Prickly Pear

Legal Alerts for the Arizona Business Community

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Ken Witt and Isaiah Wilson, Editors

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Corporate Transparency Act ("CTA") Check-In: What's the Latest?

By Matthew Ditman and Ken Witt

In less than six months' time, an estimated 32.6 million private companies will become subject to the reporting requirements of the CTA—federal legislation carrying significant civil and criminal penalties for non-compliance. Many companies that have never been required to disclose information about company ownership will now be on the hook, both civilly and potentially criminally, for failure to disclose such information.

As more fully described in our previous articles on all things CTA (linked here and here), effective January 1, 2024 any entity classified as a "reporting company" must submit an initial report to the Financial Crimes Enforcement Network ("FinCEN") detailing information about (i) the company itself, (ii) all "beneficial owners" of the company, and (iii) any "company applicant." Generally speaking, a "reporting company" is any LLC, corporation, or other entity formed by filing a document with a state's secretary of state (or other similar office) that does not fall within one of the CTA's 23 specific exemptions from the definition of "reporting company." Notable exemptions include regulated entities that already disclose significant information about themselves (e.g., SEC reporting issuers, broker-dealers, banks, credit unions, insurance companies, etc.).

Two additional exemptions on which many companies will likely rely are the "large operating company" and "subsidiary of exempt entity" exemptions. To qualify for the "large operating company" exemption, a company must meet *all three* of the following criteria: (1) employ more than 20 employees on a full-time basis (i.e., at least 30 hours a week or 130 hours a month) in the U.S.; (2) have filed U.S. federal income tax returns in the previous year demonstrating more than $5,000,000 in gross receipts or sales in the aggregate; and (3) have an operating presence at a **physical office** within the U.S. The "subsidiary" exemption states that any entity whose ownership interests are **controlled or wholly owned**, directly or indirectly, by one or more exempt entities will also be exempt from the definition of "reporting company."

It is important to note that initial FinCEN reports for reporting companies formed on or after January 1, 2024 will be due within 30 calendar days of notice from the secretary of state that the creation or registration of the reporting company is effective (while, by comparison, reporting companies formed before January 1, 2024 will have until January 1, 2025 to file their initial FinCEN reports). While a newly formed company may anticipate qualifying for an exemption from the "reporting company" filing requirements at some point in the future, often the newly formed entity will not qualify for an exemption, particularly the "large operating company" exemption, within

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Many companies that have never been required to disclose information about company ownership will now be on the hook, both civilly and potentially criminally, for failure to disclose such information.

If you have any questions about how, if at all, the CTA will affect your business, please contact a member of Kutak Rock's Scottsdale Corporate and Securities Group.

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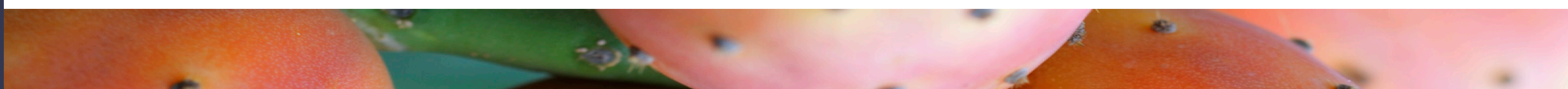
the initial 30 calendar-day window. If your company does not meet the requirements for an exemption right away, it will be necessary to file beneficial ownership and company application reports with FinCEN as a reporting company.

While "reporting companies" formed before the CTA's January 1 effective date are not required to include information about company applicants in their initial FinCEN reports (a welcome relief for many older companies who may have lost this information to the sands of time), these companies will need to disclose information about their beneficial owners (i.e., individuals who either (i) exercise "substantial control" over the reporting company, or (ii) own or control at least 25% of the ownership interests in the reporting company). Importantly, beneficial ownership is a "warm body" standard—meaning that reporting companies must identify the living, breathing human beings who own or control at least 25% of the ownership interests. For some reporting companies, this will be a relatively simple, straightforward task. Others, though, will be well advised to begin determining beneficial ownership now as ownership interests may be indirect, and beneficial ownership determination may require complex, multi-layered analysis.

As noted in our previous CTA articles, each reporting company's initial FinCEN report will include a significant amount of sensitive, personal identifiable information ("PII") about the company's beneficial owner(s) and company applicant(s), including each individual's legal name, date of birth, current residential address (or business address for a company applicant), a unique identifying number from a current passport, driver's license, etc., and an image of the document. To minimize the number of times beneficial owners and company applicants must disclose PII and allow these individuals to disclose PII to FinCEN once, rather than potentially to multiple reporting companies on multiple occasions, FinCEN recently issued a notice and request for comment outlining the process by which individuals can obtain a "FinCEN Identifier." Beginning January 1, 2024, individuals may provide their PII directly to FinCEN on a one-time basis to receive a FinCEN Identifier for use in future FinCEN reports. Individuals who regularly engage in corporate formation or who own multiple companies would be well advised to take this proactive measure as a means of protecting their PII. It is worth noting, though, that individuals who secure a FinCEN Identifier have an affirmative obligation to update any change in PII indefinitely (e.g., a change in address, a new passport or driver's license number, etc.).

