February 2, 2023

Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue, NW
Suite CC-5610 (Annex C)
Washington, DC 20580

Re: Non-Compete Clause Rulemaking, Matter No. P201200

Dear Commissioners,

I am a Certified Public Accountant and owner of Golden Parachute Tax Solutions, LLC. My firm is generally hired to assist companies in complying with the provisions and related regulations of Internal Revenue Code ("IRC") Section 280G, the "golden parachute" tax penalties. In order to compute the amount of penalty exposure, we are often required to consider what portion of payments made to an individual subject to these tax penalties may be treated as reasonable compensation in exchange for the individual agreeing to not perform services (non-compete). I have worked on over 2,000 transactions in my 25 years in practice (including 13 years as a business owner). During my career I have also been involved with valuing over one thousand executive non-compete arrangements.

As many professionals have noted since the Commission released their notice of proposed rulemaking document, where highly paid executives and/or business owners are concerned, the potential economic damage that such individual can impose if not restricted from competition is considerable. This economic damage is even more pronounced in the context of a transaction. In the absence of restrictive covenants, a buyer will need to account for goodwill impairment and a reduction in shareholder value either from the buyer's shareholders perspective (in the case of post-acquisition competition) or the target shareholders perspective (the reduced selling price of the Company based on an estimate of goodwill impairment). Accordingly, in order to protect the goodwill and other assets conveyed upon the sale of a Company, and to ensure fairness for all parties involved in a transaction, reasonable non-competition arrangements are necessary to establish competitive fairness.

I have personally worked on many transactions where a potential buyer will simply not enter into a transaction unless key executives of the target entity are restrained from competition for a reasonable time period. This is particularly true in human capital-intensive businesses where a buyer can purchase a business for $100s of millions or even billions, only to have the asset most central to the enterprise—its people—walk out the door the day after closing. I note that in almost all of these cases, the owners almost always have substantially less than 25% ownership in the target entity. Moreover, where key executives of public companies are involved, their ownership is usually less than 1%. Based on my experience in valuing non-competes we note that significant ownership is only one factor (and often an insignificant factor) in determining how much harm an individual can cause by going to a key competitor after leaving their prior company. In general, without a non-competition agreement, the C-Suite and key management team often can cause substantial and in some cases irreparable damage to their Company by going to a key competitor. Thus, the **Commission's proposed elimination of most**

non-compete provisions would significantly benefit mostly highly compensated C-Suite and key executive management team members at the expense of shareholders.

On the other hand, I have also seen situations where companies have general non-compete language contained in their employment arrangements which affects the entire company's employee base (even after a transaction). In this instance, I concur with the Commission that it could be reasonably argued that such non-competition restrictions may be considered "unfair" and/or "abusive".

In this comment letter, I/we[1] will be proposing an approach where the Commission can adopt rules that deal with the abusive nature of non-competition agreements without banning a practice that is long standing and has legitimate business value. We believe that if the Commission were to adopt these recommendations, the chances of such regulations' legal challenges would be greatly reduced.

<u>What Specifically is the "Unfair Method of Competition"?</u>

The Commission has proposed the following:

> *Pursuant to Sections 5 and 6(g) of the FTC Act, the Commission proposes the Non-Compete Clause Rule. The proposed rule would provide it is an unfair method of competition—and therefore a violation of Section 5—for an employer to enter into or attempt to enter into a non-compete clause with a worker; maintain with a worker a noncompete clause; or, under certain circumstances, represent to a worker that the worker is subject to a non-compete clause.*

The Commission has provided that under Sections 5 and 6 of the Federal Trade Commission Act ("FTC Act"), the Commission is authorized to make such changes. Specifically, it provides:

> *Section 5 of the FTC Act declares "unfair methods of competition" to be unlawful. Section 5 further directs the Commission "to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in or affecting commerce." Section 6(g) of the FTC Act authorizes the Commission to "make rules and regulations for the purpose of carrying out the provisions of" the FTC Act, including the Act's prohibition of unfair methods of competition. Taken together, Sections 5 and 6(g) provide the Commission with the authority to issue regulations declaring practices to be unfair methods of competition.*

By adopting a rule that has such a wide-sweeping impact, the Commission may have inadvertently overlooked the legitimate concern that even individuals subject to such arrangements would not consider them to be abusive, and thus compromise its duty to prevent "unfair methods of competition". Moreover, although the Commission has attempted to address issues related to higher compensated executives and business owners by citing various studies to advance the majority's opinion, it is worth noting that there is a distinction between what might be optimal public policy, to which Congress is charged with addressing, and "unfair methods of competition" which falls within the Commission's purview.

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[1] In this comment letter I often switch between the pronouns "I," "we" and "our" as this letter was put together with the help of my business partner Ari Benjamin and the other professionals (mostly CPAs and lawyers) at my firm who provided extremely valuable feedback. The advice contained within this comment letter is the result of the careful collaboration of individuals with over 100 years of combined experience in this area.

