CADWALADER

Quorum

Insights Into Corporate Governance, M&A and Securities Law

Quorum - May 2024

May 9, 2024

Table of Contents:

“Half-Truths,” Not “Pure Omissions”: Supreme Court Limits Section 10(b) Claims Based on Item 303 Nondisclosure to Omissions That Render Affirmative Statements Misleading


By **Adam Magid**
Partner | Global Litigation


By **Victor Celis**
Associate | Global Litigation

On April 12, 2024, a unanimous U.S. Supreme Court issued an opinion in *Macquarie Infrastructure Corp. v. Moab Partners, L.P.*, vacating a Second Circuit judgment that had reinstated claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 based on an issuer’s alleged failure to disclose business risks posed by an environmental regulation. The Supreme Court held that the Second Circuit erred in holding that a violation of Item 303 of Regulation S-K, which requires disclosure of known trends or uncertainties that may materially impact results, may serve as the basis for a Rule 10b-5 claim. The Court reasoned that Rule 10b-5(b) prohibits false statements and lies, as well as “half-truths”; it does not prohibit “pure omissions.”

Macquarie marks a tightening of standards in the Second Circuit, which for almost a decade stood alone in sustaining Rule 10b-5 claims based on Item 303 nondisclosure, even absent an affirmative misleading statement. On the other hand, *Macquarie* will not eliminate Item 303-based Rule 10b-5 claims, which will persist where the nondisclosure renders “statements made” misleading.

Background

Macquarie arose from a United Nations agency’s adoption of a regulation, “IMO 2020,” which sought to ban the use of shipping fuels with a sulfur content of .5% or greater by 2020. Plaintiff brought a putative class action against Macquarie Infrastructure Corporation and certain executives for violations of the securities laws, including Section 10(b), alleging that, from 2016 until a February 2018 earnings call, defendants were aware of the “cataclysmic” impact that implementation of IMO 2020 would have on a Macquarie subsidiary’s business, but concealed that assessment from investors. Plaintiff theorized that the nondisclosure implicated Section 10(b) liability, including because it violated Item 303, which requires issuers to identify “any known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.”

Following dismissal of the suit by the district court, the Second Circuit reinstated plaintiff's Section 10(b) claims. The Court explained that “[t]he failure to make a material disclosure required by Item 303 can serve as the basis for . . . a claim under Section 10(b) if the other elements have been sufficiently pleaded.” The Court, moreover, found that plaintiff adequately alleged an Item 303 violation because “it would not have been ‘objectively reasonable’ for [d]efendants to determine that IMO 2020 would not likely have a material effect on [Macquarie’s] financial condition or operations.” The Supreme Court granted certiorari on September 29, 2023.

The Supreme Court’s Decision

In a unanimous opinion authored by Justice Sotomayor, the Supreme Court framed the issue as “whether the failure to disclose information required by Item 303 can support a private action under Rule 10b-5(b), even if the failure does not render any ‘statements made’ misleading.” The Court’s answer was no: “Pure omissions are not actionable under Rule 10b-5(b).” Therefore, nondisclosure under Item 303 can only support a Rule 10b-5(b) claim “if the omission renders affirmative statements made misleading.”

The Court rooted its decision in the language of Rule 10b-5(b), which makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading." That language, the Court explained, encompasses two distinct prohibited acts: (1) an "untrue statement" and (2) an omission of a fact necessary to make "statements made . . . not misleading." Both require a "statement" to be made, either: (1) a false statement or lie; or (2) "affirmative assertions (*i.e.*, 'statements made')" as to which "other facts are needed to make those statements 'not misleading.'" In other words, Rule 10b-5(b) prohibits "half-truths"—representations that state the truth only so far as it goes, while omitting critical qualifying information—not "pure omissions." The Court thus vacated the Second Circuit's judgment and remanded the case for further proceedings consistent with its opinion.

