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EMPLOYMENT

Impact on Private Fund Advisers of Obama Administration's and State Lawmakers' Actions to Restrict Use of Non-Compete Agreements

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A growing drumbeat of government hostility toward non-compete agreements may portend state-level legislation that would restrict employers' use of such agreements. While the impetus behind this movement primarily appears to be a concern for low-wage employees, some of the proposals sweep wide and would affect the abilities of private fund advisers to impose and enforce non-competes against their professional employees.

This article reviews the call to action by the Obama Administration for state legislators to significantly curtail, through legislation, an employer's ability to use and enforce non-compete provisions; the responses from various state policymakers to this request; and the likely impact on private fund advisers if legislation that is substantially similar to the proposals were adopted.

For more on non-competes and other restrictive covenants, see "*What the NLRB Complaint Against Bridgewater Means for Hedge Fund Manager Employment Agreements*" (Sep. 8, 2016); "*District Court Decision Suggests That Overly Broad Restrictive Covenants Will Not Be Enforced in Employment Agreements in the Wealth Management Industry*" (Apr. 26, 2012); and "*Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements*" (Nov. 23, 2011).

Obama Administration Issues a Call to Action

The latest manifestation of government antipathy toward non-competes occurred on October 25, 2016, when the White House issued a "*State Call to Action on Non-Compete Agreements*" (Call to Action). Following the White House and Treasury reports issued earlier this year that were critical of non-competes (see "*White House, Non-Compete Agreements: Analysis of the Usage, Potential Issues, and State Responses,*" May 5, 2016 (White House Report); and "*U.S. Treasury Department, Non-Compete Contracts: Economic Effects and Policy Implications*," March 2016), the Obama Administration called upon state policymakers to enact legislation that would:

1. Ban non-compete clauses for categories of workers, such as workers under a certain wage threshold; workers in certain occupations that promote public health and safety; workers who are unlikely to possess trade secrets; or those who may suffer undue adverse impacts from non-competes, such as workers laid off or terminated without cause.
2. Improve transparency and fairness of non-compete agreements by, for example, disallowing non-competes unless they are proposed before a job offer or significant promotion has been accepted (because an applicant who has accepted an offer and declined other positions may have less bargaining power); providing consideration over and above continued employment for workers who sign non-compete agreements; or encouraging employers to better inform workers about the law in their state and the existence of non-competes in contracts and how they work.
3. Incentivize employers to write enforceable contracts and encourage the elimination of unenforceable provisions by, for example, promoting the use of the "red pencil doctrine," which renders contracts with unenforceable provisions void in their entirety.

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States' Attempts to Rein in Non-Competes

Prior to the Call to Action, a sense that employers' sweeping use of non-competes may have gone too far had already caused some states to undertake efforts to restrain them.

In 2013, Connecticut's legislature passed a law regulating non-competes when presented as a condition of continued employment in the context of mergers and acquisitions. Under that law – which was a watered-down version of a prior draft bill that would have had more general applicability and imposed additional restrictions – an employee was required to be provided with a reasonable time of not less than seven days to consider a non-compete. Citing concerns of vagueness, however, the Connecticut Governor vetoed the legislation. More recently, in 2016 the legislature passed and the Governor signed a law restricting the use of non-competes imposed upon physicians.

Anti-non-compete legislation also has been percolating (so far unsuccessfully) in the Massachusetts legislature for several years. The most recent effort, in 2016, saw sparring bills introduced in each chamber that ultimately could not be reconciled. The House bill would have limited non-competes to one year and required the employer to pay the former employee 50% of his or her annual salary during the non-compete period. The Senate bill would have limited non-competes to three months and required the employer to pay a full year's salary to the restrained employee.

In New York, Attorney General Eric Schneiderman has been on the warpath throughout 2016 against employers who have imposed non-competes that his office considers unfair – ultimately entering into settlements with the fast-food chain Jimmy John's (for requiring franchisees to include non-competes in contracts with low-wage employees); the legal news site Law360 (for imposing non-competes on its non-executive reporters, editors and researchers); and the medical services company EMSI (for imposing non-competes on rank-and-file workers who did not possess trade secrets or confidential information). See "*Steps Hedge Fund Managers Can Take in Light of NY Attorney General's View That Certain Non-Compete Clauses Are Unconscionable*" (Sep. 22, 2016).