As the CTA's January 1 effective date continues to draw closer, companies should start figuring out now (i) if they will be classified as a reporting company and required to file an initial FinCEN report, and, if so, (ii) who qualifies as a beneficial owner of the company. As noted above, both of these questions can be difficult to answer, but Kutak Rock is here to help clients navigate the CTA compliance process. If you have any questions about how, if at all, the CTA will affect your business, please contact a member of Kutak Rock's Scottsdale Corporate and Securities Group.



2023 Arizona Legislative Summary *By Marcus Osborn and Daniel Romm*

The 56th Arizona State Legislature, 1st Regular Session, adjourned at 5:16 p.m. MST on Monday, July 31, 2023 after 204 days. During the course of the legislative session, there were 1,675 bills introduced and 348 of those bills were sent to Governor Katie Hobbs for consideration. She signed 205 of the bills into law and vetoed 143.

Another One for the Records

At 204 days, the 2023 session was the longest legislative session in state history. Arizona does not have a set time frame for its legislative sessions; however, they typically conclude sometime between April and the end of June, once the budget is completed.

The previous record for the longest session was in 1988. It lasted 173 days, mostly due to lawmakers fighting over the impeachment of then Governor Evan Mecham (R).

Hobbs Breaks Veto Record

Back in early April, on the 100th day, Governor Katie Hobbs (D) broke the record for the most vetoes by an Arizona governor in a single legislative session.

Former Governor Janet Napolitano (D) previously held the record for the most vetoes for the 58 bills she nixed in 2005. She currently still holds the record for most vetoes in total by an Arizona governor, notching 181 over her six-plus legislative sessions (2003-2009); however, many predict that Hobbs will break that record next session. Hobbs vetoed 143 bills in her first session as governor.

Napolitano and Hobbs, both Democrats, faced Republican-controlled legislatures. Perhaps it's fitting that prior to taking office, Napolitano gifted Hobbs her veto stamp.

Liz Harris Expulsion

On April 12 the Arizona House of Representatives voted, 46-13, to expel Liz Harris for violating House rules. Harris is only the fifth member in Arizona history ever to be expelled.

Earlier in the session, Harris had invited Jacqueline Breger, a Scottsdale insurance agent, to testify at a special election integrity hearing. At the hearing, Breger alleged that numerous people, including the Arizona House speaker, the governor, other elected officials, the Mormon Church and judges were all part of schemes involving money laundering, drug trafficking, public corruption, bribery of public officials and election fraud.

A report released by the House Ethics Committee found that Harris had lied to the Committee regarding whether she had prior knowledge of what Breger was going to present at the hearing.

2023 Arizona Legislative Summary - Continued on page 3

On May 5, in accordance with state law, the Maricopa County Board of Supervisors selected her replacement, Julie Willoughby (R-Chandler). Willoughby, an ER nurse, had lost to Harris in the general election by only 275 votes. She will serve out the remainder of Harris' term.

Bible Gate

On June 13 the Arizona House voted 30-28 to censure Tucson Democrat Representative Stephanie Stahl Hamilton for disorderly behavior, following her actions of hiding Capitol Bibles.

Security camera footage from the House legislative lounge showed Representative Stahl Hamilton hiding Bibles that would later be found in various locations, including under couch cushions and in the refrigerator.

Representative Stahl Hamilton, an ordained minister in the Presbyterian Church, said her actions came in response to concerns about the separation of church and state and she had hoped to start a conversation about the subject. She later apologized on the floor for what she called a "prank."

Initially, Arizona House Republicans first tried, but failed, to expel her. They then opted for a censure.

Election Bills

Continuing to cite concerns over the handling of the 2020 and 2022 elections, a number of legislative Republicans introduced over 100 bills that would look to reform Arizona's election system. Keeping to her campaign promise, Governor Hobbs rejected all bills that she believed attempted to restrict voting access and/or make unnecessary modifications to Arizona's current voting system.

Out of the 100-plus election reform bills, the only one that the governor did sign into law was the bipartisan SB 1273 Early Ballot Delivery; Instruction Requirements (Bennett). The bill requires counties to include, in the official instructions for voters on election day and the printed instructions to early voters, a specified statement concerning the unlawful handling and return of ballots.