Key Takeaways

- *Tightened standards for Item 303-related Section 10(b) claims in the Second Circuit.* Since 2015, the Second Circuit has stood alone among circuits in allowing Section 10(b) claims based solely on an Item 303 violation, even absent an affirmative misleading statement. By contrast, the Third, Ninth, and Eleventh Circuits have held that Item 303 and other SEC disclosure requirements do not create an independent "duty to disclose," such that a violation in and of itself can support a Section 10(b) claim. With *Macquarie*, that approach now has decisively won the day, establishing a nationwide rule that *only* Item 303 violations that render affirmative statements misleading can support Section 10(b) liability.

- *Possible reduction in forum shopping and imbalance among Circuits for Item 303-related claims*. Over the last decade, it appears that less demanding pleading standard for Item 303 claims has attracted more Item 303-related litigation to the Second Circuit than elsewhere. For example, in a number of years claims in the Second Circuit have been triple or even quadruple such claims filed in the Ninth Circuit. A possible aftereffect of *Macquarie* could be an evening out in the incidence of Item 303 claims among the Circuits, given that the Second Circuit no longer offers the advantage of a plaintiff-friendly rule allowing claims based on an Item 303 violation alone.

- *Impact on ultimate Section 10(b) liability less clear.* The issue addressed in *Macquarie* is only a small piece of the Section 10(b)/Rule 10b-5 puzzle. Aside from an actionable omission, a plaintiff must plead and prove multiple other elements, including materiality, scienter (intent to deceive), and loss causation. *Macquarie* will only be outcome-determinative where plaintiffs can plead and prove an Item 303 violation, as well as all other Section 10(b) elements, but are unable to identify an affirmative misleading statement tied to the Item 303 nondisclosure. Such cases may be quite rare.

- *Clarity on Item 303-related claims under Section 11 and Section 12(a)(2) of the Securities Act*. *Macquarie* clarifies that, unlike Section 10(b), a violation of Item 303, even absent an affirmative misleading statement, may serve as the basis for a claim under Section 11(a) of the Securities Act of 1933, which prohibits misstatements in registration statements, given the language prohibiting any registration statement that "omit[s] to state a material fact required to be stated therein." Conversely, the Court's conclusions about the limits of Rule 10b-5(b) likely apply equally to Section 12(a)(2) of the Securities Act, which only prohibits prospectuses or oral communications that include, like Rule 10b-5(b), "an untrue statement of a material fact or omit[] to state a material fact necessary in order to make the statements . . . not misleading."

- *Is Macquarie the final word on Rule 10b-5 and Item 303? Macquarie* clearly rules out Rule 10b-5(b) claims based solely on Item 303 violations. However, the opinion explicitly notes that it "does not opine on . . . whether Rules 10b-5(a) and 10b-5(c) support liability for pure omissions." Rule 10b-5(a) makes it unlawful to "employ any device, scheme, or artifice to defraud," and 10b-5(c) makes it unlawful to "engage in a[n] act, practice, or course of business"

that "operates . . . as a fraud or deceit." It is perhaps unlikely that subsections (a) or (c) would be deemed to extend to nondisclosure under Item 303. Courts generally require deceptive conduct to impose liability under Rule 10b-5(a) and (c), and reject claims where the sole basis is alleged misrepresentations or omissions. On the other hand, *Macquarie* teaches that the holdings of lower courts are not necessarily absolute or permanent, and seemingly established precedent can rise or fall at the Supreme Court's command. Thus, the ultimate fate of Rule 10b-5 and its subsections, (a), (b), and (c), remains to be seen.

A version of this article was originally produced as a Clients & Friends Memo here, which was authored by Jason Halper, Ellen Holloman, Adam Magid, Jonathan Watkins, Victor Celis and Diane Lee.

Delaware Supreme Court Expands MFW Applicability in Conflicted Controller Transactions


By **Jason Halper**
Partner | Global Litigation


By **Jared Stanisci**
Partner | Global Litigation


By **Rachel Skene**
Associate | Global Litigation

On April 4, 2024, the Delaware Supreme Court issued a much-anticipated decision, *In re Match Group Derivative Litigation* ("*In re Match Group*"), extending the *MFW* doctrine more broadly to all conflicted controller transactions. In *Kahn v. M & F Worldwide Corp.* ("*MFW*"), the Delaware Supreme Court first provided a framework for freeze-out mergers to receive business-judgment review if the transaction is subject to (1) approval by an independent special committee and (2) an uncoerced, fully informed vote by minority stockholders. Since the framework was established in 2014, however, debate has swirled as to whether *MFW* applied only to freeze-out mergers, where a controlling stockholder takes a company private, or all conflicted controller transactions.