During the 2016 Legislative Session, bills were introduced in both the New York Senate and the Assembly that would have dramatically restricted the ability of employers to enforce non-competes. Senate Bill S1138 provided that a covenant not to compete, or a non-solicitation agreement with respect to employees or customers, would not be enforceable if the employee has been terminated for reasons other than misconduct; is not unique; or does not possess trade secrets or material akin to a trade secret. It further provided that a non-compete/non-solicit would not be enforceable where it is unreasonable in geographic extent or duration.

Assembly Bill A2147 provided that a non-compete/non-solicit would not be enforceable unless it is reasonable in geographic extent or duration; the employee voluntarily quit or was involuntarily terminated as a result of misconduct; and the employee is "unique as a matter of law" – meaning that the employee possesses trade secrets of the employer or confidential material akin to a trade secret. Where the employee is not unique, the Assembly bill would have allowed enforcement of a restrictive covenant where the employee voluntarily quit or was fired for misconduct, and there are "unusual circumstances unique to the business and to the employee" such that the employer has a "compelling interest" that outweighs both the employee's interest in being able to pursue his or her livelihood and the public's interest in free and open competition.

The White House Report identifies laws (promulgated or pending) in other states – New Hampshire, Illinois, Oregon, Washington and Idaho – that are designed, one way or another, to rein in the use of non-competes. Given the growing trend to regulate non-competes, the White House's Call to Action could achieve its desired result and spur further state legislation.

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The same day the Call to Action was issued, New York Attorney General Schneiderman announced his intention to introduce legislation in 2017 that would significantly curtail the use of non-competes in New York. According to a press release issued October 25, 2016, Schneiderman's intended bill (the text of which is not yet available) would:

- prohibit the use of non-competes for any employee who makes less than $900 per week;
- prohibit non-competes that are broader than needed to protect the employer's trade secrets or confidential information;
- require non-competes to be provided to prospective employees in advance of a job offer being extended;
- require employers to provide current employees additional consideration if they sign non-compete agreements after their employment has commenced;
- limit the permissible duration of non-competes; and
- create a private right of action with remedies for violations, including liquidated damages.

In addition to Schneiderman's announced initiative, lawmakers in Connecticut, Illinois, Utah and Hawaii have issued statements supporting the Call to Action.

Impact on Private Fund Advisers of Anti-Non-Compete Legislation

While at least partially motivated by concern for low-wage workers, the legislation proposed by the Call to Action, as well as proposed or promulgated laws in New York and elsewhere, sweep broadly. If passed in a state where a private fund adviser is located – or, potentially, where its employees live – these laws will significantly impact that adviser's current practices and could include the following five factors.

First, non-competes would not be enforceable against employees who are terminated without cause – without any consideration of how unique or high up the executive ladder an employee is, how much the employee will be paid during the restriction period or whether the employee possesses trade secrets. If an employee is terminated without cause, the non-compete becomes unenforceable.

Second, even where an employee voluntarily quits or is fired for cause, a non-compete only would be enforceable where the employee possesses trade secrets (or perhaps confidential information akin to trade secrets). This ignores other legitimate business interests that employers may seek to protect through non-competes – such as hard-won client or investor relationships developed on the employer's dime and time.

Significantly, although the Call to Action suggests use of non-solicitation agreements in lieu of non-competes, many courts have found non-solicits to be merely a species of non-compete. Thus, non-solicits are subject to the same analysis, and last year's New York bills expressly were applicable to both non-competes and non-solicits. Depending on how legislation is written, a non-solicit may not be available as a substitute.

Third, the red pencil doctrine would make employers proceed at their own peril by making a non-compete unenforceable if it is found to be unreasonable or otherwise violates law. The current power of courts in some jurisdictions to "blue pencil" or narrow restrictive covenants to make them reasonable enough to be enforceable would be taken away.

Fourth, there would be a bright-line limit on the duration of non-competes – e.g., three months, one year, etc. Such an approach would eliminate the ability of an employer to impose longer non-competes where circumstances (e.g., a substantial payment during the non-compete period or possession of highly sensitive knowledge about the employer's business) would make them necessary and fair.

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Fifth, there would be some kind of restriction on how and when a non-competition agreement must be presented to an employee (e.g., before employment commences). For current employees, new restrictive covenants would require new consideration (above and beyond continuation of at-will employment).

Employers in the private funds industry are, as always, well advised to examine their employment agreements to ensure they impose restrictive covenants only to the extent they are necessary – and no broader than necessary – to protect their legitimate business interests. But in light of the recent trends discussed in this article, investment advisers may want to consider actively reaching out to state policymakers, lest sweeping legislation be passed without consideration of the role non-competes play in protecting their legitimate business interests.

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