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Voices

Are non-compete agreements now unenforceable?

By Terrence Putney, Joel Sinkin July 26, 2021, 9:00 a.m. EDT 6 Min Read

President Biden, on July 9, 2021, signed an executive order that, amongst other things, asked several federal agencies to adopt regulations that would in effect make non-compete agreements unenforceable. We have already been asked by several of our client firms if the non-compete agreements they use in employment agreements, owner agreements, and even in the agreements they use to consummate merger and acquisition transactions are now unenforceable.

At the heart of establishing the value of an accounting firm is what makes up its intangible value. For most firms, client relationships are the most important intangible asset. Many agreements between a seller and a buyer or between owners of an accounting firm base the value of the transaction almost solely on the revenue generated from client relationships. Any buyer in a transaction that intends to transfer client relationships reasonably must assume that the person who is selling those relationships will not interfere with the buyer's attempt to establish a relationship with the clients. Often, the seller has a personal relationship with those clients that is unique. If a buyer is uncertain about the seller's intentions to take away the client relationships following the sale, it stands to reason the buyer would dramatically reduce the value of the practice acquired, assuming the buyer was willing to go forward with the transaction at all. This concept not only applies to third-party transactions, but also internal transactions between an owner and the firm and other owners in the firm.

Does President Biden's executive order make the restrictive covenants that most accounting firms rely on to perfect the value of a transaction between a buyer and seller or owner and firm unenforceable? If so, what does that portend for the value of accounting firms?

One of the mistakes many people make when discussing this issue is throwing all the different kinds of restrictive covenants into one concept, i.e., a non-compete agreement. There are generally three different kinds of restrictive covenants most accounting firms use. Those are:

- A restriction against practicing in a profession or business that competes with the firm. Usually, these restrictions have geographic limitations and are time bound.
- A restriction against taking or diverting clients away from the firm. Normally, these are time bound.
- A restriction against taking or diverting employees away from the firm. Again, normally this is time bound.

Firms that depend on referrals for a significant amount of business, such as law firms referring to a litigation support practice, may also place a restriction on taking away or diverting referral sources.

In the states that have restrictions on what types of restrictive covenants are enforceable, it matters whom the agreement is attempting to restrict. The general categories that may be treated differently are:

- Non-owner employees.
- Owners that are also employees; and,
- Parties to a transaction that is essentially a sale of the business, usually in reference to the seller.

Based on the laws in states that provide guidance on what kinds of restrictions are unfavorable, the most likely target of any clamp down on "non-compete agreements" is likely to be agreements that restrict a non-owner employee from practicing in a business that compete with a former employer. In virtually every situation where a sale of a business is involved, or a partner or owner is disassociating from a firm, restrictions on competing and certainly taking clients are allowed. Some states limit how long the restriction can be to be enforceable. However, in almost every case the permissible period is long enough to keep a seller or former owner from interfering in the transition of clients and employees to the buyer or other key personnel in the firm.

Here are some examples:

- An accounting firm's employment agreement with all its employees restricts their ability to work for another accounting firm after leaving the firm. In some states this restriction is already unenforceable. This type of restriction is likely the target of President Biden's executive order.
- In contrast, an accounting firm's employment agreement with all its employees restricts their right to take clients from the firm for a period after termination, but not their ability to work for another firm. Even in some states where "professional" non-competes are unenforceable, this kind of agreement may be enforceable.
- An accounting firm's owner agreement restricts former owner-employees from taking clients from the firm while their interest in the firm is being paid for by the firm or other owners. This type of restriction is likely enforceable everywhere and is probably not the target of Biden's EO. It is likely a reasonable restriction on a former owner-employer working for a competitive business is also enforceable in most jurisdictions if the restriction is reasonable in scope and especially if the owner-employee is being paid post-termination benefits.
- A transaction between two accounting firms whereby the client relationships of one are sold to the other whereby the seller agrees to not compete in any way with the buyer, including taking or diverting the clients, for a reasonable period, is likely always enforceable.

Even in a situation where a state's laws preclude a restrictive covenant that the buyer or employer wants to impose on the seller or former employee, it may be possible to create a transaction structure that can accomplish the desired goal. For example, most restrictive covenants associated with the buyout of an owner are designed to make sure that the firm is not paying the former owner while the owner is able to take or divert clients. This situation could happen if the buyout is over 10 years, but the specific state the firm operates in makes a restrictive covenant unenforceable if its term is more than seven years. It may be possible to structure the payments so that any payments beyond seven years are contingent on the former owner not competing. In other words, the former employee is not precluded from competing, but if they choose to do so, no further payments will be made to them.

Another technique some accounting firms use to strengthen a restrictive covenant when necessary is to allow terminated owners, even employees, to buy clients from the firm at a reasonable price. Allowing this provision is counter to the "one-firm-client" culture many firms are committed to as it assumes there is a special relationship owners have with clients that supersedes the firm's relationship. However, as it relates to restrictive covenants, this provision allows the firm to take the position that it is not precluding competition, just requiring fair compensation for an asset taken away from the firm.

We do not know the details of Biden's executive order. We also do not know how the federal agencies tasked with issuing the regulations will proceed or even, for that matter, if they will act, and, if so, when. It is unlikely that this change will have a detrimental impact on the value of accounting firms in sales or the buyout of owners.

This article is not intended to provide legal advice. Employment laws regarding restrictive covenants, up to this point, have generally been set at the state level. You should always consult with an attorney familiar with the jurisdictions you operate in regarding the specific agreements you are using for your accounting firm.

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