The *Match* case continues the recent trend of Delaware courts expanding the *MFW* doctrine beyond its original applicability in squeeze-out mergers. The Court's decision underscores the heightened focus companies and boards should afford special committees if they wish to avail themselves of business judgment review.

The case stemmed from the reverse spinoff of IAC/InteractiveCorp ("IAC") from its controlled subsidiary, Match Group Inc. In 1999, IAC, through one of its subsidiaries, acquired the Match.com business, which ultimately went public in 2015 through a traditional IPO.

In 2019, IAC informed stockholders that it was considering separating from Match Group. At the time, IAC held 98.2% of Match's voting power, and therefore could exert significant control over the Match Group Board. Further, because any potential separation would necessarily involve IAC on both sides of the transaction, the spinoff contemplated would thus be a conflicted controller transaction. In order to mitigate the legal implications of that control—and at the time presumably in line with the requirements of *MFW*—the respective IAC and Match Group Boards determined that any spinoff would require the recommendation of a Match Group Board Separation Committee and the approval of the holders of a majority of the shares held by Match Group's unaffiliated stockholders.

The Match Group Board appointed three directors to the Separation Committee to assess the proposed transaction, including Thomas McInerney, the former CFO of IAC. On December 18, 2019, the parties reached a final separation agreement, pursuant to which IAC was re-classified into a corporation with one class of common stock (renamed Match Group, Inc.); Match Group itself was merged into an IAC subsidiary and ceased to exist. Match Group minority stockholders received shares of the new Match Group.

Former Match Group minority stockholders challenged the separation, alleging that the reverse spin-off was a conflicted transaction and that IAC obtained significant non-ratable benefits through the transaction, at the expense of Match and its minority stockholders.

The Court of Chancery granted the defendants' motion to dismiss, finding that the defendants satisfied the framework of *MFW*, leading to a review of the plaintiffs' claims under the highly deferential business judgment standard, principally because the transaction was contingent on the "approvals of a fully empowered,

well-functioning special committee of independent directors and the uncoerced, fully informed vote of the minority stockholders." Although the plaintiffs successfully alleged facts impugning McInerney's independence from IAC, the Chancery Court held that a plaintiff must show that "either (i) 50% or more of the special committee was not disinterested and independent," or that "(ii) the minority of the special committee 'somehow infect[ed]' or 'dominate[ed]'" the Separation Committee's decision-making process.

On appeal to the Delaware Supreme Court, the plaintiffs argued that the policy underscoring *MFW* required every director on the Separation Committee to be fully independent. In reply, the defendants contended that the *MFW* framework only required a majority of Separation Committee directors to be independent and that, in any case, McInerney was fully independent. Separately, defendants claimed that the transaction only needed to employ one of *MFW*'s procedural safeguards, arguing that both an independent committee *and* a minority stockholder vote were only required in controller stockholder freeze out transactions, and not all other controlling stockholder transactions.

Agreeing with the plaintiffs first argument, the Supreme Court reversed the Court of Chancery, determining that a special committee seeking to fulfill *MFW*'s framework must be wholly independent, adding that "[a] controlling stockholder's influence is not 'disabled' when the special committee is staffed with members loyal to the controlling stockholder." The Supreme Court held that the Special Committee here was not independent so as to satisfy the special committee approval prong of MFW and therefore, remanded the case down to the Court of Chancery to consider the claims for breach of fiduciary duty under the more demanding entire fairness review.

As to the second argument, the Supreme Court again rejected the defendants' contentions. First, the Supreme Court reiterated that judicial scrutiny and the standard of review increase "where the danger of conflicts is inherent in the board's decision-making process." Looking to precedent, the Supreme Court found a "common thread running through [its] decisions" as "a heightened concern for self-dealing when a controlling stockholder stands on both sides of a transaction and receives a non-ratable benefit." As a result, the Supreme Court found that, "unless defendants can satisfy *all* of *MFW*'s requirements," entire fairness would apply.

