To Our Clients and Friends,

The last edition of our Insurance Industry Corporate Governance Newsletter covered climate-related disclosure requirements applicable to public and private insurance companies, including the recently adopted final U.S. Securities and Exchange Commission rule for climate-related disclosures.

This month, we focus on the Federal Trade Commission's (the "FTC") final rule on post-employment noncompete agreements, which will have a substantial impact on the insurance and brokerage industries should the rule survive pending legal challenges.

In late April 2024, the Federal Trade Commission (the "FTC") issued its final rule on post-employment noncompete agreements with workers. Key highlights include:

- No new post-employment noncompetes. The final rule bans employers from entering into or attempting to enter into new post-employment noncompetes with any worker after the effective date of the rule, including senior executives. The rule applies broadly to all workers, paid or unpaid, including employees, independent contractors and sole proprietors who provide services to a person.
- Limited grandfathering of existing noncompetes permitted for senior executives but banned for other workers (with notice required). The final rule allows noncompetes with certain senior executives entered into before the effective date to remain in effect. However, employers would be prohibited from enforcing or attempting to enforce an existing noncompete clause with any other worker. In addition, employers must provide notice to any such worker by the effective date that the noncompete will not be enforced. The final rule does not require individualized notice or rescission (i.e., legal modification) of existing noncompetes.
- Exception for seller noncompetes. The final rule does not apply to noncompetes entered into pursuant to a bona fide sale of a business entity. There is no requirement that the worker have at least a 25% ownership threshold for this exception to apply.

The effective date of the final rule is September 4, 2024. The final rule will supersede state law to the extent state law would otherwise permit or authorize a person to engage in conduct that is "an unfair method of competition" under the FTC's final rule or conflict with its notice requirement. State noncompete laws would still govern the enforceability of noncompetes with senior executives that are grandfathered by the FTC's final rule and sale-of-business noncompetes. In addition, the FTC's final rule allows for parallel enforcement by state attorneys general and other state agencies of state noncompete laws.

A challenge to the FTC's final rule is currently pending in federal court in the Northern District of Texas. The plaintiffs, including Ryan LLC, the U.S. Chamber of Commerce, and other business groups, have filed a motion seeking a stay of the rule's effective date and a preliminary injunction against the rule. The court is scheduled to rule on this motion by July 3, 2024.

Requirements of the Final Rule

What Is Considered a Noncompete Clause under the Final Rule?

Under the final rule, a noncompete clause is defined as a term or condition of employment (including a contractual term or workplace policy) that prohibits a worker from, penalizes a worker for or functions to prevent a worker from either: (1) seeking or accepting work in the United States with a different person where such work would begin after conclusion of their employment; or (2) operating a business in the United States after conclusion of their employment.

A noncompete clause under the final rule includes a term or condition that expressly prohibits a worker from seeking or accepting other work or starting a business after their employment ends. As noted above, a noncompete also includes a clause that "penalizes" a worker for doing so, such as liquidated damages provisions, forfeiture-for-competition provisions (where post-employment compensation and benefits are forfeited if the employee engages in competitive activity) and severance arrangements in which the worker is paid only if they refrain from competing. Certain other provisions, such as nondisclosure agreements ("NDAs"), training repayment agreement provisions ("TRAPs") and nonsolicitation agreements, may also be considered noncompete clauses under the rule if they are broad enough to "function to prevent" a worker from (or penalize a worker for) seeking or accepting other work or operating a business after they leave their employer. For these other types of provisions, case-by-case adjudication would be required as to whether they are considered noncompetes under the FTC's final rule.

The notice of final rulemaking describes some provisions that would not be considered noncompete clauses under the rule, such as:

- an NDA where the NDA's prohibitions on disclosure do not apply to information that (1) arises from the worker's general training, knowledge, skill or experience, gained on the job or otherwise or (2) is readily ascertainable to other employers or the general public;[1]
- a clause requiring repayment of a bonus when a worker leaves their job before a certain period of time where the repayment amount is no more than the bonus amount, and the agreement is not tied to who the worker can work for, or their ability to start a business, after they leave their job;
- a garden leave arrangement whereby the worker is still employed and still receiving the same total annual compensation and benefits on a pro rata basis, even if the worker did not meet a condition to earn a particular aspect of their expected compensation, such as a condition for payment of a bonus; and
- mutual fixed-duration employment contracts whereby a worker agrees to remain employed with an employer for a fixed term, and the employer agrees to employ the worker for that period.

[1] However, the notice of final rulemaking provides that an NDA may be a noncompete where they cover such a large scope of information that they function to prevent workers from seeking or accepting other work or starting a business. An example in the notice is an NDA that "bars a worker from disclosing, in a future job, any information that is 'usable in' or 'relates to' the industry in which they work. A second example is an NDA that "bars a worker from disclosing any information or knowledge the worker may obtain during their employment whatsoever, including publicly available information."

