Sherman Atlas Sylvester & Stamelman

CORPORATE ALERT

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Federal Trade Commission Unveils Rule Banning Non-Compete Agreements

On April 23, 2024, the United States Federal Trade Commission ("FTC") promulgated a rule banning the majority of non-compete clauses in employment contracts (the "Rule"). The Rule prohibits employers from imposing on employees, independent contractors, and unpaid workers (e.g., volunteers, interns, and externs) non-compete covenants upon the conclusion of the employment or engagement.

Absent a successful challenge to the Rule, and subject to exceptions and limited carve outs discussed below, any non-compete agreement entered into after the new Rule goes into effect (which is 120 days after the Rule is published in the Federal Register) will be void.

In addition to traditional non-compete agreements, the Rule bans (i) agreements or acts by employers that are deemed to be alternatives to non-competes (i.e., penalizing a worker covered by the Rule for seeking or accepting other work, or for starting a new business after leaving an employer), and (ii) severance agreements that condition payment of the severance package on a worker's compliance with a non-competition agreement.

Some existing non-competes will not be affected by the new Rule. For instance, existing non-competes with "Senior Executives" will remain effective until the non-competition covenant expires pursuant to the terms of the underlying agreement. The Rule defines "Senior Executive" as a worker earning more than $151,164[1] a year who is in a "policy-making position", which includes a company's president, chief executive officer or other officer with "policy-making authority".

[1] Although the Rule doesn't expressly state whether this income threshold will increase over time, footnote 682 of the Rule notes an annual salary of $151,164 is in the 85th national percentile of earnings for full-time salaried workers. Accordingly, as salaries increase, the salary threshold may increase as well.

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“Policy-making authority” is defined as the “final authority to make policy decisions that control significant aspects of a business entity or common enterprise” but does not include “authority limited to advising or exerting influence over such policy decisions or having final authority to make policy decisions for only a subsidiary of or affiliate of a common enterprise.”

Non-competition provisions tied to the sale of a business will also be permitted, but are limited to bona fide sales of a business, a person’s ownership interest in a business, or the sale of all or substantially all of a company’s assets.

The definition of “worker” under the Rule is limited to a “natural person.” Accordingly, the Rule likely does not apply to non-competition agreements among businesses or between franchisors and franchisees.

Under the Rule, employers will be required to notify all non-senior executives it has entered into a non-compete agreement and that such agreements are no longer in effect and will not be enforced once the Rule goes into effect. The FTC provided model language for employers to use which can be accessed on the FTC’s website (https://www.ftc.gov/legal-library/browse/rules/noncompete-rule).

Suspected non-compliance with the Rule can be reported to the Bureau of Competition and violations can result in fines, penalties and injunctive relief. Note though, that the Rule does not provide for a private right of action for violations of the Rule.

After the FTC announced the Rule, the United States Chamber of Commerce and several business groups swiftly filed suit against the FTC to prevent enforcement of the Rule.

Notwithstanding the ban on non-competition agreements between employers and workers, the Rule does not expressly ban non-disclosure agreements, customer non-solicitation agreements, or employee or non-solicitation agreements. Accordingly, businesses may continue to zealously protect their confidential trade secrets and proprietary information through these avenues. Employers, however, must avoid situations where such restrictive covenant agreements are just as onerous as non-compete agreements in practice, and function as a non-compete in violation of the Rule.

In addition, employers in some states (including New Jersey and New York) may enjoin former employees from taking on certain duties and responsibilities at a competing company under the “inevitable disclosure” doctrine where such role would inevitably lead to the disclosure of the former employer’s trade secrets to its competitor. Former employers have to satisfy a heightened evidentiary burden to succeed under this doctrine.

Given the filed and further anticipated challenges to the Rule, as well as the numerous carve-outs and exceptions thereto, enforcement of and compliance with the Rule remains murky.

Please contact an attorney in Sherman Atlas Sylvester & Stamelman’s Corporate Department for any questions or inquiries.

Delaware Chancery Court Deals Blow to Stockholder Agreements that Favor Single Stockholders

In a recent 131-page decision, a Delaware court sent shockwaves through the Delaware corporate community and confirmed the primacy of a corporation's board of directors to manage the company's affairs. Specifically, common marketplace agreements to retain governance and control rights often favored and promulgated by private equity sponsors or controlling stockholders appear to be no longer on strong footing, absent swift action by Delaware's legislature.

Earlier this year, Vice Chancellor J. Travis Laster of Delaware's Court of Chancery struck down a package of common stockholder veto rights contained in a corporation's stockholder agreement and held that the majority of the challenged provisions are facially invalid under Delaware law.

In West Palm Beach Firefighters' Pension Fund v. Moelis & Company, 311 A.3d 809 (Del. Ch. Feb. 23, 2024), plaintiff, owner of Class A stock in Moelis & Company ("Moelis" or the "Company"), filed suit against Moelis to challenge several provisions in a stockholder agreement between the Company and its founder, Ken Moelis (the "Founder"). Specifically, prior to its initial public offering, Moelis and its Founder entered into a stockholder agreement (the "Agreement")[1] that gave the Founder several rights and protections, including (collectively, the "Challenged Provisions"):

- 18 veto rights over various corporate actions (which the court re-named "pre-approval rights");[2]
- restrictions on the size of Moelis's board of directors, whereby the board could not exceed 11 members;
- the right to designate a majority of the 11 board members;
- an obligation that the board recommend that stockholders vote to elect the Founder's designees to the board and that the Company use "reasonable best efforts" to enable the Founder's designees to be elected and continue to serve on the board;
- a requirement that the board fill any vacancy in any seat previously occupied by a Founder designee with a new Founder designee; and
- a requirement that the Board populate any committee with a number of the Founder's designees that is proportionate to their membership on the full board.

