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FTC PROPOSES BAN ON WORKER NON-COMPETE AGREEMENTS WITH LIMITED M&A EXCEPTION

By Peter Julian, Craig Waldman, Andrew Levine, and Kristin Berger Parker

Craig Waldman is co-leader of Jones Day's global Antitrust & Competition Law Practice and is based in the firm's Washington, D.C. office. Andy Levine co-leads Jones Day's Corporate Practice and is based in the New York office. Peter Julian and Kristin Berger Parker are partners based in the firm's San Francisco and Minneapolis offices, respectively. Contact: cwaldman@jonesday.com or amlevine@jonesday.com or pjulian@jonesday.com or kparker@jonesday.com.

Consistent with a trend of increased antitrust scrutiny in labor markets, in early January 2023 the Federal Trade Commission proposed an unprecedented rule banning non-compete clauses in employment agreements, a day after announcing three challenges and simultaneous settlements to employer/employee non-compete agreements in *Prudential*, *O-I*, and *Ardagh*.

The proposed rule and its retroactive effect also have significant implications for current, future, and even past M&A deals that utilize non-competes to ensure that value of the target business is protected for a reasonable period of time.

1. The Proposed Rule Would Ban Most Non-Competes

The FTC's proposed non-compete rule, if implemented, would ban almost all employer/employee non-compete clauses nationwide, superseding state laws that are less restrictive than the FTC rule. Under the proposed rule, an employer would violate FTC Act § 5's prohibition on "unfair methods of competition" if it:

- **enters** or attempts to enter into a prohibited non-compete clause with an employee;
- **maintains** or does not rescind an existing prohibited non-compete clause; or
- **represents** that an employee is subject to a non-compete without a good-faith belief that the non-compete is lawful.

Once adopted, the non-compete rule would require employers, within 180 days of the final rule's publication, to inform each employee who is subject to a prohibited non-compete that the employer has rescinded the non-compete.

As drafted, the non-compete rule would apply to almost all employers and workers. The broad definition of "worker" covers both em-

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ployees and independent contractors, as well as other workers (whether or not classified as employees), including externs, interns, volunteers, apprentices, or sole proprietors who provide a service to a client or customer.

2. The Proposed Non-Compete Rule Would Limit a Buyer's Ability to Use Non-Competes in the M&A Context

While the proposed non-compete rule would ban and invalidate most employer/employee non-compete clauses, it provides an exception for non-compete clauses between a buyer and seller of a business, *where the non-compete clause restricts a seller who is a "substantial owner," meaning the holder of at least a 25% interest in the sold business.*[1]

There are also other limited categories of industries and employees that would be exempt from the rule:

- Some employers, such as certain banking institutions, credit unions, and air carriers, are exempt from the FTC Act, so the FTC has no power to regulate them.

- State or local governments and government-affiliated private entities may be exempt under state action immunity, to the extent they are considered "state actors" under the law.

- Non-compete agreements between franchisors and franchisees that restrict franchisees are not covered by the proposed "non-compete" definition, although the proposed non-compete rule will still cover any employer/employee non-competes between franchisors or franchisees, on the one hand, and their respective employees, on the other hand.

Notably, unlike many state laws, which allow reasonable non-competes or include some exceptions for highly compensated, executive, and managerial employees, the FTC's proposed ban contains no exemptions for high-level employees or those with unique, specialized skills or knowledge, regardless of whether they were explicitly agreed to at the time of employment (in connection with a transaction or otherwise) and part of an overall employment package reviewed and understood at that time by sophisticated parties.

3. M&A Implications of the FTC's Proposed Non-Compete Rule

The proposed non-compete rule's "substantial ownership" exception for non-competes in the transactional setting is intended to protect the value of a business

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acquired by a buyer. But non-competes are also often used in the M&A context to retain key talent—and key talent rarely hold such a substantial stake in a company.