Hobbs' Director Nominations

Back in February, Republican leadership created the Senate Committee on Director Nominations with the purpose of evaluating Hobbs' nominees for department director positions; however, the Committee did not vet the vast majority of the governor's nominees during the first several months of the session and overall, only five of the governor's nominees won full Senate confirmation.

The Committee was supposed to meet over the early part of the summer to hear the remaining agency director nominations; however, Senate leadership cancelled those meetings in response to two Executive Orders issued by Governor Hobbs related to prosecutions of abortion-related cases, gender affirming healthcare and conversion therapy.

Eventually, the Legislature adjourned without getting to the long list of nominees, a to-do list that leaves most agency directors in limbo for the foreseeable future.

Senate President Warren Petersen (R-Queen Creek) has mentioned the possibility of a special session to confirm the remaining nominees; however, he said that some could wait to be confirmed next year when the Legislature returns to work. Executive nominees can serve for up to a full year without Senate confirmation.

Proposition 400 Continuation (Take 2)

Proposition 400, a Maricopa County half-cent sales tax that was first approved by voters in 1985 and extended in 2004, is set to expire in 2025. The majority of transportation projects across Maricopa County, including highway loops 101, 202 and 303, arterials and transit services have all been largely funded in part with Proposition 400 tax money.

In 1999, Republican lawmakers passed a law requiring Maricopa County to receive legislative permission to put any extension of the tax on the ballot. While a bipartisan coalition of lawmakers backed an effort to do just that last session, the proposal was surprisingly vetoed by Governor Doug Ducey, citing rising inflation among other concerns; however, some speculate the real reason for the veto was a trade for the necessary votes to expand the Empowerment Scholarship Accounts school choice voucher program.

Since last year's veto, Maricopa County and the County's numerous municipalities have been working to find support for an extension of the tax, but efforts to move forward any meaningful legislation to continue Proposition 400 were met with significant resistance, especially with regard to transit funding.

Multiple versions of the extension were introduced throughout the legislative session, but none resulted in consensus among Republican leaders and the governor until the final day of the session.

After several months of negotiations, a bipartisan agreement was finally reached to allow Maricopa County voters the opportunity to vote on the extension of the transportation tax for an additional 20 years, starting on January 1, 2026; however, the brokered deal required Governor Hobbs to sign off on a bill that would prohibit municipalities from imposing rental tax. She had vetoed a similar bill earlier in the session.

If the extension is approved by the voters, money from the half-cent transportation tax would be deposited into the Regional Area Road Fund (RARF) and distributed to freeways, highways and street improvements. A total of 40.5% of RARF revenue will go toward freeways and state highways while 22.5% for major arterial streets. In addition, 37% will go to the Public Transportation Fund, which goes toward the maintenance and operation of public transportation and light rail.

Renewing the tax won't actually be an increase to taxpayers for the next 20 years. It's expected to raise over $1 billion per year for a total of $21.7 billion. The ballot proposition will appear during the 2024 General Election.

ESG/DEI Legislation

Arizona, like several other states throughout the country, saw a number of bills introduced this session targeting the policy of environmental, social, and governance (ESG) investing and diversity, equity and inclusion (DEI) investing; however, the governor vetoed every ESG and DEI bill that reached her desk.

This topic continues to be a hot-button issue in Arizona and around the country. While most of the initial ESG/DEI legislation targeted government and financial services companies, we are now seeing the scope expanded to go after other private entities.

What Me Worry?
How To Properly Evaluate ESG Factors In Jurisdictions Hostile To Same

By Marc Lieberman and Colson Franse*

Environmental, Social, and Governance ("ESG") investing refers to the practice of utilizing a set of social rather than pecuniary factors to vet potential investments. Typically, ESG investors eschew investment in companies doing business in industries they believe impair the climate, cause adverse health effects, or increase violence—such as fossil fuel companies, tobacco companies or arms manufacturers. Other ESG investors avoid investment in Israel because Israel, in their view, is an apartheid state. And still others insist that investors should divest from companies whose boards lack what they perceive to have sufficient diversity. ESG investors comprise a significant portion of the industry; in 2021 alone, $500 billion was invested in ESG-oriented investment funds.

Those who manage money for others owe an unwavering duty of loyalty to their clients, and several attorneys' general have opined (and some states have enacted legislation providing) that those who manage public moneys, such as trustees of government pension systems, are prohibited from making investment decisions based on any factor other than promoting the economic interests of plan members. As a result, state or municipal pension trustees, treasurers or finance officers who invest public money in jurisdictions prohibiting consideration of ESG may incur significant liability if they sacrifice investment returns or take on additional investment risk as a means of achieving what they perceive to be salutary societal aims.

