You Sold Your Company, Now What?

Understanding Non-Competes in M&A Transactions

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You founded your company several years ago. You built your product and brand, went through several investment rounds, and painstakingly assembled a team of incredible professionals that helped you scale the business. You receive overtures from potential buyers about acquisition. Congratulations, you've built a successful company!

However, when reviewing the term sheets for multiple offers you notice that the potential buyers would like you, your co-founders and perhaps even certain key employees to agree to a non-compete provision post-closing. This is very customary in the M&A process as it helps buyers protect their investment. They are also distinguishable from employment non-competitions under the law. Recently the FTC announced it would take action to significantly limit non-compete agreements, or possibly eliminate them completely in the majority of cases. Additionally, the Senate just reintroduced the "Workforce Mobility Act of 2023" bill, which would similarly ban non-competes (and has bipartisan support). It was introduced twice before with little traction. While the results of these actions remain to be seen, it is unlikely that limited and targeted non-competition obligations will not remain part of the M&A landscape going forward. These non-competition obligations ensure that, post-closing, selling founders are limited from immediately working with a direct competitor of the business the buyer just acquired, or starting a business that intends to compete. Additionally, it can incentivize a founder to remain employed with a Company he or she just sold, in order to properly manage the Company's operations, and hit revenue targets. This satisfies the needs of both the buyers and the financial interests of the selling shareholders that may be entitled to potential earn-out payments.

However, many entrepreneurs struggle with answering the question upon exit: "What do I do now?" Some refer to this as "identity foreclosure" i.e. after spending so much time, energy and resources being the face and vision for a company, you no longer own it, and may not even run it anymore. Yet, you still have a lot left to accomplish. Luckily, negotiation for certain terms within your non-compete will give you space to continue on to other projects and goals following your exit. As public policy regarding non-competes continues to evolve, narrow reach and specificity become your friends, and enforcement of these non-competes by a buyer becomes less burdensome on founders. Many states still apply a "reasonableness" standard when scrutinizing these non-competes, so founders will want to apply a similar lens when negotiating their own non-competes. Below is an examination of some of the more common carve-outs to consider when negotiating the non-competition clauses in M&A agreements.

The "Side Hustle" Carve-Out

Plenty of founders have passion projects or additional businesses with which they are involved, either as a board member, shareholder, or officer. Sometimes these projects are in adjacent or parasitic industries to their primary projects. More often than not a buyer is willing to grant specific carve-outs that will not preclude a founder from continuing to participate in these "side-

hustles." This is normally contingent on (i) prior disclosure of such involvement during the negotiation phase, and (ii) the understanding and acknowledgment by the founder that this outside activity shall not compete with the business nor is that its intent. If a "side hustle" could potentially compete down the road, in theory, the non-compete obligations will have expired by then. However, if such potential is much more near-term, additional considerations and perhaps approvals by the buyer may need to be integrated.

Passive Activity

Many founders are often financially invested in other ventures. For such ventures there is a twofold avenue to explore: 1) negotiate for a threshold of ownership in side projects that is both reasonable and acceptable to the buyer. Generally, 2%-5% ownership stakes are market. If your ownership stake is higher than that, 2) negotiate for a carve out regarding day-to-day activity and/or holdings, i.e. if you are majority shareholder in another business, requesting to maintain your ownership and board seat, while relinquishing day-to-day operation of that business may be enough to comfort a buyer. It assures that you will not actively engage in competition with the target on day one, post-closing.

Tailored List of Competitors

Recently, many buyers are more inclined to offer specificity on what qualifies as "competition;" even going so far as to specify which companies are deemed competitors for the purpose of a non-compete. In this way buyers are providing clarity regarding the expectations for your non-compete. It also allows for founders to actively negotiate for concessions, and preemptively clear certain future endeavors, without running afoul of non-competition obligations. If you sell Company XYZ, and Company ABC wishes to engage your services, if Company ABC is not a listed competitor in your non-compete you should be able to participate.

This area of the law continues to evolve and maintain its status as an essential component of the M&A process. It is important to discuss post-closing activity expectations with both your potential buyers and your M&A counsel to get all parties on the same page. This will make both the deal process and post-deal life much smoother and happier. It also helps you answer the profound life question: "What do I do now?"

If you have questions about understanding non-competes in M&A transactions or are contemplating the sale of your company, please contact Peter Cifichiello or visit our M&A Practice Area page.