Hedge Funds Luncheon Series:

Non-Competes Are Under Attack - What To Do

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Agenda

- Introduction
- FTC Proposed Rule
- Recent Delaware Case Law
- State Legislative Developments
- What to Do Now

FTC Proposed Rule

FTC Proposed Rule (Jan. 5, 2023)

- Would impose a near-complete ban on the use of non-competes by employers.
- Employer may not
  - enter into or attempt to enter into new non-compete clauses
  - maintain pre-existing non-compete clauses
  - represent to workers, under certain circumstances, that the worker is subject to a non-compete
- “Non-compete clause”: “a contractual term between an employer and a worker that prevents 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.”

FTC Proposed Rule

- "*De facto* non-compete clause": a clause that "has the effect of 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."
  - FTC example of a *de facto* non-compete clause: a non-disclosure agreement that is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer
- What's likely not impacted by the proposed rule:
  - Most confidentiality and non-disclosure agreements
  - Agreements providing for the forfeiture of deferred compensation or benefits by competing workers
  - Agreements restricting a worker from soliciting clients, customers, or other workers
  - Notice-of-resignation and garden leave clauses
- But these other clauses might be viewed as "functional non-competes" if they are so onerous as to functionally prevent an employee from leaving.

FTC Proposed Rule: Impact on Partners

- Sale-of-business exception: non-competes allowed for “substantial owner, substantial member, or substantial partner” who holds at least a 25% ownership interest in the business entity to be sold.
- No other exceptions for partners, founders, or senior executives.
- If the rule is finalized, expect disputes over whether various types of “partners” are within the scope of the rule.
  - *E.g.*, employees who receive both a K-1 (from a GP/managing member) and a W-2 (from the management company)

FTC Proposed Rule: Next Steps

- Public comment period ended April 19, after an extension from March 20.
- FTC has received 19,506 comments.
- In our view:
  - The final rule will include revisions that address some, but not all, of the public comments.
  - The final rule will be immediately challenged in court as an improper exercise of the FTC's authority, as intruding on an area of the law traditionally reserved for the states to regulate, and on other grounds.
  - Whether finalized in its current (proposed) form or with revisions, the rule is likely to be enjoined, either permanently or pending full judicial review of its legality.

Recent Delaware Case Law

Recent Delaware Case Law Striking Restrictive Covenants

- Several recent decisions from the Delaware Chancery Court reflect a trend toward non-enforcement of overly broad restrictive covenants and a refusal to “blue-pencil” those covenants to make them enforceable.
- Businesses with agreements that are subject to Delaware law, or that require disputes to be heard in Delaware courts, should be concerned about how this trend may impact enforcement of their covenants.

Ainslie v. Cantor Fitzgerald L.P. (Jan. 4, 2023)

- Cantor's limited partnership agreement contained two covenants:
  - Non-compete/non-solicit: If you're a partner and you leave, you can't compete with or solicit the customers of the partnership or its affiliates anywhere in the world for one year.
  - Forfeiture-for-competition: If you violate the one-year noncompete or if you compete with the partnership or its affiliates during the four years after you withdraw from the partnership, we're not going to pay out your capital account.
- The plaintiffs were employed by the Hong Kong affiliate of Cantor, but were limited partners of the main partnership.
- They each breached their one-year noncompete.
- Cantor took the position that by competing, they forfeited their capital account payments (200K to 5m+).
- The court held that:
  - The one-year noncompete was unenforceable as to scope and geographic reach, because it was worldwide and covered not only the partnership, but its affiliates.
  - Because the non-compete was unenforceable, the violation of it by the partners could not support the forfeiture of the partners' capital account balances.
  - The four-year forfeiture-for-competition was also not enforceable, for the same reasons.
- The court refused to blue-pencil the overly broad covenants.

Kodiak Building Partners, LLC v. Adams (Oct. 6, 2022)

- Purchaser of a business entered into a non-compete with an employee-stockholder of the acquired business.
- The non-compete prohibited the employee-stockholder from competing *not only* with the acquired business, but with the purchaser's *other* businesses (other companies the purchaser had acquired in other transactions with other company group members in other industry segments).
- The court held that:
  - A covenant not to compete in the sale of a business context must still be limited to the purchased asset's goodwill and competitive space that its employees developed or maintained.
  - Kodiak's non-compete clause was overly broad, and therefore unenforceable.
- The court noted that Delaware courts are reluctant to "blue pencil" an overly broad covenant, even if the noncompete agreement specifically allows or requires blue-penciling of overly broad covenants, and it declined to do so here.
  - As a result, the entire noncompete was simply written out of the agreement, even as to the legitimate interest of protecting the target company's goodwill and business.
  - Classic "baby with the bathwater" result

Intertek Testing Services NA, Inc. v. Eastman (Mar. 16, 2023)

- Intertek purchased a business (Alchemy) and, in exchange for a $10m payment, Alchemy's co-founder/CEO (Eastman) agreed not to compete for 5 years anywhere in the world with Alchemy or Alchemy's subsidiaries.
- Eastman worked for Alchemy post-sale for 5 months, quit, and then founded a competitive business 2 years later.
- Intertek sued to enforce the non-compete, and the court held that the worldwide restriction was overbroad in scope and therefore went beyond Intertek's legitimate interest.
  - Intertek only conducted business in the U.S.
- The court refused to blue-pencil the non-compete, noting that "revising the non-compete to save Intertek—a sophisticated party—from its overreach would be inequitable."