So, let's presume you're a state or municipal government official. As such, you're not subject to recent regulations issued by the U.S. Department of Labor interpreting the federal Employee Retirement Income Security Act to authorize the use of ESG in evaluating the merits of an investment. Let's further suppose you work in a state which specifically requires all investments of public moneys to be based on pecuniary factors instead of the achievement of social goals. Does this mean you cannot use ESG considerations in evaluating the merits of an investment? Respectfully, we don't think that is the case.

It is our thesis that because those who manage public moneys have an obligation to do so prudently, they must weigh the risks inherent in every investment. If factors relating to climate might have a material effect on the risk of a particular investment, investment managers certainly can (and should) evaluate such factors in determining whether that investment is worthwhile. Put another way, those managing public moneys will not be in violation of their fiduciary duty to manage that money prudently by choosing investments based on ESG considerations so long as such considerations are designed to enable their state or municipality to achieve the best rate of risk-adjusted return as opposed to being motivated by the promotion of societal goals.

An example

Let's presume a municipal pension system is considering investments in two petrochemical companies, Company A and Company B.

Company A's operations are headquartered in California, and its aim is to exploit oil and gas leases it has already acquired in California's Imperial Valley and the Alaska Wildlife refuge. Company B is based in Saudi Arabia and its aim is to exploit oil and gas fields it has acquired just offshore of the Saudi coast.

Both companies project equal returns, but because of strong opposition to domestic drilling by the California and federal administrations, as well as U.S. environmental groups, there is a real risk that Company A's efforts to exploit its oil fields in California and Alaska may be stymied by lawsuits as well as government intervention. No such political or legal pressures are being threatened with respect to Company B's fields in Saudi Arabia.

Given these realities, consideration of the political and legal threats affecting each Company are legitimate risks to be considered in deciding which of the two Companies is a most suitable investment, despite the fact that these risks ultimately arise out of environmental concerns.

Thus, ESG considerations can be taken into account when evaluating the risks of an investment in a state precluding investment decisions based on ESG considerations, *so long as* the ultimate determinant in selecting an investment is not to promote societal goals but instead to achieve the best return possible in the asset class selected.

Correspondingly, while it is true that a government pension system subject to anti-ESG laws should not select an external investment manager whose investment selections are motivated by promotion of societal goals instead of achieving superior returns, there is nothing wrong with an external manager's consideration of ESG-style risks for purposes of determining whether those risks might affect returns. This is because to ignore such risks might jeopardize realizations.

So, bottom line: In those jurisdictions that bar investments of public moneys based on ESG considerations, consideration of ESG factors for purposes of risk analysis is certainly acceptable so long as the ultimate determinant in making the investment is not to promote social goals but to achieve the best risk-adjusted return possible in the circumstances.

** Marc Lieberman and Colson Franse are members of Kutak Rock's Institutional Investments Group.*

Where to Invest?

ESG considerations can be taken into account when evaluating the risks of an investment in a state precluding investment decisions based on ESG considerations, *so long as* the ultimate determinant in selecting an investment is not to promote societal goals but instead to achieve the best return possible in the asset class selected.

Why You Probably Need an Artificial Intelligence (AI) Policy

By Colson B. Franse and Ken Witt

Do you know if your employees or vendors are using generative AI in their work? Chances are that some of them are (and yes, that can be a big deal). This article takes a quick look at why your company probably needs an AI policy to be proactive instead of reactive in the ever-evolving AI world.

ChatGPT is the fastest growing app of all time since its launch in November 2022 and generative AI continues to take the world by storm. Unfortunately, many businesses (including law firms) have not paused to consider how they should approach generative AI. Before we get ahead of ourselves, let's make sure we are on the same page as to what we mean by generative AI. Generative AI is any type of artificial intelligence system that can generate text, images or other media in response to a prompt based on the patterns and structure of their input training data. On the surface that doesn't sound so bad but let's narrow in on what we mean by "input training data," specifically in the context of ChatGPT.

Like your browsing history, ChatGPT by default keeps a chat history of the "conversations" that you have with ChatGPT and uses this data to train and improve ChatGPT, meaning that both data you input and outputs you receive from ChatGPT are out of your control and subject to the whims of the complex AI algorithm. Fortunately, the ChatGPT feature introduced on April 25 now allows users to turn off their chat history. Conversations that take place after chat history is turned off will not be used to train and improve Chat GPT and will be deleted after 30 days. While this is a step in the right direction, keep in mind that ChatGPT is not the only generative AI platform and by default ChatGPT will be keeping a chat history.

