Professional Perspective

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On Jan. 5, 2023, the Federal Trade Commission (FTC) proposed a sweeping ban on non-competition clauses in employment agreements. The ban, if approved, would cover not only express non-competition clauses but also other contractual terms that have the "effect" of a non-compete by "prohibiting the worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer."

Under this "functional test," an overbroad non-disclosure agreement or an unreasonable training-repayment agreement could run afoul of the ban. Other contractual terms that may be subject to the ban include client or customer non-solicitation agreements, no-business agreements, no-recruit agreements or liquidated damages provisions that are "so broad in scope that they serve as de facto non-compete clauses" as well.

Forfeiture-for-Competition Clauses

One type of contractual term that was not explicitly mentioned in the FTC's proposed ban are forfeiture-for-competition clauses. These are clauses under which an employer typically conditions the payment of certain post-employment benefits—e.g., severance, stock incentives or some form of deferred compensation—on an employee's agreement to abide by post-employment restrictive covenants. This is different from a standard "garden leave" clause where the employee, after resignation, continues to collect salary for a defined period of time and remains subject to duties and obligations—e.g., duty of loyalty—to the employer.

Such clauses have been enforced by a majority of jurisdictions without regard to the reasonableness of the restrictive covenants on the theory that the employee is afforded a choice between not competing—and thereby preserving the benefits—or competing—and thereby risking forfeiture. This is often referred to as the "employee choice doctrine" and is an exception to the heightened level of scrutiny courts usually apply to restrictive covenants.

How will forfeiture-for-competition clauses fare under the FTC's proposed rule? That remains to be seen, but the breadth of the FTC's proposed ban makes it likely that such clauses too will invite scrutiny from regulators. As noted above, under the FTC's functional test, an unreasonable liquidated damages clause, or a training repayment agreement—a type of liquidated damages clause—may functionally serve as a de facto non-compete.

And a recent decision from the Court of Chancery of Delaware has found that a forfeiture-for-competition clause is but a "small step" removed from a liquidated damages provision. *Ainslie v. Cantor Fitzgerald, L.P.*, C.A. No. 9436-VCZ, 2023 BL 49274 (Del. Ch. Ct. Jan. 4, 2023). While the latter requires a former employee to make payments to a former employer if the employee competes, the former excuses the employer from paying amounts if the employee competes. As the judge found in declining to follow the "employee choice doctrine" in *Ainslie*, either type of contractual term can effectively restrain trade.

The *Ainslie* decision serves as a useful reminder that forfeiture-for-competition clauses may also be subject to scrutiny under the FTC's non-compete ban. Given the uncertainties of how the FTC intends to enforce the proposed ban—or any final rule—it is not safe to assume that such clauses will continue to enjoy the benefits of the "employee choice doctrine" or be enforced without regard to reasonableness.

Under the FTC's "functional" test, a forfeiture tied to an overly broad restrictive covenant could be deemed a de facto non-compete, particularly if the forfeiture is significant. Employers who use forfeiture-for-competition clauses should therefore monitor developments concerning the FTC's proposed ban and apply best practices to tying forfeitures to reasonable restrictive covenants.

Employee Choice Doctrine

Forfeiture-for-competition clauses typically condition the payment of post-employment benefits upon the employee's compliance with restrictive covenants after his or her resignation from the employer. Such clauses are attractive to employers because they can serve as a powerful disincentive for an employee to engage in unfair competition after they leave the company, and can be enforced without filing a lawsuit or seeking a court order.

Moreover, because forfeiture-for-competition clauses do not impose a per se bar on employees from working for a competitor—but only impose financial consequences for doing so—courts have generally taken a far more relaxed approach with respect to such clauses. Indeed, courts in a majority of jurisdictions have deemed such provisions enforceable without regard to the reasonableness of the restrictive covenant.