Essentially, the key issue before the Commission should be to address the part of non-competition arrangements which are abusive or constitute unfair methods of competition as the FTC Act provides, and leave the items which are more akin to public policy debate to an elected Congress.

In my opinion, the answer to this is surprisingly simple. The abusive practice is not because of the existence of non-compete agreements, but rather because some companies are not paying ample consideration (i.e., garden leave) in exchange for such arrangements. This abuse is most prevalent where rank-and-file employees are covered by such arrangements as a condition of employment but are not separately compensated for them when a termination of employment occurs.

In order to address this situation in a more equitable manner, we are offering for your consideration the perspective from my area of expertise, the golden parachute tax penalties as provided by Internal Revenue Sections 280G and 4999 and the related Treasury Regulations. Specifically, Treasury Regulations Section 1.280G-1 Q/A 40(b) which provides in part that:

> *For purposes of section 280G, reasonable compensation for personal services includes* ***<u>reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as a covenant not to compete)</u>****.*

Accordingly, the 280G Regulations are essentially providing that if someone is paid in exchange for a non-compete, then such amounts should not be considered a benefit in connection with a change in control (and therefore would not be subject to excise tax), **<u>provided such amounts constitute reasonable compensation</u>**. In everyday practice, we note that where key employees (mostly highly compensated executives) or business owners are concerned, the consideration being conveyed in exchange for the non-compete arrangements is generally a multiple of the executives' total remuneration (including some combination of annual salary, bonus and / or accelerated vesting of long-term incentives). With regards to more closely held companies, we often see the parties to the agreement separately determine what constitutes reasonable restrictions.

Moreover, we believe that if a "reasonable compensation" philosophy were adopted by the Commission, such rulemaking could provide the mechanism to fix the abusive practices inherent in certain non-compete arrangements. By focusing on adequate consideration rather than the outright banning of a long-established business practice used by most Companies, such rules would have a far greater chance surviving legal challenges, specifically the "Major Question Doctrine" which was the basis for the Supreme Court to dismiss recently enacted EPA regulations (See West Virginia v. Environmental Protection Agency, 597 U.S. ___ (2022)).

<u>Applying a Reasonable Compensation Standard</u>

One of the more subjective questions in preparing an Internal Revenue Section 280G analysis is what constitutes "reasonable compensation" in exchange for not providing services? For this analysis, the guidance requires that we clearly and convincingly address two specific tasks: 1) to determine whether a non-compete agreement is likely to be enforced and substantially constrains the executives' ability to perform services; and 2) to consider what constitutes "reasonable compensation." In this analysis, the former is accomplished by preparing a report which demonstrates by clear and convincing evidence that absent a non-compete, an executive could cause considerable harm to the company and that the provisions are such that the executive is substantially constrained from providing services commensurate with his/her current skillset/knowledge. The latter considers both historic compensation (what the individual earned in the past) and market compensation (what the individual could earn in the marketplace if not for such restrictions).

With respect to the Commission's task of removing an abusive practice of non-competes, we believe that the 280G regulations are instructive because they introduce the concept of fairness by determining whether an individual is reasonably compensated in exchange for a non-compete, thus providing some general guidance as to what should be required for a non-compete to be "fair" (which we believe the FTC should consider as condition of enforceability). Moreover, we note that this standard of determining reasonable compensation can be universally applied, whereby companies could evaluate an employee's impact from the perspective of competition and determine whether it is worthwhile to pay them (i.e., garden leave) in exchange for restricting them from competition[2].

Highly Compensated Employees, Officers & Substantial Shareholders

Another aspect of "assessing fairness" is consideration as to whether it is fair to impose a non-compete on individuals who are highly compensated, substantial owners or officers of a company. In these cases, we note that such individuals generally receive substantial consideration in the event of an involuntary termination with some combination of a multiple of annual salary, bonus and / or accelerated vesting of long-term incentives. Moreover, because such individuals' current level of compensation/wealth is extremely high, such individuals should not be afforded the relief the Commission proposes for lesser compensated workers.

The Commission has specifically requested advice on how to classify senior executives if they were to adopt different standards for senior executives:

> *The Commission seeks comment on how, if the Commission were to adopt different standards for senior executives, this category of workers should be defined. The Commission is not aware of a generally accepted legal definition of "senior executive." This term may be challenging to define, given the variety of organizational structures used by employers.*

In determining this narrow class of employees, the Internal Revenue Code Section 280G rules may be instructive in assisting the Commission. In fact, we recommend the same class of individuals to whom these regulations apply ("Disqualified Individuals") be the basis for who is considered automatically exempt from the relief proposed by the FTC.