What does this mean for your business? Here are a few quick examples:

First, unbeknownst to you, your employee may have used ChatGPT or a similar platform to generate that blog post requested by your client and there are a number of issues, including copyright, that could be the subject of another article.

Second, imagine you have an outdated filing system and your company signs a contract with a new online document management platform that will help you become more organized. One of the key selling points is that this document management company scans the documents and then uses OCR (optical character recognition) combined with AI to process those piles of documents around the office into orderly online folders. What you failed to consider was that the document management platform utilizes a third-party AI provider whose policy provides that your documents will be used as "input training data" for the AI provider. Hopefully those documents did not have confidential client information, personal health information covered by HIPAA or data from customers in Europe subject to the General Data Protection Regulation because they are now forever part of the AI platform.

Third, imagine you hire an attorney to do some research for you surrounding some of your company's trade secrets. This attorney prepares a draft memo but decides to use ChatGPT to rewrite part of the memo to make it more understandable (not knowing to turn off chat history). The attorney uploads the memo, and out comes a much more polished product for you. The first problem is that the lawyer has probably violated the important duty of confidentiality (Model Rules of Professional Conduct 1.6) and may have waived attorney-client privilege by disclosing confidential client information to ChatGPT. The second problem is that you may have lost trade secret protection because the trade secrets were discussed in the memo, and the memo is now part of the ChatGPT training data and used to generate content for other users.

Perhaps you now see some of the risks surrounding generative AI. We recommend that every company consider adopting AI policies and procedures both for employees and external vendors. An AI policy should at a minimum (i) provide for general training on the topic to all employees; (ii) address permitted uses, prohibited uses and uses requiring internal approval; (iii) define what company information may or may not be uploaded; (iv) specify what generative AI platforms are permitted and prohibited (possibly having your IT department block prohibited platforms); (v) adopt transparency protocols which help internal and external stakeholders identify content created by generative AI and (vi) provide for continuous monitoring of new platforms and technology.

What are the risks?

An employee generates a blog post with ChatGPT

» Copyright infringement

A new document scanning system employs OCR and AI retains data for training purposes

» Violation of HIPAA or General Data Protection Regulation

An attorney prepares a draft using ChatGPT

» Violation of confidentiality and loss of trade secret protection

SEC v. Ripple Labs: The SEC Suffers a Partial Reverse in its Ongoing War on Crypto

By Ken Witt and Colson Franse

A federal judge in the Southern District of New York recently handed the SEC a significant setback in its closely watched lawsuit against Ripple Labs Inc. The SEC had alleged that Ripple's crypto asset, XRP, was a security, and that sales of XRP by Ripple and two of its senior executives were made in violation of the federal securities laws.

U.S. District Judge Analisa Torres issued her landmark ruling on July 13, 2023, holding that programmatic (open market) sales of XRP tokens did not require registration under the securities laws but that sales of XRP by Ripple to institutional investors were sales of securities that required registration under the securities laws. In other words, in this novel decision, whether XRP is a security subject to the federal securities laws depends on how XRP is sold and who buys it.

The SEC had sued Ripple and two of its executives back in December 2020, claiming that they raised over $1.3 billion through the sale of XRP tokens in unregistered securities offerings, in violation of Section 5 of the Securities Act of 1933. The SEC argued that XRP is a security within the meaning of the Securities Act because it is an "investment contract" under the Supreme Court's *Howey*[1] test: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits solely from the efforts of others.

Applying the *Howey* test, the Court held that "XRP, as a digital token, is not in and of itself, a 'contract, transaction or scheme' that embodies the *Howey* requirements of an investment contract. Rather the Court examines the totality of circumstances surrounding [d]efendants' different transactions and schemes involving the sale and distribution of XRP[2]."

Following this protocol, the Court found first that sales of XRP by Ripple to institutional investors, such as hedge funds, pursuant to written contracts were sales of securities that, absent an exemption, should have been registered under the securities laws. Judge Torres reasoned that such sophisticated investors understood that Ripple would use the proceeds to develop thefunctionality of XRP and increase its value, thereby meeting the third "prong" of the *Howey* test, expectation of profits from the efforts of others.

By contrast, "programmatic sales" of XRP on digital asset exchanges and through trading algorithms did not meet the "third prong" of *Howey*. Unlike institutional buyers who purchased XRP directly from Ripple, buyers of XRP through an exchange had no expectation that the performance of the seller, whoever that might have been, would enhance the value of the token.

Finally, the Court held that issuances of XRP to employees and developers as payment for services did not meet the "first prong" of the *Howey* test, the investment of money, in spite of the fact that value was clearly exchanged.