The 25% threshold is not only on its face high (and in all likelihood would arbitrarily limit a valid seller non-compete to individuals that are founders of a company, and even then only if their holdings have not already been diluted by venture capital partners), it also assumes that the actual dollar amount paid to an individual in a sale is irrelevant. To state the obvious, 25% of a $10 million transaction would require a payout of only $2.5 million for a non-compete to be permitted; whereas a $1 billion transaction would require $250 million—an absurdly high threshold given current M&A practices on what amount of money should be enough to warrant protection. To provide one example, Jeff Bezos, Amazon's founder and Executive Chairman, reportedly owns less than 10% of outstanding Amazon shares. He would not qualify for the FTC's M&A exemption in a hypothetical sale of Amazon, even though he would receive tens of billions in consideration (if not more).[2]

The proposed non-compete rule also could create difficulties for buyers that have already completed deals, and could create potential windfalls for sellers, as the proposed ban would require rescission of previously entered agreements. That would mean that key employees who were subject to non-compete agreements may suddenly become free agents, regardless of the amount they pocketed in a transaction. These scenarios would create uncertainty for buyers and deprive them of the benefits for which they have already bargained.

4. Companies Should Consider Alternative or Additional Means to Protect M&A Investments

Businesses may need to consider alternative protections to fill the gaps that non-competes address.[3] If the FTC's proposal becomes effective (which appears to be unlikely, at least in its current form), acquirers may seek alternative methods to retain employees, all of which are likely to increase the costs of a transaction. These include:

- **Golden Handcuffs**: Acquirers can offer financial incentives, such as bonuses, stock options, or other incentives to encourage key employees to stay with the company. Those incentives, known as "golden handcuffs," can help to retain employees who may otherwise be tempted to leave after an acquisition. To state the obvious, that is likely to increase the cost of transactions (unless the cost can be pushed to sellers in the negotiations, as part of sellers' transaction expenses) because any of those payments would be in addition to any purchase price paid for the company.

- **Installment Payouts**: Another alternative method is to offer installment payouts to key employees as part of the acquisition. While that would require that buyers and sellers navigate structural limitations to differential treatment of purchase price, if navigable, it could include paying a portion of the purchase price to employees over time, which could provide them with a financial incentive to stay with the company.

- **Customer and Employee Non-Solicitation Agreements**: Another alternative is to use non-solicitation agreements, which prohibit employees from soliciting customers or other employees to leave the company. Those clauses help to protect the value of the company's customer and employee bases.

- **Garden Leave**: Employers also could consider fixed-term contracts with garden leave provisions that keep an employee on the payroll during the term of the contract.

Employers should ensure that alternative terms do not become prohibited "de facto non-competes." The back-up to the FTC's proposed rule states that "the definition of non-compete clause would generally not include other types of restrictive employment covenants—such as non-disclosure agreements . . . and client or customer non-solicitation agreements.” The FTC cautioned, however, that it may consider such covenants to be prohibited “de facto non-compete” clauses where “they are so unusually broad in scope that they function as such.” That analysis would turn, in part, on the competitive dynamics in a given industry. For example, if a customer non-solicitation agreement applies to sales employees that sell into a downstream market with very few customers, the FTC may argue that a customer non-solicit is a de facto non-compete.

Similarly, the FTC could view a broad non-recruit agreement applied to an in-house recruiter (*e.g.*, a limitation prohibiting the employee from being able to effectively recruit talent in his or her particular industry) as potentially also running afoul of the FTC’s rules. Additionally, and while the proposed rule does not expressly address whether garden leave or fixed employment agreements are prohibited, the same arguments may be applied to such an agreement, if the worker attempts to terminate the agreement to work for a competitor.

Beyond retaining talent, the proposed non-compete rule also could make it more difficult for companies to protect their confidential information and investments in employees. Without the ability to use non-compete agreements, companies will have to find alternative ways to protect their confidential information and trade secrets, such as trade secret laws and confidentiality agreements. While those are contractually-based remedies, enforcing those types of arrangements is by its nature more difficult than enforcing non-competes, given the less tangible nature of confidential information and evidentiary hurdles. Practically, it also may be difficult for a company to discover whether its trade secret protections have been violated, and if there is a breach, the available remedies may or may not offer adequate compensation, since the buyer may be unable to put the trade secret genie back in the bottle. Employers may also be able to protect training investments with reimbursement or fixed-term contracts.