Who is a Disqualified Individual?

Treasury Regulations Section 1.280G-1 Q/A 15 provides the following:

> *For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation—*

[2] We note that this garden leave concept is also contained within the rules governing non-competition agreements in the State of Massachusetts. Pursuant to Section 24L(b)(vii) of chapter 149 of the General Laws of Massachusetts, an enforceable non-compete requires that a "employer agree to pay an employee during restricted period a minimum of 50% of the "highest annualized base salary paid by the employer within the 2 years preceding the employee's termination." We note that our recommendation has a substantially higher amount than what Massachusetts currently requires

(1) A shareholder (but see Q/A-17 of this section);

(2) An officer (see Q/A-18 of this section); or

(3) A highly compensated individual (see Q/A-19 of this section).

There are some significant nuances within these provisions, but the general rules are as follows;

1.) A <u>Shareholder</u> is *"an individual who owns stock of a corporation with a fair market value that exceeds **1 percent** of the fair market value of the outstanding shares of all classes of the corporation's stock."*
2.) An <u>Officer</u> *"an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties)."* The Regulations limit the number of officers to be *"no more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group)."*
3.) <u>A Highly Compensated Individual</u> is *"any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the **highest paid 1 percent of the employees** of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation."* The Regulations also provide that "*no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly compensated individual."*

We note that this framework provides for a select group of the most highly compensated/largest stakeholders of the Company to be automatically exempt from the relief proposed by the FTC. We also note, as indicated above, that where these select individuals are subject to a non-compete, <u>**Congress has explicitly acknowledged that reasonable compensation paid in exchange for restrictive covenants should be excluded from additional tax penalties as Congress has recognized that there are legitimate business purposes for a non-compete**</u>[3].

[3] See General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369) which provides that "*an amount to be made under an employment contract, consulting agreement covenant not to compete, or similar arrangement for a stated term entered into between the acquiring company and a disqualified individual with respect to the target corporation may constitute parachute payments. To the extent that payments under such an agreement, at the time such agreement is entered into, determined to be reasonable for the consideration including consideration in the form of not competing to be provided by the individual under the agreement, such payments are to be treated under the provisions of as reasonable compensation for personal services."*

<u>Suggested Reasonable Compensation Framework</u>

1.) Rank-and-File Employees - We recommend the Commission define this group as all employees who are NOT highly compensated employees ("non-HCEs") as defined by Internal Revenue Code Section 414(q)[4]. We suggest that this non-HCE group fall under the new FTC proposed non-compete ban, unless some level of consideration is provided for the employee. A suggestion for the minimum consideration for a non-compete to be enforceable for this group is as follows:
   a. **<u>Minimum</u>** consideration must be equal to the greater of 100% of the employees' base salary or 80% of total direct compensation earned by the employee during the 12-month period preceding the date of termination[5]. In effect, the employer is paying the employer for the period not to work so therefore, this demonstrates the employer has a business purpose and therefore it is not abusive.
   b. Where a restrictive period is less than 12 months, the prorated portion of such amount would be applied.
      i. Compensation earned includes base salary, bonus, and commissions earned during the period that the employee performed services.
      ii. Amounts should include earned but unpaid commissions and/or bonuses.
      iii. By way of example, assume an employee had a base salary of $80,000 per year, 12 month trailing total compensation of $120,000 and 6-month non-competition restriction. In order to enforce such restrictions, the Company would need to pay the employee $48,000[6] in exchange for the non-compete.
      iv. If an employee were to breach such covenants the employer would be entitled to damages as well as injunctive relief.
   c. A non-compete arrangement agreed to as part of an employment agreement for non-HCEs should not be more than 12 months in length unless the Company and employee **<u>separately</u>** agree to additional terms within 30 days of any termination. Such a provision would allow parties at the time of termination to further negotiate in a mutually beneficial way.
   d. The Commission should consider extenuating circumstances where no consideration is required of a non-compete in the event of a for cause termination or where an individual breaches an enforceable confidentiality clause which could harm the Company.

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[4] Under Code section 414(q), a highly compensated employee is defined as any employee who was a 5-percent owner at any time during the preceding year or for the preceding year had compensation from the employer in excess of the amount that the Secretary of Treasury determines as highly compensated (currently $150,000).

[5] Where the concept of "total direct compensation" is used and long-term incentives are part of such compensation, the acceleration of vesting of total long-term incentives equal to the lesser of target of the most recent target long-term incentive awards (subject to proration as discussed above) or a proration of unvested long-term incentives would become vested where the numerator is the non-compete restriction period and the denominator is the total vesting period of such award(s). Where performance-based equity is part of such remuneration, acceleration of vesting may also be subject to actual achievement of any performance criteria. For example, if an Executive received 1,000 shares of restricted stock award that vests over a four-year period (either graded [i.e., annual vesting] or cliff vesting), and the executive were subject to a 6 month non-compete, the amount of remuneration would be equal to 6/48 or 125 shares. If such awards were also subject to performance-requirements, the payout would also be subject to the achievement of those metrics and would be made at the time such awards would have normally become vested.