What Is the Effect on New Noncompetes?

The final rule would ban employers from entering into or attempting to enter into new post-employment noncompetes with any worker (including senior executives) following the effective date of the final rule (i.e., September 4, 2024). The final rule would also prohibit an employer from representing that a worker is subject to a noncompete.

What Is the Effect on Existing Noncompete Clauses?

The final rule prohibits employers from enforcing or attempting to enforce an existing noncompete clause with any worker after the effective date, other than that employers are permitted to maintain and enforce a noncompete clause entered into with a "senior executive" before the effective date of the final rule.

In addition, by the effective date of the final rule, the employer must provide notice to each such non-senior executive worker who is party to a noncompete that the noncompete will not be, and cannot legally be, enforced. The final rule includes safe harbor model language for this notice, and it can be hand-delivered, mailed, emailed or texted. The notice must also be sent to former workers subject to a continuing noncompete clause unless the employer does not have record of a street address, email address or mobile telephone number. The notice does not require identifying the recipient as having a noncompete, so employers have an option to send a mass communication such as an email to current and former workers. The final rule does not require rescission (i.e., legal modification) of existing noncompetes.

How Is "Senior Executive" Defined in the Final Rule?

A "senior executive" is defined as a worker who is in a "policy-making position" and received total annual compensation of at least $151,164 in the preceding year (on an annualized basis if the worker was employed during only part of the year). Key terms used in this definition are defined by the final rule:

- A "policy-making position" means a president, CEO or the equivalent or any other officer of a business entity who has policy-making authority (or similar person).[2] This can include an officer of a subsidiary or affiliate of a common enterprise if the officer also has policy-making authority for the common enterprise in its entirety—i.e., not just for a subsidiary or business unit or function. Whether a subsidiary or a business unit is part of a common enterprise would be a factual inquiry.[3]
- "Policy-making authority" is defined as final authority to make policy decisions that control significant aspects of a business entity or common enterprise; it 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 an affiliate of a common enterprise.
- "Total annual compensation" may include salary, commissions, nondiscretionary bonuses and other nondiscretionary compensation (i.e., compensation paid pursuant to any prior contract, agreement or promise, including performance bonuses the terms of which the worker knows and can expect) but does not include board, lodging or other facilities or fringe benefits.

This narrow definition of a senior executive will limit the applicability of this exception for most employers. The notice of final rulemaking estimates that 0.75% of workers are likely to be considered senior executives under the final rule.

What Is the Impact on Seller Noncompetes?

The final rule permits noncompete clauses entered into with workers 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." There is no minimum ownership threshold under this exception.

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[2] "Officer" is defined in the final rule to mean a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer and any natural person routinely performing corresponding functions with respect to any business entity, whether incorporated or unincorporated. This definition was derived from the SEC's definition of "officer" in 17 CFR 240.3b-2.

[3] To be considered a "common enterprise," the FTC states that it will look to whether there is a common enterprise of "integrated business entities"—e.g., the various components of the common enterprise maintain officers, directors and workers in common; operate under common control; share offices; commingle funds; and/or share advertising and marketing.

A number of interpretive questions may remain about the scope of this exception. State noncompete laws would still govern the enforceability of noncompetes exempt from the FTC's rule as a sale-of-business noncompete.

What Would Be the Impact on State Law?

The FTC's final rule would supersede any state statute, regulation, order or interpretation only to the extent it would permit or authorize actions prohibited by the final rule or otherwise conflict with the notice requirement.

While the majority of states currently permit the enforcement of noncompetes, subject to reasonableness limitations imposed by case law, some states ban employee noncompetes entirely or prohibit them for specific subsets of employees (e.g., lower-paid employees or certain occupations). Other states have adopted a variety of limitations on noncompetes, including limitations on the length of noncompetes, notice requirements or requirements to provide continued compensation during the period in which a noncompete is in effect. The FTC's final rule would preempt any elements of state law that conflicted with its final rule.

The FTC's final rule provides that it does not impact the authority of a state attorney general or other regulatory or enforcement agency or entity or the rights of a person to bring a claim or regulatory action under applicable state law. For example, a state may continue to enforce a ban on noncompetes under its state statute for workers earning less than a specified wage even though all noncompetes covered by the FTC's final rule are banned (regardless of earnings).

Importantly, the state noncompete law framework would still apply to (1) noncompetes with senior executives that are permitted to remain in effect under the final rule and (2) non-competes allowed under the FTC's sale-of-business exception.