The SEC may consider an appeal of this decision, especially because applying this precedent would mean the same token could be a security or not depending on the buyer's expectations and the manner of sale. Note as well that, if upheld, the ruling would mean that, unlike institutional investors, retail investors with less money and sophistication would not be protected by the federal securities laws.

An order just handed down by a colleague of Judge Torres in the Southern District of New York does not augur well for her Ripple decision. In a July 31, 2023 order[3], Judge Jed Rakoff refused to dismiss the SEC's case against Terraform Labs Pte Ltd. and its founder, alleging a multi-billion dollar fraud involving various cryptocurrencies. Judge Rakoff expressly rejected Judge Torres' *Ripple* reasoning, stating that *Howey* makes no such distinction between retail and institutional purchasers: "That a purchaser bought the coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts."[4]

Time will tell, but Judge Torres' split decision will most likely only cause a "Ripple" in the SEC's ongoing anti-crypto campaign.

1. SEC v. W. J. Howey Co., 328 U.S. 293 (U.S. May 27, 1946).
2. Order at 15, SEC v. Ripple Labs, Inc., No. 20-10832 (S.D.N.Y. July 13, 2023), ECF 874.
3. Securities and Exchange Commission v. Terraform Labs Pte Ltd., 1:23-cv-01346, (S.D.N.Y. Jul 31, 2023) ECF No. 51.
4. Id. at 41.

The NLRB's General Counsel Targets Employee Non-Competes

On May 30, 2023, General Counsel for the National Labor Relations Board ("NLRB") issued Memorandum GC 23-08 ("Memo 23-08"), asserting that many employee non-competes violate the National Labor Relations Act ("NLRA") because they interfere with employees' exercise of their rights under the NLRA. The General Counsel sets forth a proposed legal standard under which an employee non-compete will be found to violate the NLRA if it reasonably tends to "chill" employees' exercise of their Section 7 rights unless it is "narrowly tailored" to the special circumstances that justify infringing on employee rights. Because the NLRA protects most employees regardless of whether the employer's workforce is unionized or not, all employers should be mindful of the legal standard proposed by the NLRB's General Counsel.[1]

The General Counsel's proposed legal standard follows the reasoning in the NLRB's recent decision in *McLaren Macomb*, 372 NLRB No. 58 (Feb. 21, 2023). In *McLaren Macomb*, the NLRB ruled that overbroad confidentiality and non-disclosure provisions in severance agreements for certain employees—and even the mere offering of severance agreements with such overbroad provisions—violated the NLRA because such provisions may chill employees in the exercise of their NLRA rights.

The NLRB General Counsel's Proposed Legal Standard

The NLRB's General Counsel argues in Memo 23-08 that "the proffer, maintenance, and enforcement of" non-compete agreements[2] generally violate Sections 7 and 8 of the NLRA. As explained in our prior Legal Alert, Section 7 of the NLRA guarantees employees "the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection," as well as the right "to refrain from any or all such activities." Under Section 8(a)(1), employers may not "interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in Section 7."

The General Counsel believes non-compete provisions chill employees' exercise of protected activities under the NLRA "when the provisions could reasonably be construed by employees to deny them the ability to quit or change jobs by cutting off their access to other employment opportunities that they are qualified for based on their experience, aptitudes, and preferences as to type and location of work."[3]

By way of illustration, the General Counsel sets forth five specific ways that non-compete agreements purportedly interfere with Section 7 rights:

1. Concertedly threatening to resign to demand better working conditions.
2. Carrying out concerted threats to resign, or otherwise concertedly resigning, to secure improved working conditions.
3. Concertedly seeking or accepting employment with a local competitor to obtain better working conditions.
4. Soliciting their co-workers work for a local competitor as part of a broader course of protected concerted activity.
5. Seeking employment, at least in part, to specifically engage in protected activity with other workers at an employer's workplace.

Applicability to the Solicitation of Co-Workers

The fourth example listed above specifically mentions the solicitation of co-workers. Although Memo 23-08 does not directly address employee non-solicitation provisions, the General Counsel specifically references the "broader course of protected concerted activity" under the NLRA, including soliciting fellow employees. This indicates that non-solicitation provisions banning the solicitation of other employees may be next on the NLRB's chopping block.

The "Special Circumstances" Defense (or Lack Thereof)

While the NLRB's General Counsel opines that "the proffer, maintenance, and enforcement of" non-compete provisions chill employees' exercise of protected activities under the NLRA, she left the door open for employers to enforce such provisions under "special circumstances." Specifically, the General Counsel notes that "unless the [non-compete] provision is narrowly tailored to special circumstances justifying the infringement on employee rights," "the proffer, maintenance, and enforcement of" such provisions violate the five above-referenced protected activities.