[6] Fifty percent of the greater of $80,000 (100% of base salary) and $96,000 (80% of total compensation earned in the last 12 months). Fifty percent proration derived from the 6 month restriction period over 12 month compensation period.

2.) For Highly Compensated Employees ("HCEs") who are not compensated enough to be subject to the provisions of Internal Revenue Code Section 280G (e.g., "Disqualified Individuals" as defined in Treasury Regulations 1.280G-1 Q/A 15), we generally recommend the same provisions with the following exceptions:
   a. A non-compete arrangement agreed to as part of an employment agreement for a HCE cannot have an initial term of more than 24 months unless the Company and employee separately agree to additional terms within 30 days of termination. The same proration rules provided for non-HCE's would remain, whereby a two-year non-compete would require two years of base salary or 80% of two years' worth of total direct compensation.

3.) For those individuals who would be subject to the provisions of Internal Revenue Code Section 280G (e.g., "Disqualified Individuals" as defined in Treasury Regulations 1.280G-1 Q/A 15), we recommend this small class of individuals automatically be excluded (disqualified) from the benefit of such rules, because Congress has explicitly acknowledged the validity and fairness of restricted covenants for this class of individuals.
   a. We also propose that, for the purpose of determining who may be exempted from the proposed FTC rules, such individuals be exempted from such rules without regard to whether a transaction occurs (an area IRC Section 280G rules specifically address) or whether the entity is organized under Subchapter C of the Internal Revenue Code (to which IRC Section 280G specifically excludes from its scope). We note in these cases such individuals who are substantial owners and/or officers could create serious economic harm which would otherwise affect ordinary stakeholders.

4.) An alternative, less nuanced structure the Commission may consider is disqualifying all individuals who are HCE's from the FTCs proposed rules. We note that although this structure would in practice yield similar results, our recommended approach is designed to address specific unfair practices rather than be a blanket ban of non-competes. We believe the former is more commensurate with the Commission's authority.

Conclusion

The Commission's proposed rule to abolish a long-standing business practice on the grounds that such practice fosters "unfair methods of competition in or affecting commerce" based upon a Congressional law enacted in 1914 is uncertain to survive judicial review. As noted on page three, I believe that upon challenge the Courts are likely to follow the United States Supreme Court holding in West Virginia v. Environmental Protection Agency, 597 U.S. ___ (2022) that a far-reaching change in rules would fall under the "Major Question Doctrine." This specifically provides that where a government agency seeks to decide an issue of vast economic or political importance, a general delegation of authority from Congress is not enough and that the agency must have clear statutory authorization to decide the issue. Moreover, **the Commission's insistence that essentially all non-competition agreements constitute "unfair methods of competition in or affecting commerce" is, in of itself, an unpersuasive claim – especially where parties to such arrangements have entered into them in good faith and for ample consideration, as is generally the case with business owners and highly compensated executives**. Lastly, in cases where an individual would have been a "Disqualified Individual" as defined by Internal Revenue Code Section 280G, such individuals should be exempted from any proposed rules, as Congress has previously acknowledged that payments received for non-competition agreements may constitute reasonable compensation.

Accordingly, what we have proposed in this comment letter would potentially help shield the Commission from issues stemming from the Major Question Doctrine by having the Commission focus solely on unfair abuses of non-competition agreements, particularly with respect to lower compensated workers, while at the same time preserving non-compete arrangements where legitimate business interests remain AND individual's subject to such arrangements are adequately compensated. Moreover, by requiring adequate consideration instead of banning such non-competes altogether, the vast majority of individuals subject to such restrictions would likely be exempt from such, as companies are not likely to pay individuals not to work who otherwise could not cause any considerable harm to the company by competing. Lastly, we note that an **unintended consequence of an outright ban would be a potential windfall to HCE at the expense of the legitimate business concern of protecting the shareholders of a Company**.

In summary, the Commission should re-consider this far-reaching approach and increase the chance that such rulemaking would survive judicial review by focusing on the truly abusive practices they have been authorized to address. This noteworthy goal can more easily be addressed by defining a legitimate/permissible non-compete arrangement as one requiring ample consideration utilizing the reasonable compensation approach codified in our federal tax laws. Stated another way, instead of trying to treat a broken leg via amputation, the Commission should first try and treat the injury with remedies that are well established and currently available.

We appreciate the opportunity to comment on these proposed rules. If I can be of any further assistance, please do not hesitate to contact me.

Sincerely,

Laurence Wagman

Laurence Wagman CPA

[redacted]