsors. While the use of noncompetes is common in the private equity industry, there are other measures and protections that managers can implement or improve upon now in anticipation of the adoption of the Proposed Rule.

Private equity sponsors utilize restrictive covenants, including noncompete covenants, to protect important commercial interests. For example, firms utilize noncompete clauses with co-founders, key stakeholders, and employees to protect business strategies, strategic information, methods of evaluating industries for potential investments, and intellectual property. This is particularly the case with mid-market and emerging private equity managers, where the development and growth of the manager's business depends upon a small group of individuals who necessarily share sensitive information about investment processes, clients, potential investments, and strategies.

As outlined in a previous K&L Gates client alert, the Proposed Rule would prohibit the following:[2]

- Provisions which prevent an employee—termed "worker" in the Proposed Rule—from seeking or accepting employment with a competitor after the conclusion of employment with the employer;
- Provisions which prevent an employee from operating a business which engages in competitive activities after the employee's relationship is terminated; and
- Other types of restrictive covenants, which by their breadth would, in the view of the FTC, operate as de facto noncompete covenants that would prohibit the employee from engaging in either of the foregoing activities.

The Proposed Rule defines the term "worker" broadly, and would encompass relationships at nearly every level of responsibility within a private equity firm, including partners, officers, and entry-level personnel. Noncompetes

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would be prohibited regardless of the context in which they may be used—meaning that they would be prohibited not only in private equity firm employment agreements, but also in the operating agreements of sponsor-founder operating company vehicles, in general partner and special purpose carried interest vehicles, and in carried interest award arrangements.[3]

The FTC in its Notice of Proposed Rule Making (the NPRM) cited research which found that the use of noncompete clauses has negatively affected competition in labor markets in general, resulting in reduced wages; reduced competition in product and service markets; and a negative impact on business formation, innovation, and the ability of competitors to hire skilled workers.[4] Whether or not these impacts have been felt in the private equity industry, the fact remains that noncompete provisions have been utilized by emerging and mid-sized private equity sponsors to protect legitimate business interests that sweep beyond competition by individual employees. Such firms have limited personnel and so necessarily must concentrate multiple key functions within a small number of senior and mid-level individuals. In these circumstances, a departed employee's ability to leverage his or her role in a competitive enterprise creates a significant risk of harm to the emerging or mid-sized private equity sponsor's overall business. In these circumstances, restrictive covenants, including noncompete provisions, take on a heightened role in the protection of the franchise.

The interest in protecting the private equity firm's business through the use of noncompete and other restrictive covenants extends to the entire firm, as personnel at almost all levels of an emerging or mid-sized private equity sponsortypically have, in one form or another, an equity or incentive-based interest that is tied to the overall success of the firm. Misuse of proprietary expertise gained while at the firm therefore impacts everyone who has a stake in the economic success of the firm.

Eliminating the ability to utilize noncompetes also has an impact on the investors of emerging and mid-sized private equity sponsors. First-time and growing managers rely on the abilities and track record of the investing team who are making the decisions to acquire or dispose of investments. Fund investors necessarily rely more heavily on a small group of individuals who make up the specific management team, as opposed to the overall franchise of a large private equity sponsor that employs hundreds of investment professionals. Stability and predictability of personnel is key to an investor's decision to commit capital and in negotiating important terms such as “key person” provisions. The Proposed Rule, if adopted, would eliminate an important mechanism for fostering such stability, and heighten the risk of exposure to post-departure disruptive competition from ex-investment personnel.

It is not yet clear whether the Proposed Rule is likely to be adopted in substantially its current form. Approximately 25,000 comments were submitted from a wide range of interested parties and organizations. For instance, the Investment Adviser Association submitted a comment letter in which it took the position that noncompete arrangements serve a legitimate business purpose in the financial services industry and recommended that: (i) noncompete agreements be allowed for certain senior staff, in the governing agreements of the firm's principals, and in connection with sale-of-business transactions; (ii) non-solicitation agreements, non-disclosure agreements, and similar arrangements be expressly permitted by the final rule; and (iii) the final rule should only apply prospectively.[5]

Regardless of the final contours of this rule, private equity sponsors need not take a wait-and-see approach, especially given that the Proposed Rule in its current form would have retroactive effect. Managers can take proactive steps to protect their growing businesses. Noncompete provisions are one of several protective

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covenants used by private equity sponsors, along with confidentiality provisions, employee and client nonsolicitation provisions, and nondisparagement provisions. Established emerging and mid-sized managers can assess whether current contractual arrangements in fund-related governing agreements and employment arrangements require protective improvements that would sufficiently rely on and strengthen such other restrictive covenants in the event that the Proposed Rule, when enacted, rescinds the noncompete covenant. At the same time, there needs to be a careful balance so as to avoid creating a "de facto" noncompete provision through an overly broad suite of restrictive covenants, which the FTC in the NPRM noted would be impermissible under the Proposed Rule. Emerging and mid-sized private equity sponsors can also assess the need for more robust vesting, termination, and buy-back provisions with key personnel, providing economic incentives to avoid disruption to the firm by departed personnel who move on to competing ventures.

These measures can be taken as new hires are made, or in the incentive award documentation when new funds are launched. Given that personnel of emerging and mid-market private equity sponsors typically have their incentive compensation and future prospects closely tied to the success of the overall enterprise, commercially reasonable measures to protect the firm in the absence of noncompetes hopefully should be seen as a benefit to all personnel who are committed to the franchise.

Accordingly, while the use of noncompetes by private equity sponsors is common, there are alternatives that will allow the firm to comply with the Proposed Rule when adopted without sacrificing legitimate protective considerations. Indeed, noncompete provisions are already prohibited in some states such as California, and the ease of enforceability of these covenants in other states vary. Moreover, the fact remains that while noncompetes serve important purposes, the sheer monetary, human resources, and reputational costs of judicially enforcing such covenants is high. Adopting and improving alternative methods to protect the private equity franchise will allow private equity sponsors to achieve the same goals once the Proposed Rule is adopted.

We acknowledge the contributions to this publication from our associate Shaun Goodfriend.

FOOTNOTES

[1] *See*, Non-Compete Clause Rule, 88 Fed. Reg. 3482 (proposed Jan. 19, 2023) (to be codified at 16 C.F.R. pt. 86).

[2] FTC Proposes Sweeping Ban on Employee Noncompete Clauses: What Employers Need to Know, Proposed Alternatives, and Opportunity for Public Comment | HUB | K&L Gates (klgates.com)

[3] The sole carve-out in the Proposed Rule allows for non-compete clauses for individuals who have at least a 25% ownership interest in the entity (a Substantial Owner) and are looking to sell their interest. This exception is intended to protect the value of acquiring a business from a former Substantial Owner, and thus it may not apply to some instances when a founder chooses to leave employment at a firm to start his or her own competing business.

[4] *See supra* note 1 at Part II.C.

[5] *See*, Investment Advisor Association, Comment Letter on Proposed Rule to Non-Compete Clause (Apr. 17, 2023), https://investmentadviser.org/wp-content/uploads/2023/04/Investment-Adviser-Association-FTC-Non-

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