Rather than defining such "special circumstances," the General Counsel sets forth two business interests that she declined to recognize as such. First, the General Counsel declines to recognize the business interest to generally "avoid competition from a former employee" as a legitimate interest supporting a special circumstances defense.[4] Second, the General Counsel opines that the business interest of retaining employees or protecting special investments in training employees would be "unlikely to ever justify an overbroad non-compete provision."

The General Counsel, however, explains that employers may protect their proprietary and trade secret information through "narrowly tailored workplace agreements that protect those interests." The reference to "narrowly tailored workplace agreements" without mention of the use of a non-competition agreement to protect such information is likely an indication the General Counsel believes a non-compete agreement would be more than what is necessary to protect an employer's proprietary information. This is because a confidentiality or non-disclosure agreement would likely be sufficiently narrow to protect such information without a non-compete agreement.

Additionally, the General Counsel states that some non-compete provisions may not violate the NLRA if they restrict "only individuals' managerial or ownership interests in a competing business, or true independent-contractor

The NLRB's General Counsel Targets - Continued on Page 8

relationships." The General Counsel most likely sets forth this proposition because the NLRA's definition of "employee," as used in Sections 7 and 8 of the NLRA, excludes "any individual employed as a supervisor"—among a few others—from its protections.[5]

Although the General Counsel indicates some non-compete provisions may comport with the NLRA, she also states that employers would be "unlikely" to justify imposing such provisions upon "low-wage and middle-wage workers" without access to protectable business interests. The General Counsel's proposed heightened standard of justification also would apply in situations where state law prohibits the use of non-compete provisions.

The General Counsel Calls on all NLRB Regional Directors

The General Counsel urges all NLRB Regional Directors to submit to the NLRB's Division of Advice any cases whereby employment agreements with non-compete provisions arguably have a chilling effect on employees' rights guaranteed under the NLRA. Additionally, all NLRB Regional Directors are instructed to submit to the NLRB's Division of Advice "arguably meritorious special circumstances defenses."

The General Counsel further instructs all NLRB Regional Directors to seek make-whole relief for employees who can demonstrate lost employment opportunities due to an employer's "unlawful maintenance of an overbroad non-compete provision," even in situations where employers do not attempt to enforce such provisions. In other words, if an employee loses out on a job prospect due to their employer merely maintaining an overbroad non-compete provision, "even absent additional conduct by the employer to enforce the provision," then such employees would be entitled to make-whole relief.

If the NLRB elects to adopt the General Counsel's position on non-compete provisions, it would likely be challenged to the appropriate federal court of competent jurisdiction. In fact, the U.S. Chamber of Commerce has already publicly opposed Memo 23-08, calling the General Counsel's position an "extreme and blatantly unlawful overreach." The U.S. Chamber of Commerce's Vice President of Labor Policy referred to the General Counsel's proposed standard as "speculative at best" and "hardly a sound justification for banning a practice that has been legal since the founding of the Republic."

Information Sharing Among Federal Agencies

Finally, the General Counsel foreshadows the possibility of increased information sharing among the NLRB, the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ"). The General Counsel explains in a footnote that the NLRB entered into an agreement last year with the FTC and the DOJ's Antitrust Division to foster an "interagency approach to restrictions on the exercise of employee rights, including limits to workers' job mobility." Accordingly, Memo 23-08 implores all NLRB Regional Directors to alert the NLRB's Division of Operations-Management of cases concerning non-compete provisions "that could potentially violate laws enforced by the FTC and the [DOJ's] Antitrust Division for possible referral to those agencies."

In our prior Legal Alert concerning the FTC's attack on employee non-competes, we explained that the FTC recently published a Notice of Proposed Rulemaking (the "Proposed Rule"), which would preclude employers from entering into non-compete agreements with employees. The Proposed Rule would apply not only to employees, but also to independent contractors, externs, interns, volunteers, apprentices and sole proprietors offering services to the company's clients or customers. Given the FTC's shared stance on non-compete provisions, it is not surprising that the General Counsel is calling for more information sharing between the two agencies.

Employer Takeaways

While Memo 23-08 represents the General Counsel's position on non-compete provisions, it is not legally binding—yet. Any changes to NLRA precedent must first be approved by the NLRB; therefore, the NLRB would need to adopt the General Counsel's position set forth in Memo 23-08 for the Memo to become legally binding. Given the NLRB's recent ruling in McLaren Macomb, the NLRB's adoption of the General Counsel's position on non-compete provisions is likely.