Commentary

In recent decisions, including *In re Sears Hometown and Outlet Stores, Inc.* and *Tornetta v. Musk*, Delaware courts have scrutinized controller transactions, including transactions where the alleged controller holds significantly less than 50% of the voting power. The Supreme Court's decision underscores the need for all transactions, even those that may not at first blush seem conflicted controller transactions, to "employ[] procedural tools to replicate arm's length bargaining" as "best practice."

The *MFW* framework provides a pathway for conflicted controller transactions to be reviewed under the more lenient business judgment rule standard which presumes that, in making business decisions, "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *In re Match Group Inc.* particularly emphasized the need for unquestionably independent directors. Interestingly, although the Court acknowledged the compensation paid to the director in question, its decision appeared to rest more on the appearance of a "debt of gratitude" between the director and the controller as sufficient to impugn the independence of the director, emphasizing the long-standing business affiliation as indicia of "personal ties of respect, loyalty, and affection." This trend suggests an approach towards holistic and subjective suggestions of control, rather than objective bright line standards.

Proposed Amendments to the DGCL Address Issues Raised by Recent Delaware Court Decisions

By **Lauren Russo**
Associate | Corporate

By **Peter Bariso**
Partner | Corporate

On March 28, 2024, the Council of the Corporation Law Section of the Delaware State Bar Association approved legislation proposing to amend the Delaware General Corporation Law ("DGCL") in response to recent Delaware Court of Chancery decisions. The proposed amendments will be introduced to Delaware's General Assembly for consideration and, if enacted, will grant more deference for boards of directors to act consistent with current market practice, after Delaware courts recently held that a strict reading of the DGCL did not permit such behavior in certain contexts. The proposed amendments generally focus on three areas, as summarized below.

Stockholder Agreements

As previously discussed in the Cadwalader Quorum here, in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, 2024 WL 747180 (Del. Ch. Feb. 23, 2024), the Court examined whether a stockholder agreement entered into between a corporation and its founding stockholder violated Section 141(a) of the DGCL, which provides generally that the business and affairs of a Delaware corporation "shall be managed by or under the direction of a board of directors." Although the Court acknowledged that it is common for private equity sponsors and other controlling stockholders to enter into agreements allowing holders to retain governance rights and exercise veto rights over certain corporate actions, it read Section 141(a) to require that such arrangements generally be subject to stockholder approval and incorporated into the charter, or risk circumventing the board's authority.

The proposed amendments seek to address the Court's decision in *Moelis* by amending Section 122(18) of the DGCL to expressly permit a corporation to enter into governance agreements with current or prospective stockholders, in exchange for such minimum consideration as determined by the board of directors. The proposed amendments also set forth a non-exhaustive list of the types of provisions that may be incorporated into such agreements, including: (i) veto rights and restrictions on the corporation from taking specified actions; (ii) consent or pre-approval rights in favor of such stockholders; and (iii) covenants that the corporation or certain persons will take, or refrain from taking, specified actions. As noted by the proposed legislation, if adopted, the amendment would include a "bright-line authorization for these contractual provisions, and therefore would reach a different result from a holding in Moelis."

Merger Agreement Remedies

In *Crispo v. Musk*, C.A. No 2022-0666-KSJM (Del. Ch. Nov. 4, 2023), the Court addressed the validity of a "lost-premium damages" provision. When the plaintiff sued for specific performance and lost-premium damages in connection with Elon Musk's attempts to terminate his agreement to acquire Twitter, the Court dismissed the stockholder's claims. Because the merger was ultimately consummated, the Court reasoned that such lost-premium damages could be obtained by Twitter stockholders only if they had a direct right as a third-party beneficiary, which were not conferred by the merger agreement. In *dicta*, the Court reasoned that the lost premium provision in the merger agreement might have conferred limited third-party beneficiary status on Twitter stockholders had the deal terminated.