5. Companies Should Take Note of the FTC’s Non-Compete Enforcement Actions for Due Diligence Risk Assessments of a Target’s Existing Non-Competes

As noted above, the day before announcing the proposed non-compete rule, the FTC announced that it had settled challenges to three companies’ non-competes in *Prudential*, *O-I*, and *Ardagh*. The FTC brought these challenges under its current FTC Act § 5 authority. Accordingly, buyers should evaluate whether a target’s existing non-competes may be subject to challenge and invalidation and be aware that agencies may inquire into non-competes as part of their merger review process.

Under existing federal antitrust law, a valid non-compete clause must be reasonable, generally meaning that the duration and scope are no greater than necessary to protect the employer’s legitimate interests, and not unduly burdensome. Accordingly, the risk a buyer incurs will depend upon the target’s need for non-competes, the justification, and how narrowly tailored any provisions are. Subject to state law restrictions, the following five indicia of reasonably tailored non-competes suggest a limited risk of drawing an FTC challenge, at least under federal antitrust law:

1. **Tailored to the Geographic Scope to the Reasonable Need for the Non-Compete.** O-I’s non-compete covered the United States, Ardagh’s covered North America, and Prudential’s covered 100 miles. Non-competes for executives with access to strategy regarding national or global markets will justify a broader geographic scope than non-competes for sales employees with a defined territory.

2. **Tailored Duration to the Reasonable Need to Protect Confidential Information**. If a target’s confidential information becomes quickly stale, a shorter non-compete may be appropriate. Alternatively, confidential information with a longer shelf-life may justify a longer non-compete.

3. **Tailored Scope to the Legitimate Need to**

Protect the Company and/or Its Confidential Information. It may not be necessary to prohibit an employee from working for a competitor if that employee will work in a competitor's business unit that does not compete against the target, or that would not allow the employee to use the target's confidential information.

4. **Non-Competes Used Reasonably and Judiciously: Does the Target Need Them for Lower-Level Employees?** In all three cases, the FTC cited large numbers of employees that had non-competes. In *Prudential*, the FTC focused on the fact that many of the non-competes covered low- or minimum-wage earners (security guards), applied a 100-mile radius to those workers, and included $100,000 liquidated damages clauses. The *O-I* and *Ardagh* settlements excluded senior executives (the FTC is considering such an exception in the Non-Compete Rule) and R&D employees, but included engineers and managers in an allegedly highly concentrated industry with substantial barriers to entry. Of course, there may be instances in which low-wage earners have access to a company's key confidential information that justify a non-compete, but practically speaking blanket non-competes that apply to everyone without regard to whether there is a real threat will result in higher scrutiny.

5. **No Available Less Restrictive Alternatives to Non-Competes.** The FTC's complaints allege that the legitimate objectives of non-competes can be achieved through "significantly less restrictive means"—for example, through confidentiality agreements. Putting aside the accuracy of the FTC's argument, consider whether confidentiality agreements, customer non-solicit agreements, or other similar agreements could adequately protect the target's interests, without becoming de facto non-compete clauses.

To be clear, those rules of thumb are not a silver bullet against an FTC inquiry. To the contrary, the proposed non-compete rule makes clear that the FTC is highly skeptical of most non-competes. However, they should serve as a practical guide for companies to assess risk of FTC enforcement under federal law, during the uncertainty ahead.

6. The Non-Compete Rule Is Currently Only a Proposal, and It Is Uncertain When and If It Will Become Law

The rule is not likely to take effect for at least eight months, if ever. The FTC has opened the 60-day public comment period, which ends March 20, 2023. If the FTC makes significant changes to the rule, it may have to issue a revised rule for public comment. For example, the FTC has invited comments about whether the final rule should have an exemption for senior executives, which we believe is appropriate, or apply a rebuttable unlawfulness presumption to non-compete clauses between employers and senior executives, as compared to the ban for other workers. The FTC also has requested comments on whether the "substantial ownership interest" should be set at a different percentage level or dollar amount, or whether the FTC should instead consider a facts-and-circumstances approach instead of a bright-line test.