Cantor, Kodiak, and *Intertek*: Key Takeaways

- In general, courts will expect covenants to be no broader—either in substantive scope, definition of competitive activity, length of time, or geography—that is necessary to protect a legitimate economic interest of the company.
  - Over-reach at your peril.
- Provisions regarding affiliates, while appropriate in some contexts, can be dangerous in restrictive covenants.
  - *E.g.*, a release of claims or non-disparagement provision that includes a broad definition of affiliates is often strategic.
  - But in the context of a restrictive covenant—when the court will scrutinize it for reasonableness—the argument for including affiliates would need to be defensible *(e.g.*, necessary to protect a legitimate business interest).
- Agreements that define an employer "group" to include "affiliates" in a section where it makes sense, and that simply carry that broad definition into the restrictive covenants, may be at risk.

Cantor, Kodiak, and *Intertek*: Key Takeaways

- Don’t count on your blue-pencil language to save the day.
- In most states, courts can—and many will—blue-pencil an overly broad covenant, but they are not required to do so.
- When courts refuse to blue-pencil an overly broad covenant, it’s often because they recognize that the company has the superior bargaining power.
  - *E.g.*, the company can insist on an overly broad covenant assuming that the upside is high and the downside is low (because if it’s challenged, the court will simply blue-pencil it down to what the company really needs protection for).

Cantor, Kodiak, and *Intertek*: Key Takeaways

- Is this a trend?
- Might other courts in other jurisdictions adopt a similar analysis?
- If the courts are applying this level of scrutiny in the sale-of-a-business context (where restrictions on post-closing competition have historically been given more lenient review), what does that signal about "everyday" departures?
- Have non-competes become a fundamental worker protection issue? A social justice issue?
- While we expect heightened scrutiny of non-competes for low-wage and rank-and-file employees, is the law not making no distinction based on level of income or sophistication?

Cantor: Appeal on the Horizon

- Apr. 27, 2023: Cantor filed a court notice confirming that it intends to file an appeal of the Chancery Court's decision with the Delaware Supreme Court.
- The parties agreed to a stay of enforcement of the decision pending appeal, in exchange for Cantor's posting of a $12.5m bond.

State Legislative Developments

State Legislative Developments

- The FTC proposed rule would create a national minimum standard.
- But it would not preempt state law or otherwise impact states' ability to further regulate restrictive covenants.
- States have been active in restricting non-competes in recent years.
- Three states ban most non-competes: California, North Dakota, Oklahoma
- A number of states prohibit non-competes for workers below a certain earnings threshold or similar factor: Colorado, D.C., Illinois, Maine, Maryland, Massachusetts, Nevada, New Hampshire, Oregon, Rhode Island, Virginia, Washington.
- Certain states have imposed additional limitations/requirements on the use of non-competes:
  - Time limitations: MA (1 year), NJ (proposed—1 year), OR (1 year), WA (18 months)
  - Garden leave/paid non-compete requirements: MA, OR
  - Notice requirements: CO, DC, IL, ME, MA, NH, NJ (proposed), OR, WA

State Laws

- Even in states that currently limit or place additional requirements on non-competes, the laws on non-solicitation covenants, forfeiture-for-competition covenants, and other restrictive covenants that are not "pure" non-competes are generally more permissive.
- For example, Massachusetts' law limiting non-competes applies to forfeiture-for-competition agreements, but does not apply to (among other things):
  - covenants not to solicit or hire employees
  - covenants not to solicit or transact business with customers, clients, or vendors
  - sellers of a business who receive significant consideration or benefit from the sale
  - restrictive covenants outside of an employment relationship
  - garden leave clauses

What To Do Now

What To Do Now

- Take a full inventory of your restrictive covenants across all agreements:
  - Employment agreements/offer letters
  - GP/management company/operating agreements
  - Other partnership agreements
- Assess whether those covenants may be vulnerable to attack, and why.
- On a going-forward basis (*e.g.*, new hires, amended/restated agreements), draft covenants with an eye toward increasing enforceability.
  - Avoiding overly broad covenants
  - Protecting legitimate business interests to which the employee is connected

What To Do Now

- Consider opportunities for amending existing agreements to shore up vulnerable provisions.
  - For employees: promotions, changes in title, changes in incentive allocations, admission as a partner, etc.
- Stay abreast of evolving state developments, including for remote workers.
- Consider strategies for protecting your business and assets other than through pure non-competes.
  - Tighten confidentiality and non-disclosure agreements
  - Ensure confidential information is secured (and retrieved from departing employees)
- Consider strategies for incentivizing employee retention other than through pure non-competes.
  - *E.g.*, stay bonuses, forfeiture/claw back agreements, deferred compensation

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