Are There Any Other Exceptions to the Final Rule?

The FTC's final rule does not apply where a cause of action related to a noncompete accrued prior to the effective date. In addition, a person is permitted to enforce or attempt to enforce a noncompete or make representations about a noncompete where a person has a good-faith basis to believe the FTC's final rule is inapplicable.

In addition, certain companies are not subject to the rule because they are exempted from coverage under the Federal Trade Commission Act, such as certain banks, persons subject to the Packers and Stockyards Act of 1921 and non-profit entities. The FTC did not exclude bank holding companies, subsidiaries or other affiliates of federally regulated banks from the final rule.

And finally, the FTC's final rule does not apply to noncompetes if they restrict only work or the operation of a business outside the United States.

What Happens Next?

The effective date of the final rule is September 4, 2024.

A challenge to the FTC's final rule is currently pending in in the U.S. District Court for the Northern District of Texas. The plaintiffs, including Ryan LLC, the U.S. Chamber of Commerce, and other business groups, have filed a motion seeking a stay of the rule's effective date and a preliminary injunction against the rule, and the court is scheduled to rule on this motion by July 3, 2024.

The FTC's final rule includes a severability clause that, if a reviewing court were to hold any provision or application of the rule invalid or unenforceable, the remainder of the final rule would remain in effect.

Advice for Insurance Industry Participants

The insurance industry is an intensely competitive and people-driven business. We recommend that you audit current noncompete programs, even while we await the outcome of litigation. Although noncompetes with "senior executives" entered into before the effective date may remain enforceable, for all other workers, you should be prepared to send out notice of unenforceability by the effective date of the final rule. (Note that a mass

communication to current and former workers would be an option because the model notice does not identify the recipient as having a noncompete.) You will also want to review and revise any employment policies or handbooks that include noncompete clauses; and you may also want to enter into new or modified existing noncompetes with "senior executives" prior to the effective date to take advantage of the final rule's limited grandfathering.

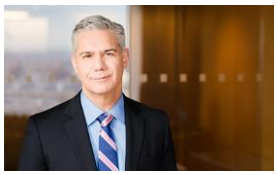
We also recommend focusing on enhancing trade secret protections beyond the use of noncompetes. For example, you can take steps to ensure that there are in place effective and enforceable policies and NDAs and invention assignment agreements. You should also review or put in place new internal processes that limit, control and track access to trade secrets. You could also consider enhancing the remedies for breach of other restrictive covenants (although with care not to violate the FTC's rule by functionally preventing an employee from working for another employer or operating a business following termination of employment).

It may also be a good time to begin to consider compensation changes designed to enhance retention. For example, you may consider retention bonuses or longer vesting periods for long-term awards (e.g., cliff-vesting or back-loaded schedules), pay annual bonuses in part in equity or deferred compensation subject to vesting or reduce severance entitlements on a going-forward basis. Also consider bonus repayment agreements or garden leave arrangements, as described in the FTC's notice of final rulemaking.

Finally, you should also stay on top of state legal developments in this area, as state law will continue to apply to noncompetes with senior executives that are permitted to remain in effect under the final rule and non-competes permitted under the FTC's sale-of-business exception.

For more information, please also see our Navigating the New FTC Noncompete Rule webcast.

Please do not hesitate to contact us with any questions. We look forward to hearing from you!


Eric Dinallo
Partner, New York
+ 1 212 909 6565
edinallo@debevoise.com


Jyotin Hamid
Partner, New York
+1 212 909 1031
jhamid@debevoise.com


Ted Hassi
Partner, Washington, D.C.
+1 202 383 8135
thassi@debevoise.com


Simone S. Hicks
Partner, Washington, D.C.
+1 202 383 8210
sshicks@debevoise.com


Meir D. Katz
Partner, New York
+1 212 909 6615
mdkatz@debevoise.com


Jonathan F. Lewis
Partner, New York
+1 212 909 6916
jflewis@debevoise.com


Franklin L. Mitchell
Partner, New York
+1 212 909 6104
flmitchell@debevoise.com


John (Jay) Neukom
Partner, San Francisco
+1 415 738 5719
jneukom@debevoise.com


Nicholas F. Potter
Partner, New York
+ 1 212 909 6459
nfpotter@debevoise.com


Michael Schaper
Partner, New York
+1 212 909 6737
mschaper@debevoise.com


J. Michael Snypes, Jr.
Partner, New York
+1 212 909 6319
jmsnypes@debevoise.com


Alison E. Buckley-Serfass
Counsel, Washington, D.C.
+1 202 383 8084
aebuckleyserfass@debevoise.com


Tricia Bozyk Sherno
Counsel, New York
+1 212 909 6717
tbsherno@debevoise.com