As for now, Memo 23-08 indicates that employers should consider using non-compete agreements only for employees satisfying the NLRA's definition of "supervisor" or "managerial employees." For non-supervisor and non-managerial employees, employers should carefully scrutinize the use of non-compete agreements. First, employers should ensure that one or more legally protected interest exists to warrant their use, and that such agreements are narrowly tailored, such that the restrictions imposed on the employee are limited only to those that are necessary to protect those interests. Where customer goodwill can be protected with a narrowly drafted customer non-solicitation provision, and proprietary information or trade secrets can be adequately protected with a confidentiality or non-disclosure agreement, employers should consider utilizing those in lieu of a non-competition agreement. Finally, employers may want to wholly avoid non-compete agreements for low wage, non-managerial employees.

We will closely follow the NRLB's handling of Memo 23-08, as well as other state and federal developments involving non-competition agreements. In the meantime, if you have questions about the enforceability of your organization's non-compete agreements, including whether your policies, practices and employment agreements are compliant with state and federal law, or how to properly revise or draft a non-compete agreement in your jurisdiction, please contact any member of Kutak Rock's National Employment Law Group.

1. The NLRA applies to most private sector employers, including manufacturers, retailers, private universities and healthcare facilities. The NLRA does not apply to federal, state or local governments; employers who employ only agricultural workers; and railroad and airline employers covered by the Railway Labor Act.

2. In the Memo, the General Counsel generally describes non-competes as agreements "between employers and employees [that] prohibit employees from accepting certain types of jobs and operating certain types of businesses after the end of their employment."

3. While the General Counsel concedes the NLRA does not specifically protect employees' right to engage in these concerted resignations, Memo 23-08 reasons that "such a right follows logically from settled [NLRB] law, Section 7 principles, and the [NLRA]'s purposes."

4. However, by citing to the Restatement (Second) of Contracts to support her conclusion that the desire to prohibit ordinary competition is not a special circumstance justifying a non-competition agreement, the General Counsel implicitly acknowledged that "post-employment restraint on competition 'must usually be justified on the ground that the employer has a legitimate interest in restraining the employee from appropriating valuable trade information and customer relationships to which he has had access in the course of his employment.'" See Restatement (Second) of Contracts § 188 cmt. b (1981).

5. For purposes of the NLRA, a "supervisor" is "any individual having authority, in the interest of the employer, to hire, transfer, suspend, lay off, recall, promote, discharge, assign, reward, or discipline other employees, or responsibly to direct them, or to adjust their grievances, or effectively to recommend such action, if in connection with the foregoing the exercise of such authority is not of a merely routine or clerical nature, but requires the use of independent judgment." Like "supervisors," "managerial employees" are not protected by Section 7 of the NLRA. "Managerial employees" are those "who formulate and effectuate management policies by expressing and making operative the decisions of their employer, and those who have discretion in the performance of their jobs independent of their employer's established policy." Therefore, the General Counsel's proposed standard may not apply to executives, supervisors, managerial employees and independent contractors because they are outside the definition of "employees" covered by the NLRA.

Scottsdale Corporate and Securities Group

Mark Lasee
Partner

mark.lasee@kutakrock.com
480.429.4828

Marc Lieberman
Partner

marc.lieberman@kutakrock.com
480.429.7103

Emily Smith
Partner

emily.smith@kutakrock.com
480.429.4886

Michael Tobak
Partner

michael.tobak@kutakrock.com
312.602.4105

Ken Witt
Partner

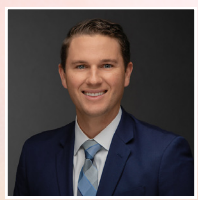
ken.witt@kutakrock.com
480.429.4864

Richard Lieberman
Transition Partner

richard.lieberman@kutakrock.com
480-429-4830

Isaiah Wilson
Of Counsel

isaiah.wilson@kutakrock.com
480.429.7122

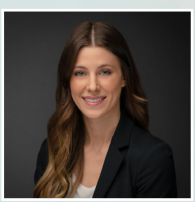


Matthew Ditman
Associate

matthew.ditman@kutakrock.com
480.429.5000

Colson Franse
Associate

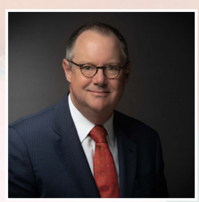
colson.franse@kutakrock.com
480.429.4851



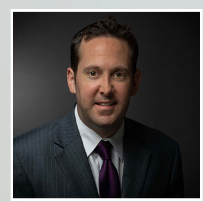
Christina Ribble
Associate

christina.ribble@kutakrock.com
480.429.4844

Scottsdale Government Relations Practice Group



Marcus Osborn
Senior Government Relations Director
marcus.osborn@kutakrock.com
480.429.4862



Daniel Romm
Government Relations Director

daniel.romm@kutakrock.com
480.429.4852