Following the public comment period, the FTC will review and address comments before adopting the final rule. As drafted, the proposed non-compete rule also provides a 180-day grace period for companies to become compliant after final publication of the rule.

The proposed non-compete rule already has drawn significant attention and controversy, and employers or industry groups are likely to challenge it before the ban takes effect. The Chamber of Commerce already has announced plans to bring an action if the proposed non-compete rule is finalized as drafted, calling it "blatantly unlawful."[4] Challengers likely will argue that the FTC lacks "unfair competition" rulemaking authority under FTC Act § 5, and that a rule that, by the FTC's own accounting, would impact one in five workers and would increase wages almost $300 billion violates the major questions and non-delegation doctrines, among other arguments.

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

ENDNOTES:

[1] More specifically, the exception carves out "a person who is selling a business entity or otherwise disposing of all of the person's ownership interest in the business entity, or . . . a person who is selling all or substantially all of a business entity's operating assets," where the person selling the business is a "substantial" owner, member, or partner in the business being sold. The proposed non-compete rule defines "substantial" to mean a person holding at least a 25% ownership interest in the target business.

[2] Of course, similar considerations apply in private equity, venture capital, and other contexts where key talent could take the benefit of the investment and turn around and compete against the investor.

[3] This is not to say that alternatives provide the same level of protection as a non-compete or that they do so as efficiently.

[4] U.S. Chamber of Commerce, *The FTC's Noncompete Rulemaking is Blatantly Unlawful* (Jan. 5, 2023), https://www.uschamber.com/finance/antitrust/the-ftcs-noncompete-rulemaking-is-blatantly-unlawful.

CLAIMS THAT SPAC DIRECTORS, SPONSOR BREACHED FIDUCIARY DUTIES SURVIVE MOTION TO DISMISS

By Andre G. Bouchard, Ross A. Fieldston, Jeffrey D. Marell and Laura C. Turano

Andre Bouchard is a partner in the Wilmington, Delaware office of Paul, Weiss, Rifkind, Wharton & Garrison LLP. Ross Fieldston, Jeffrey Marell, and Laura Turano are partners in Paul, Weiss' New York office. Contact:
abouchard@paulweiss.com or
rfieldston@paulweiss.com or
jmarell@paulweiss.com or
lturano@paulweiss.com.

In *Delman v. GigAcquisitions3, LLC, et al.*,[1] the Delaware Court of Chancery, in an opinion by Vice Chancellor Will, recently held on a motion to dismiss that it was reasonably conceivable that the directors of a special purpose acquisition company ("SPAC") and its sponsor breached their fiduciary duties by disloyally depriving the SPAC public stockholders of information material to their decision on whether to redeem their shares in connection with the deSPAC transaction. Evaluating the claims under the stringent entire fairness standard, the court concluded that the SPAC's sponsor qualified as a controlling stockholder due to its control and influence over the SPAC, even though it held a minority interest, and that the SPAC directors lacked independence from the sponsor. In addition, entire fairness review was warranted based on the divergent interests between the sponsor and public stockholders that are inherent in the SPAC structure, including the sponsor's unique incentive to take a "bad deal" over a liquidation of the SPAC and returning the public stockholders' investment. The opinion provides important key takeaways for sponsors, directors and investors in Delaware SPACs.

Background

GigCapital3, Inc. ("Gig3") was a Delaware corporation formed with a standard SPAC structure by its sponsor, GigAcquisitions3, LLC ("Sponsor"), in 2020. Among Gig3's features the court found to be "within the [] structural norms" for a SPAC were the facts that its Sponsor received a "promote" in the form of 20% of the post-IPO equity; that the Sponsor appointed all of the members of the SPAC board, who were partially compensated with promote shares; that public stockholders had redemption rights in connection with a deSPAC transaction allowing them to recoup their investment of $10 per share while retaining their warrants (sold as a unit in the IPO) regardless of how they voted on the deSPAC transaction; and that the SPAC