Paul | Weiss

CLIENT MEMORANDUM

February 6, 2024

Recent Non-Compete Developments

The landscape surrounding non-compete agreements in the United States has seen numerous recent developments, at both the state and the federal level. Below we summarize some key updates that parties seeking to enter into or enforce these types of covenants should be aware of.

Delaware Supreme Court Enforces Forfeiture-for-Competition Provision

The Delaware Supreme Court in *Cantor Fitzgerald, L.P.* v. *Ainslie* relied on the State's strong policy toward enforcing contracts as written to enforce a forfeiture-for-competition provision in a limited partnership agreement, and in so holding, reversed an earlier decision of the Delaware Court of Chancery (discussed here). Plaintiffs, former limited partners of the defendant, agreed to a so-called "forfeiture-for-competition" provision in which they would be paid balances in their capital accounts in installments over four years after their withdrawal as partners, but would forfeit these payments if they engaged in certain conduct, including "Competitive Activity" during the four-year period following their withdrawal for any reason. The restricted Competitive Activity encompassed both non-competition and employee and customer non-solicitation covenants. Following the limited partners' voluntary withdrawal from the partnership, the partnership determined that the limited partners were all ineligible to receive the payments because each had engaged in Competitive Activity and withheld amounts from just under $100,000 to over $5 million from the limited partners. In its earlier decision, the Court of Chancery ruled that the limited partnership agreement's forfeiture-for-competition provision should be reviewed for reasonableness, rather than enforced on its terms, and concluded that it was unenforceable as "an unreasonable restraint built on unreasonable restrictive covenants."

On appeal, the Delaware Supreme Court reversed. The court noted Delaware's strong public policy in favor of freedom of contract, particularly as embodied in the Delaware Revised Uniform Limited Partnership Act (DRULPA). It distinguished non-compete covenants from forfeiture-for-competition provisions, noting that the former temporarily deprive employees of their livelihood, thus exposing them to the risk of serious financial hardship. In contrast, forfeiture-for-competition provisions do not prohibit employees from competing and remaining in their chosen profession, and do not deprive the public of the employees' services. Therefore, in the absence of these concerns, there was no justification overriding DRULPA's policy of giving maximum effect to the principle of freedom of contract and enforceability of limited partnership agreements. The court therefore held that the forfeiture-for-competition provision at issue was enforceable and not subject to a reasonableness review.

Currently, there is a jurisdictional split regarding whether forfeiture-for-competition provisions constitute restraints on trade. Jurisdictions viewing them as restraints on trade note that their purpose is similar to that of non-compete provisions with a similar threat of economic loss to the employee. Other "employee-choice" jurisdictions do not view them as restraints on trade because they do not prohibit the employee from competing but give the employee a choice between competing and forfeiting a certain benefit on the one hand, and retaining the benefit by avoiding competitive conduct on the other. The Delaware Supreme Court's decision in *Ainslie* sided with employee-choice jurisdictions, at least with respect to forfeiture-for-competition provisions in limited partnership agreements for partners who voluntarily withdraw from the partnership. Notably, *Ainslie* does not discuss whether the ruling would apply to the termination-without-cause context.

The Delaware Supreme Court's decision in *Ainslie* did not address other recent Court of Chancery decisions that have refused to enforce or blue-pencil non-compete and non-solicitation provisions in various contexts, including employment (*Centurion Service Group, LLC* v. *Wilensky*, discussed here) and sale of business (*Kodiak Building Partners, LLC* v. *Adams* and *Intertek Testing Services, NA, Inc.* v. *Eastman* (discussed here)).

© 2024 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this publication may be considered attorney advertising. Past representations are no guarantee of future outcomes.

New York Governor Vetoes Proposed Ban on Non-Competes

On December 22, 2023, New York Governor Kathy Hochul vetoed a bill (discussed here) proposing to ban nearly all employment-related non-compete agreements. She called for modifications to the legislation that would protect "middle-class and low-wage workers" from "unfair practices that would limit their ability to earn a living," while still balancing New York businesses' interests "to retain highly compensated talent." New non-compete legislation is expected to be proposed for a vote this session.

California Non-Compete Laws Take Effect; Another Fails to Advance

On January 1, 2024, two California non-compete laws, Senate Bill 699 (SB 699) and Assembly Bill 1076 (AB 1076) went into effect, adding new requirements and penalties to California's existing statutory framework prohibiting certain restraints on trade, including employee non-compete restrictions. While employee non-compete agreements have long been largely void in California, with limited exceptions, these new laws are significant in that they expand the ability of employees to challenge non-competes in California and add an affirmative notice requirement by February 14, 2024 for employers who have entered into non-compete agreements that are void under California law. For more, see here.

A related bill, Assembly Bill 747 (AB 747), failed to advance ahead of a key deadline on January 31, 2024. AB 747 would have imposed a $5,000 per employee penalty for violations of California's laws against non-compete provisions. Business organizations, including the California Chamber of Commerce, opposed the measure, arguing that it was unnecessary given current laws that make non-compete clauses a violation of the State's laws on unfair competition. The bill also would have narrowed a key exception to the ban for the sale of businesses. California law allows a person selling their stake in a business to sign an agreement prohibiting him or her from operating a similar business in a certain geographic area. AB 747 would have limited this exemption to instances where a person is selling a 10% or greater interest in a business. Industry groups argued that the 10% threshold was arbitrary and would allow those selling a lesser stake to compete immediately utilizing the advantage of their industry knowledge. AB 747 also would have modified California Labor Code Section 925, which permits non-compete restrictions that are a condition of employment for a California employee to be governed by non-California choice-of-law and choice-of-forum if the employee is individually represented by legal counsel in negotiating the terms of the agreement. AB 747 would have required that such counsel not be paid for by, or selected based upon, the suggestion of the employer.

Possible Upcoming FTC Vote on Proposed Ban on Non-Compete Agreements

As we discussed here, early last year, the Federal Trade Commission (FTC) proposed a rule that would ban existing and new employer-worker non-compete agreements by classifying them as "unfair methods of competition." The proposed rule also would require employers to rescind existing employer-worker non-compete agreements and actively inform former workers subject to such agreements that they are no longer in effect. Since proposing the rule last year, the FTC has received tens of thousands of comments. News outlets reported last year that the FTC is expected to vote on its proposed ban on existing and new employer-worker non-compete agreements in April 2024, and we are not aware of any updates on this timing. If the proposed rule becomes final, it would likely face legal challenges, including under the major questions doctrine and on grounds that the FTC arguably lacks authority to issue rules regarding unfair methods of competition. These challenges could ultimately reach the U.S. Supreme Court, which, in other contexts, has been skeptical of agency overreach.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Andre G. Bouchard
+1-302-655-4413
abouchard@paulweiss.com

Jean M. McLoughlin
+1-212-373-3135
jmcloughlin@paulweiss.com

Brette Tannenbaum
+1-212-373-3852
btannenbaum@paulweiss.com

Liza M. Velazquez
+1-212-373-3096
lvelazquez@paulweiss.com

Lawrence I. Witdorchic
+1-212-373-3237
lwitdorchic@paulweiss.com

Pietro J. Signoracci
+1-212-373-3481
psignoracci@paulweiss.com

Practice Management Attorney Mark R. Laramie and Legal Consultant Cara G. Fay contributed to this memorandum.