The proposed amendments would provide some certainty on this issue by amending Section 261(a) of the DGCL to expressly specify the penalties and consequences of a party's failure to perform and authorize lost-premium damages provisions in merger agreements and the appointment of one or more persons to act as representatives of the target corporation's stockholders, with authority to enforce the rights of such stockholders with respect to the merger. The proposals make clear that the new Section 261(a) does not exclude any remedies otherwise available to any party, nor does it alter the fiduciary duties of directors in connection with determining whether to approve, perform or enforce any such provision.

Merger Agreement Approval and Notification Process

As previously discussed in the Cadwalader Quorum here, in *Sjunde AP-Fonden v. Activision Blizzard, Inc.*, C.A. No. 2022-1001-KSJM (Del. Ch. Feb. 9, 2024), the Court addressed a plaintiff's claims that there were several procedural deficiencies in connection with Microsoft's acquisition of Activision, including, among other items, the board of directors' failure to approve the final merger agreement as required by Section 251 of the DGCL. As with *Moelis*, the Court recognized the market practice that sophisticated parties may continue to negotiate and finalize merger agreements and disclosure schedules "up until the moment a deal closes, if not beyond" but noted that "[w]here market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself."

Much like the amendments in response to *Moelis*, the proposed additions to Section 147 of the DGCL would lead to a different result from the holding in *Activision*. The proposed amendments would enable a board of directors to approve any agreement, instrument or document requiring approval under the DGCL that is in final or "substantially final" form. In the published synopsis of the proposal, the Delaware State Bar clarified that an agreement is considered to be in "substantially final" form if all material terms are set forth therein or determinable through other information or materials presented to or known by the board of directors. The new Section 147 of the DGCL would additionally provide that, if the board of directors approves an agreement, instrument or document required to be filed with the Secretary of State in Delaware, or referenced in a certificate to be filed with the Secretary of State, the board of directors may adopt resolutions ratifying such agreement, instrument or document up until the time of filing. Such ratification can serve as evidence that the agreement, instrument, or document was in substantially final form at the time of its approval.

In direct response to the decision in *Activision*, the proposed amendments would also add a new Section 268(a) to the DGCL to provide that a merger agreement may exclude provisions relating to the certificate of incorporation of the surviving corporation in certain circumstances, and a new Section 268(b) to the DGCL to clarify that the disclosure letter and accompanying schedules would not generally be deemed as part of the merger agreement. To further eliminate an open issue from *Activision*, the proposed amendments would amend Section 232(g) of the DGCL to provide that any document enclosed with or attached to a notice (such as a proxy statement) would be deemed part of the notice for the sole purpose of determining compliance with the DGCL and the corporation's governance documents.

Effective Date of Proposed Amendments

If enacted in their current form, the proposed amendments will be become effective on August 1, 2024, and shall apply to: all contracts made by a corporation; all agreements, instruments or documents approved by a board of directors; and all merger agreements entered into by a corporation, regardless of whether or not they are made, approved or entered into on or before the effective date of the proposed amendments.

Treasury Proposes Enhancing CFIUS Enforcement Authority


By **Richard Rowe**
Special Counsel | Corporate


By **Claire McGuinness**
Associate | Corporate

On April 11, 2024, the U.S. Department of the Treasury announced a notice of proposed rulemaking that would expand the enforcement authority of the Committee on Foreign Investment in the United States ("CFIUS" or the "Committee"). If implemented, the proposal's main impact will be to empower the Committee in its engagement with transaction parties before, during, and after the Committee's review of a transaction. There are three main areas impacted by the rulemaking:

1. Expanding the Committee's information gathering powers.
2. Increasing civil monetary penalties that the Committee can impose.
3. Enhancing the Committee's ability to control the transaction review process.

The proposed rule is a supplement to, rather than an overhaul of, the CFIUS regulations that were extensively revised in the years after the enactment of the Foreign Investment Risk Review Modernization Act of 2018. The rulemaking nevertheless could have a significant impact on how certain transaction parties evaluate the legal and business decisions concerning when and how to engage with CFIUS.

