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FTC Issues Final Rule Banning Most Non-Compete Agreements: Takeaways and Next Steps for Employers

On April 23, 2024, the Federal Trade Commission ("FTC") voted 3-2 to promulgate a Final Rule that prohibits the use of almost all non-compete clauses in employment contracts. Absent an effective legal challenge delaying or barring enforcement, the Rule will go into effect 120 days following its publication in the Federal Register (or approximately August 2024). Employers will be required to comply with the Rule by that date.

Quick Takeaways

- Following the effective date, most non-compete agreements will be banned nationwide.
- Non-compete agreements with "senior executives" entered into prior to the effective date may remain in force; however, non-compete agreements with all other workers will be unenforceable after the effective date.
- Employers must provide notice to employees regarding existing agreements being rendered unenforceable due to the new FTC Rule.

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- The Final Rule is already facing legal challenges, as the U.S. Chamber of Commerce has filed suit seeking to invalidate the Rule altogether.

Key Features of the Final Rule

The Rule Bans Non-Compete Agreements and Precludes the Enforcement of Most Existing Non-Compete Agreements.

The Rule bans future non-compete agreements for all workers. It also renders existing non-competes for the vast majority of workers unenforceable after the rule's effective date.

Existing non-compete agreements for "senior executives" – who are estimated to represent fewer than 1% of workers – may remain in force under the FTC's final rule. However, employers are banned from entering into any new non-compete covenants, even if they involve senior executives. The rule defines "*senior executives*" as workers earning more than $151,164 annually and who are in policy-making positions. A "*policy-making position*" is defined as "a business entity's president, chief executive officer or the equivalent, any other officer of a business entity who has policy-making authority, or any other natural person who has policy-making authority for the business entity similar to an officer with policy-making authority." Thus, it is important to

underscore that an employee's high-level earnings alone are insufficient to justify a non-compete, as the employer must also identify the functional officer(-type) role at issue for the non-compete restriction.

Notice Requirement

Once the Rule takes effect, employers must advise current and former employees, other than senior executives, who are bound by an existing non-compete agreement, that the company will not be enforcing any non-competes against them. The FTC's Rule provides a model form of notice employers may use to do so.

What is a Non-Compete?

The rule defines a "*non-compete clause*" as a term or condition of employment that prohibits a worker from penalizing a worker for or functions to prevent a worker from (i) 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 (ii) operating a business in the United States after the conclusion of the employment that includes the term or condition.

The FTC has stated that non-*solicitation* restrictions and non-*disclosure* restrictions do

not, as a general rule, qualify as prohibited "non-compete clauses" because while "they restrict who a worker may contact after they leave their job" (in the case of non-solicitation agreements) and they bar a worker from misappropriating the employer's confidential information (in the case of NDAs), "they do not by their terms or necessarily in their effect prevent a worker from seeking or accepting other work or starting a business." However, under the FTC's "functional test," non-solicitation restrictions and non-disclosure restrictions *can* qualify as prohibited "non-compete clauses" if they *function* as such – an inquiry which the FTC has stated is "fact-specific."

Impact on Existing Law and Ongoing Litigation

The regulation is clear that the final Rule "shall supersede" all state laws, regulations, orders, and interpretations of them that are inconsistent with the FTC's Final Rule. The Rule does not, however, prevent states from implementing more stringent prohibitions against restrictive covenant agreements.

While the Rule prevents the enforcement of existing non-compete agreements vis-à-vis most employees, the ban does not apply "where a cause of action related to a non-compete clause accrued prior to the effective date." This verbiage in the Rule suggests that

current, ongoing litigation seeking to enforce a non-compete may continue. That said, the Rule's required-notice provisions mandate that employers alert employees that any non-compete agreements existing as of the Rule's effective date will not be enforced in the future. Therefore, even if a non-compete agreement was in place prior to the Rule's effective date, an employer seemingly may not initiate litigation to enforce that same non-compete agreement after the Rule takes effect.

Exceptions to the rule

The rule includes a sale-of-business exception for non-competes "entered into by a person pursuant to a bona fide sale of 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." Significantly, the Final Rule differs from the FTC's prior Proposed Rule insofar as the Proposed Rule had required a business owner to hold at least a 25% ownership interest in the business before the sale-of-business exception applied. According to the Final Rule, any divestiture of a "person's ownership interest in a business entity" (regardless of the percentage of ownership) will qualify for the exception as long as the transaction is "bona

fide" (*i.e.*, not a sham designed to circumvent the Final Rule).

Will the Final Rule Take Effect?

The Final Rule is scheduled to take effect 120 days after its publication in the Federal Register. However, the Rule's enforcement likely will be delayed – or perhaps barred in whole or in part – by court challenges.

Indeed, on April 24th – just one day after the FTC's vote on the Final Rule – the U.S. Chamber of Commerce filed a lawsuit against the FTC challenging the Final Rule, arguing that the Agency lacks the authority to issue rules that define unfair methods of competition. The Chamber's CEO, Suzanne Clark, made a statement that "the Federal Trade Commission's decision to ban non-compete agreements across the economy is not only unlawful but also a blatant power grab that will undermine American businesses' ability to remain competitive." Other companies and interest groups are expected to follow suit. In fact, tax services and software company Ryan LLC already has filed litigation in Texas challenging the regulation, arguing that the ban represents a dramatic overreach of the FTC's rulemaking authority.

The arguments made in litigation are expected to mirror many of the concerns of the dissenting FTC Commissioners, Melissa

Holyoak and Andrew N. Ferguson, who on April 23rd voted "no" on the Rule's implementation. Both Holyoak and Ferguson expressed concerns that the FTC lacks authority to promulgate this rule. "There is no clear congressional authorization," said Holyoak, who argued that the FTC Act gave the agency authority only to issue "procedural" rules. Holyoak further emphasized concerns regarding federal overreach, stating that the "Final Rule regulates the subject of earnest and profound debate across the country and seeks to intrude into an area that is the particular domain of state law."

Next Steps?

We anticipate the Rule will be delayed due to imminent litigation regarding both the Rule's substance and the FTC's authority to promulgate such a Rule in the first place. The litigation may result in a restructuring of the Rule or even an overall prohibition on the Rule taking effect. However, what lies ahead remains to be seen. For the time being, employers should prepare for the Rule to take effect (in one form or another) by:

- Reviewing any existing non-compete clauses and other contractual provisions that may be argued to function as non-compete covenants, including non-

disclosure and non-solicitation clauses; and

- Thinking strategically about the use of non-compete and other restrictive covenant agreements, including with respect to planning around onboarding, contract implementation, data access and protection, and employee exits.

We are here to help employers navigate these questions and issues. If you have any questions about the FTC's final rule, the impact it may have, or recommended next steps, please contact Chad W. Moeller, William J. Tarnow, Alissa J. Griffin, or your Neal Gerber Eisenberg attorney.
