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FTC Issues Final Rule Banning Non-Compete Agreements; Significant Enforceability Challenges Likely

Key Takeaways

What Happened?

On April 23, 2024, on a party line 3–2 vote, the Federal Trade Commission (FTC) voted to issue a final rule imposing a national ban on all employers from using non-compete clauses in contracts with all workers at any level, except for existing agreements with senior executives (defined as those with policy-making authority who earn more than ~$151k annually) and non-competes entered into in connection with a bona fide sale of a business (the Rule).

The majority Democratic Commissioners support the ban because they argue non-compete clauses suppress wages and inhibit business formation and innovation. The dissenting Republican Commissioners argue that the FTC lacks the legal authority to promulgate what is not a rule, but in effect national legislation, with Commissioner Holyoak commenting, among other things, that the Rule "will likely not survive a legal challenge."

Is The Rule Enforceable?

The Rule is being aggressively challenged (for example, the Chamber of Commerce has already filed suit), and the statutory and Constitutional arguments against its enforceability are strong. Opponents of the Rule raise challenges under several statutory and Constitutional theories including:

- The FTC lacks statutory authority to promulgate the Rule. The FTC has virtually never attempted to exercise similar authority in the many decades of its existence. And while Congress did pass a law (called the Magnusson-Moss Act) giving the FTC authority to regulate certain *consumer protection* behavior, it never authorized this sort of regulatory rulemaking activity vis-à-vis *competition*. The rational implication of historical Congressional and FTC behavior suggests that the FTC lacks the statutory authority to do what the Rule purports to do — to nullify more than 30 million existing contracts nationwide, preempt the laws of 46 states and declare contracts unlawful across the entire country regardless of their terms, conditions, historical context and competitive effects, as explained by Commissioner Ferguson during his remarks.
- The "major questions doctrine" blocks the FTC from promulgating the Rule. This doctrine generally requires clear Congressional authority for an agency to promulgate rules of general applicability that would have a material impact on economic behavior. Such authority is absent here. The majority Democratic Commissioners argue that their authority stems from Sections 5 and 6(g) of the FTC Act; they say that, taken together, these provisions empower the FTC to promulgate rules for the generalized purpose of preventing what the majority of the FTC believes to be unfair methods of competition. Republican minority Commissioners Holyoak and Ferguson disagree, instead arguing that the fact that states have regulated employee restrictive covenants for more than 100 years and have come to varying conclusions depending on distinct public policy preferences, suggests strongly there is an absence of clear Congressional authority given to the FTC

to regulate these questions nationally. As the Chamber of Commerce has stated, moreover, the broader implications for the U.S. economy if three unelected regulators at the FTC have authority to pass a rule like this are profound, given the other types of rules that could be promulgated under the FTC's logic.

- Even if a case could be made for the actual delegation of this authority to the FTC under existing law, it would be an unconstitutional delegation of legislative authority to an administrative body. If enacted, the Rule would have a major impact on the U.S. economy, including the 46 states where some non-competes are permissible. The fact that dozens of states have enacted their own legislative regimes to govern these agreements suggests that delegation of questions this important to an administrative agency is impermissible.

When will the Rule be Effective?

Per the FTC, the Rule is scheduled to become effective 120 days following publication in the Federal Register (likely in the next few days). However, in light of the already-existing legal challenges discussed above, many commentators expect an injunction enjoining application of the Rule until a final determination of its enforceability is made by a court (likely before the effective date). The timing of the litigation is uncertain and could take years. We will continue to monitor these developments.

What Should Employers Do Now?

While a stay of enforcement could be lengthy, many state legislatures have been trending toward restricting or prohibiting non-competes in any event. Thus, even if the Rule is ultimately found unenforceable, employers may face increasingly restrictive laws passed by state legislatures. As a result, employers should consider working with counsel to determine which individuals will qualify as "senior executives" and consider auditing existing contracts to understand the scope of their existing non-compete use (including terms that may be deemed a *de facto* non-compete clause, as discussed below). Below, we offer strategies that employers can consider in lieu of traditional non-compete restrictions if a stay is not implemented, the Rule is ultimately found to be enforceable or more restrictive state laws are passed.

Key Aspects of the Rule

Overview

The Rule varies only somewhat from the proposed rule published by the FTC on January 5, 2023. Other than for existing agreements with senior executives and outside a sale of a business, it prohibits an employer from entering or attempting to enter into a non-compete clause with a worker, as well as representing to a worker that they are subject to a non-compete clause. In other words, the Rule prohibits all existing non-competes (other than those with senior executives) and all new non-competes after the effective date (including those with senior executives), in each case, other than non-competes as part of a sale of business.

The Rule's definition of "worker" is broad, including a natural person who works or previously worked, whether paid or unpaid, regardless of the worker's title or status under state or federal laws, including independent contractors. "Employers" is similarly defined broadly in the Rule, including partnerships, corporations, associations or other legal entities within the FTC's jurisdiction in addition to any natural person.