Information Collection

While most transaction parties expect robust questioning from agencies' staff after voluntarily disclosing a transaction for CFIUS review, the proposed rule would expand the Committee's ability to engage parties that either have not voluntarily filed with, or have already concluded a review with, CFIUS.

- Non-Notified Transactions. With respect to a transaction not voluntarily filed with CFIUS, current rules authorize the Committee only to collect information regarding whether such a transaction falls within its jurisdiction. The proposed rule expands that authority to include requesting information regarding whether the non-notified transaction may raise national security considerations and whether a pre-closing filing may have been mandatory under existing rules. The proposal would therefore empower the Committee to gather information that would allow it to focus resources on those non-notified transactions that are more likely to give rise to national security risk or that should have been disclosed to CFIUS as mandatory filings.

- Information Regarding False Statements, Omissions, and Breaches. The proposed rule would expand CFIUS authority to gather information to monitor compliance with or enforce an existing mitigation agreement, order, or condition and to determine whether any party has made a material misstatement or omitted material information during the course of a previously concluded review. This clarification would ensure CFIUS can more effectively determine if there have been breaches or if its prior assessments were based on incomplete or inaccurate information.

- Subpoena Authority. The proposed rule would also facilitate issuing subpoenas, which tool CFIUS would be able to apply across its existing and new authorities. The proposed rule would allow the Committee to obtain information from parties to a transaction or other persons through subpoena "if deemed appropriate", a lower threshold than the current "necessary" standard. The proposed rule also assigns to the Staff Chairperson the task of

issuing a subpoena, a significant clarification to facilitate using this authority in practice.

These new information gathering authorities for the Committee should be viewed in combination with the Committee's new penalty authority.

Civil Monetary Penalties

In line with CFIUS leaders' focus on the Committee's enforcement responsibilities in recent years (CFIUS Enforcement and Penalty Guidelines), the proposed rule increases the authority to penalize violations.

- New Penalty Authority. The proposed rule would allow CFIUS to penalize making a material misstatement or omission outside the context of a statutory review period (for example, when CFIUS is collecting information with respect to non-notified transactions). This change can be expected to incentivize more forthcoming disclosures to CFIUS inquiries from respondents.

- Increased Potential Amounts. The proposed rule would also increase the maximum civil penalty amount from $250,000 to $5 million per violation for material misstatements or omissions, or false certifications, in a filing made to CFIUS. The potential penalty amount would also be increased to the greater of $5 million (from $250,000) or the value of the transaction for failure to make a mandatory filing. Lastly, the amount per violation of mitigation measures would also increase to the greater of $5 million per violation (from $250,000), or the value of the transaction, or the value of the violating person's interest in the U.S. business.

In combination, the proposed rule's increased penalty authority and the information gathering authority described above provide the Committee with an enhanced ability to target cross border transactions not voluntarily disclosed to CFIUS and to deter and correct violations of national security risk mitigation measures.

Mitigation Negotiations

CFIUS annual reports show an increased percentage of its transaction reviews resulting in mitigation measures, most of which are negotiated rather than unilaterally imposed. Current regulations do not specify any timeframe for negotiations other than the statutory period for the transaction review. The absence of more specific milestones can mean that certain parties have little incentive for timely engagement (for example, if their transaction has already closed). The proposed rule would require transaction parties to substantively respond within three business days to mitigation measures that the Committee staff proposes, subject to extension by the Staff Chairperson.

The remedy for noncompliance with the proposed change would be the Committee's rejection of the parties' notice. This action may not be feasible in practice for the Committee in all circumstances, given that rejection in some ways limits the Committee's options to mitigate national security risk, but the proposed rule sets a clear standard that the Committee expects prompt engagement and finalization of mitigation terms.

The comment period is open until May 15, 2024. The Committee can be expected to finalize the rule later in 2024, at which time we plan to review the implications for transaction parties in more detail.