[1] The Agreement was disclosed prior to Moelis' IPO, and no one disputed that investors who purchased stock in the IPO had notice of the Agreement.

[2] Under the Agreement, the Founder could veto the following corporate actions: incurrence of indebtedness above a certain threshold, issuances of equity in excess of certain thresholds, M&A and investment matters, removal or appointment of any "Section 16" officer, amendment of any governing documents, declaration or payment of any dividend, liquidation of the corporation or its subsidiaries, any amendment to a material contract; initiation or settling material litigation and commencing any voluntary liquidation. These corporate actions required the Founder's *consent* before the board could authorize any of the relevant corporate actions.

Plaintiff filed suit against Moelis and asked the Court to declare the Challenged Provisions invalid and unenforceable because they violated "bedrock" principles of corporate director decision-making under well-settled Delaware law. Specifically, the Plaintiff argued that the Challenged Provisions violated the Delaware General Corporations Law ("DGCL") because the Challenged Provisions effectively stripped directors of their duty to use their own best judgment on matters of management "in a very substantial way".

The Court's Decision

The Court began its analysis by reviewing Section 141 of the DGCL, which provides, in pertinent part, "the business and affairs of any corporation…shall be managed by or under the direction of a board of directors, except as may be otherwise provided in…its charter." (citation omitted).

After analyzing numerous cases relating to the DGCL, the Court stated the Challenged Provisions would be subject to a two-factor test. First, is the Agreement part of the corporation's internal governance arrangement. If this is answered in the affirmative, then the Challenged Provisions are evaluated pursuant to the Abercrombie test, which originated from the Court of Chancery's decision in Abercrombie v. Davies, 123 A.2d 893 (Del. Ch. 1956), to determine whether a provision improperly strips a company's board of directors of its duty to use its own best judgment on management matters.

With respect to the first prong, the Court held that the Agreement "fall[s] on the governance side of the line" because it (i) had provisions that have a statutory grounding in the DGCL, (ii) was among only the Company and its majority stockholder's and Founder's affiliated entities (rather than an unaffiliated counterparty at arms' length), (iii) mandated how corporate actors agree on exercising the corporation's powers, (iv) unlike a commercial contract, was a governance agreement that did not result in an underlying commercial exchange, (v) did not protect an underlying commercial purpose, and (vi) could not be terminated by the Company.

In evaluating the Challenged Provisions under the Abercrombie test, the Court held that the veto rights are facially invalid because they are overreaching and "encompass virtually everything the Board can do." The Court also held that the size, recommendation, vacancy, and committee composition requirements were facially invalid because they removed the directors' ability to candidly and honestly communicate their views on a candidate to the Company's stockholders and determine, when authorized by the DGCL and the Company's charter, the composition of the Moelis's board of directors and committees thereof.

Notably, the Court explained that the Company and Founder could have achieved similar results by using blank check authority to issue preferred stock and granting the preferred stockholders governance rights in the preferred stock's certificate of designations, which forms part of the Company's certificate of incorporation. Further, most of the invalidated provisions would likely be valid if included in a company's certificate of incorporation rather than in a stockholder agreement.

Finally, in striking down the Challenged Provisions, the Court noted "market practices" will not be a defense because "when market practice meets a statute, the statute prevails."

Aftermath

There have been notable reactions since the West Palm Beach Firefighters' Pension Fund v. Moelis & Company decision.

First, the National Venture Capital Association ("NVCA") has revised, among other things, its form Certificate of Incorporation and Investors' Rights Agreement to address issues raised by the West Palm Beach Firefighters' Pension Fund v. Moelis & Company decision.

Second, the Delaware State Bar Association's Council of the Corporate Law Section has proposed amendments to the DGCL, including, without limitation, adding a new subsection 18 to Section 122 of the DGCL that would give corporations the power to enter into contracts with current or prospective stockholders that contain many of the provisions Vice Chancellor Laster invalidated in West Palm Beach Firefighters' Pension Fund v. Moelis & Company. The proposed amendment includes a non-exhaustive list of provisions companies may include in stockholder agreements, including:

- restricting or prohibiting a corporation from taking actions specified in a stockholder contract, whether or not the taking of such action would require approval of the board under the DGCL;
- requiring the approval or consent of one or more persons or bodies before the corporation may take actions specified in a stockholder contract; and
- provisions where the corporation covenants that the corporation or one or more persons or bodies will take, or refrain from taking, actions specified in the contract.

The foregoing proposed amendments to the DGCL, if enacted, will not modify or otherwise alter the fiduciary duties owed by directors or existing standards of review of corporate actions or decisions. Further, the above amendments only address a corporation's agreement with stockholders in their capacity as stockholders, and not in any other capacity (such as creditors, vendors, or suppliers).

The proposed amendments are expected to be introduced to the Delaware General Assembly for approval this year and could be become effective as early as August 1, 2024.

Next Steps

Delaware corporations with stockholder agreements that have provisions similar to the Challenged Provisions should take proactive steps to amend such agreements and their governance documents. Further, corporations should be vigilant and monitor the development of the proposed amendment to the DGCL, as well as any future decisions by the Delaware courts that could either reverse or expand the Moelis decision.

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