On the other hand, the Rule defines "senior executive" narrowly, as a worker who is in a "policy-making position" and earns total compensation (including salary, commissions, nondiscretionary bonuses and other nondiscretionary compensation) of at least $151,164 annually. A "policy-making position" is limited to a business entity's president, chief executive officer or the equivalent and any other officer of a business entity who has policy-making authority or person who has policy-making authority for the business entity similar to an officer with policy-making authority. "Policy-making authority" is defined to mean final authority to make policy decisions that control significant aspects of a business entity or common enterprise and

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 or affiliate of a common enterprise.

Employers who operate as nonprofits or banks are technically exempt from the Rule, but the FTC has indicated it may nevertheless investigate applicable non-competes. These employers are encouraged to consult counsel in the event the Rule is implemented.

Required Notification

The Rule further requires employers to actively inform workers other than senior executives that any non-compete agreements are no longer in effect and provides a sample notice.

"Non-Compete Clause" Defined Broadly

The Rule defines "non-compete clause" broadly as "a term or condition of employment that either 'prohibits' a worker from, 'penalizes' a worker for, or 'functions to prevent' a worker from (A) 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 (B) operating a business in the United States after the conclusion of the employment that includes the term or condition." The definition sweeps in a wide variety of provisions, for example, as discussed in the Supplementary Information to the Rule, forfeiture for competition provisions, which will be considered non-compete clauses as they penalize workers for seeking other employment.

De Facto Non-Competes

Even if terms in an agreement do not appear on their face to be a non-compete clause, the FTC suggests it will test whether the terms are a *de facto* non-compete clause. This will be a broad analysis due to the breadth of the definition of "non-compete clause." This can include for example, other types of restrictive covenants like non-solicitation or non-interference agreements, if they are so broad in scope as to effectively function as a non-compete. Similarly, a non-disclosure agreement that is written so broadly that it prevents a worker from working in the same field after the conclusion of the worker's employment, or a contractual term that requires a worker to pay for training costs if the worker concludes employment within a specified period may be deemed a *de facto* non-compete under the terms of this FTC Rule.

Sale of Business Exception

The Rule provides a carveout for sale-based non-compete clauses when the clause 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 all of or substantially all of a business entity's operating assets." The Rule eliminated the proposed rule's requirement that the seller would have to hold at least a 25% ownership interest in the entity in order to fall within the sale of business exception. However, the FTC's commentary to the Rule explains that a "bona fide" sale is one made between independent parties at arm's length, in which the seller has a reasonable opportunity to negotiate the terms of the sale, and that so-called "springing" non-competes and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale.

Other Exceptions

The exceptions to the Rule also include non-compete clauses that are subject to a cause of action arising before the effective date and non-compete clauses when a person has a good-faith basis to believe the Rule is inapplicable.

Structuring Employment Terms if the Rule is Enacted

If the Rule is enacted at any point or if similarly restrictive laws are passed at the state level, consider structuring employment terms with the following concepts:

- **Fixed-Term Employment Agreements**: Consider fixed-term employment agreements with non-competes during the employment term, as well as notice or garden leave periods. Fixed-term employment agreements (as opposed to at-will employment) could incentivize employee retention and potentially provide damages or a cause of action against an employee who breaches the agreement by refusing to work for its duration or competes during the employment term. Notice or garden leave periods would allow the employer time to counteroffer the resignation and transition work, information and relationships over to successors, and provide at least some protection of an employer's confidential information.
- **Alternative Retention Methods**: Consider alternate employee retention methods such as retention bonuses, deferred compensation plans that require continued employment for payout, time vesting equity arrangements and other benefits to incentivize employees to remain employed. Where prior vesting schedules were predicated on non-compete compliance, consider lengthening vesting schedules predicated on *employment* in the future.
- **Review Severance Entitlements**: Review severance provisions in employment agreements or severance plans that are conditioned upon non-compete compliance. Consider eliminating severance if employees obtain any other work (as opposed to just competitive work).
- **Confidentiality and IP Protections**: Review agreements to ensure appropriate protections around confidentiality, including taking reasonable measures to protect trade secrets, such as requiring return of all employer property/information upon termination, providing for monitoring/access rights, and restricting use of personal devices for company business. Also, avoid protecting trade secrets solely using restrictive covenants that might be seen as *de facto* non-compete agreements. Agreements with workers should contain appropriate assignment and work-made-for-hire language to ensure the company's ownership of worker-developed intellectual property. Employers should also prepare for the need to initiate more trade secrets litigation than they were anticipating if they are not permitted to use restrictive covenants to protect their confidential information.
- **Other Covenants**: To the extent permissible within the context of the FTC rule and under state law regimes, ensure protections around non-solicitation of customers, non-solicitation of workers, non-disparagement, etc.

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