FTC Adopts Broad Ban on the Use of Non-Compete Clauses in Employment Agreements


By **Bilal Sayyed**
Counsel | Antitrust


By **Peter Bariso**
Partner | Corporate

The Federal Trade Commission has adopted a final rule (the "Rule") declaring it to be an unfair method of competition:

- With respect to ***a worker*** other than a senior executive:
    1. To enter into or attempt to enter into a non-compete clause;
    2. To enforce or attempt to enforce a non-compete clause; or
    3. To represent that the worker is subject to a non-compete clause.
- With respect to a ***senior executive***:
    1. To enter into or attempt to enter into a non-compete clause;
    2. To enforce or attempt to enforce a non-compete clause entered into after the effective date of the Rule; or
    3. To represent that the senior executive is subject to a non-compete clause, where the non-compete clause was entered into after the effective date of the Rule.

A non-compete clause is:

- A term or condition of employment that prohibits a worker from, penalizes a worker for, ***or functions to prevent***, a worker from:
    - Seeking or accepting work in the United States with a different person where such work would begin after the conclusion of the employment that includes the term or condition; or
    - Operating a business in the United States after the conclusion of the employment that includes the term or condition.

The Rule:

- was published in the Federal Register on May 7, 2024, and will take effect on September 4, 2024;
- preempts state law and state regulation with respect to such clauses, unless state law or state regulation is more restrictive;
- requires "clear and conspicuous" notice to each worker, other than senior executives, subject to a non-compete clause, that enforcing or attempting to enforce the non-compete clause will not be and cannot legally be, enforced

against the worker;

- permit the continued enforcement of existing non-compete agreements with senior executives, whereas for other workers all non-competes (even existing) will become unenforceable;

- does not apply to a non-compete clause that is entered into by a person pursuant to a bona fide sale of a business entity, of the person's ownership interest in a business entity, or of all or substantially all of a business entity's operating assets;

- does not prohibit non-compete agreements between a franchisor and franchisee (but such agreements remain subject to the antitrust laws), but does prohibit non-compete agreements between natural persons who work for either a franchisee or franchisor; and

- adopts a functional test towards identifying non-compete clauses, noting that other restrictive employment covenants may be a non-compete clause if the covenant expressly prohibits a worker from, or penalizes a worker for, seeking or accepting other work or starting a business, or, if it does not do so expressly but is so broad or onerous in scope that it functionally has the same effect as preventing a worker from doing the same.

The Rule identifies a few exceptions: (i) the bona fide sale of a business, discussed above; (ii) existing causes of action related to a non-compete clause accrued prior to the effective date of the Rule; and (iii) good faith belief that the Rule is inapplicable. Additionally, because the FTC does not have jurisdiction over non-profit entities, the Rule does not apply to non-profit entities.

The vote to adopt the Rule was 3-2, with the two newest Commissioners voting against adoption, and both noting their belief that the FTC did not have authority to promulgate rules defining conduct as an unfair method of competition, nor a rule with the breadth and scope of this Rule. There is substantial recent literature on the authority of the FTC to issue so-called "competition rules" with much of it questioning whether the FTC will be able to sustain such rules. Affected businesses and their trade association representatives are likely to have substantial grounds for seeking to delay implementation of the Rule, and, ultimately, to reverse or substantially narrow the Rule. Litigation has already commenced, including in Federal District Court in Pennsylvania and Texas. The U.S. Chamber of Commerce also filed a complaint in Federal Court in Texas for Declaratory and Injunctive Relief, and its President and CEO, Suzanne P. Clark, declared the FTC's decision to ban employer noncompete agreements as "not only unlawful but also a blatant power grab that will undermine American businesses' ability to remain competitive." However, in line with the first to file rule, the Court sided with the FTC and suspended the Chamber's action, allowing the Chamber instead to join existing litigation already filed in District Court in Texas.

Uncertainty with respect to whether the FTC can sustain the Rule, after judicial review, makes it likely that states and localities will continue to legislate and regulate on this issue. Recently, after the Governor of New York and the State Legislature could not agree on legislation that would have limited the use of non-compete clauses, the New York City Council proposed its own legislation prohibiting non-compete clauses. The Rule does not preclude additional efforts such as these, and we expect they will continue. Affected parties should take notice of these efforts.

A version of this article was originally produced as a Clients & Friends Memo here.