For example, in *Morris v. Schroder Capital Management*, the New York Court of Appeals explained that there is no unreasonable restraint on an employee's ability to earn a living when the employee "is given a choice of preserving his rights under his contract by refraining from competition or risking forfeiture of such rights by exercising his right to compete." 7 N.Y.3d 616, 622 (N.Y. 2006).

In that case, the former employee, Morris had agreed to forfeiture-for-competition provisions in deferred compensation agreements with Schroder. After Morris resigned and established a competing hedge fund before the vesting period ended, Schroder notified him that he had forfeited his deferred compensation benefits.

On certification by the Second Circuit to the New York Court of Appeals, the *Morris* court reaffirmed that the employee choice doctrine is an exception to the general rule that "noncompete clauses in employment contracts are not favored and will only be enforced to the extent reasonable and necessary to protect valid business interests." The court also held that the constructive discharge test is the appropriate legal standard to apply when determining whether an employee voluntarily or involuntarily left his employment for purposes of the employee choice doctrine.

Other courts in New York and elsewhere have adopted similar approaches to forfeiture-for-competition clauses. For example, in *Lenel Sys. Int'l, Inc. v. Smith*, 106 A.D.3d 1536, 1538-39 (4th Dep't 2013), the court cited *Morris* and applied the employee choice doctrine to an incentive stock option agreement under which employee agreed to refrain from competing with employer for two years after termination of his employment.

Ainslie Decision

In *Ainslie*, the Delaware Chancery Court took a different approach with respect to a forfeiture-for-competition clause in a limited partnership agreement. That agreement contained non-compete and customer and employee non-solicitation provisions.

After plaintiffs withdrew from the partnership and allegedly began competing, the company withheld certain payments, which the former partners sued to recover. They argued that the forfeiture-for-competition provision was an unreasonable restraint of trade and that it should be subject to the same reasonableness review applied to traditional restrictive covenants. In opposition, the company urged the Court to adopt the employee choice doctrine, and refrain from applying a reasonableness review.

In weighing these competing approaches, the court looked to Delaware law on the enforcement of liquidated damages provisions in non-compete and non-solicitation agreements. The court noted that Delaware has regarded such provisions skeptically, and as "particularly suspect as potentially-unreasonable restraints on competition, and on ex-employees' interests in earning a living."

According to the Court, it is "only a small step to move from a liquidated damages provision requiring a former employee to pay amounts to a former employer if the employee competes, to a forfeiture-for-competition provision excusing the employer from paying amounts if the employee competes." And "[l]ike liquidated damages provisions based on competition, forfeitures are disfavored because of their potential to cause unjust outcomes."

Based on such reasoning, the court declined to apply the employee choice doctrine. Instead, given that the plaintiffs were still free to compete, the court determined to apply the more employer-friendly review that Delaware courts apply to restrictive covenants in the sale of business context. Even under that more lenient standard, however, the court determined that the forfeiture-for-competition clause was unreasonable.

In reaching that conclusion, the court found it significant that the forfeited amounts—between approximately $100,000 to $5.5 million—were not tethered to the company's actual or potential harm, and that such forfeiture could be triggered even if the plaintiffs violated the conditions unintentionally. According to the court, "Delaware law is clear that imposing financial consequences on former employees for competitive circumstances that are not their fault, and in an amount that is untethered to the former employer's loss, has an *in terrorem* effect and operates as an unreasonable restraint of trade."

Conclusion

Ainslie is a reminder that not all jurisdictions will apply the employee choice doctrine to forfeiture-for-competition clauses. Further, if such clauses are tethered to overbroad restrictive covenants, they may be regarded as de facto non-competes under the FTC's proposed ban.

The clauses that are likely to draw the heaviest scrutiny if the proposed rule—or some form of it—goes into effect are those tethered to unreasonable restrictive covenants that are not tailored to protecting the employer's legitimate interests, including confidential information and goodwill. Employers should thus review the breadth of such clauses, including their duration and geographic scope, in preparation for the possibility that the FTC ban, in some form, may go into effect.