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FTC Issues Final Rule Banning Non-Competes

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Practice Area: Business and Corporate Law & Labor and Employment & Mergers and Acquisitions

On Tuesday, April 23, 2024, the Federal Trade Commission (the "FTC") issued its long-awaited Non-Compete Clause Rule (the "final rule"). The final rule prohibits non-compete clauses as an unfair method of restraining competition under the Federal Trade Commission Act ("FTC Act"). The broad scope of the final rule extends to many workers, whether paid or unpaid, including, employees, independent contractors, interns, externs, volunteers, and apprentices.

The final rule follows the FTC's proposed rule from January 2023 and ongoing conversations regarding the impact of non-competes at both the federal and state levels. The FTC contends that of the 26,000 comments received regarding the proposed rule issued in January 2023, approximately 25,000 of the comments were in support of the proposed ban. Nonetheless, legal challenges to the rule and the FTC's authority are anticipated. In fact, the legal challenges have already begun with at least two lawsuits being filed against the FTC within 12 hours of the final rule's release.

The final rule is set to take effect 120 days after publication in the Federal Register, however, the looming possibility of an injunction and court review may delay or invalidate the final rule's implementation. Nonetheless, employers should familiarize themselves with the final rule and prepare for compliance, evaluating options in the protection of the business.

Unfair Methods of Competition

The final rule prohibits the following as unfair methods of competition:

- To enter into or attempt to enter into a non-compete clause;
- To enforce or attempt to enforce a non-compete clause; or
- To represent that the worker is subject to a non-compete clause.

Under the final rule, a non-compete clause is "a term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from" (1) seeking or accepting work in the United States with another person, or (2) operating a business in the United States, after separation from employment with the original employer.

This definition includes, but is not limited to, such restrictions in employment policies and contractual agreements, whether written or oral. Whether an agreement with an employee is considered a non-competition agreement will be a fact-specific assessment on a case-by-case basis.

The "prohibits ... penalizes ... or functions to prevent" language used in the final rule in employment agreements and policies is a shift from the specific examples of "de facto non-compete clauses" outlined in the proposed rule. However, this language reflects the desire of the FTC to prevent overly broad restrictive covenants that may act to prevent competition and could be considered a prohibited non-competition agreement subject to the final rule.

An example may assist in illustrating the application of the final rule. Assume that a Non-Disclosure Agreement (NDA) or Confidentiality Policy prohibits disclosure of any information obtained during employment, including publicly available information. Under the final rule this would be an example of a policy/agreement that is so broad that it would likely be found as functioning to prevent the worker from working in that field following separation. However, if the agreement is revised to reflect that it limits the prohibition to certain confidential information of the employer, which is not generally known and is obtained by the employee solely due to their employment with the employer, the final rule may not prevent an agreement with the worker as the limitation does not prohibit/restrict the employee from seeking work with a competitor.

Further, the final rule's definition of a non-compete clause focuses on limitations to competition after employment. Therefore, the rule does not apply to restrictions on competition during the worker's employment, such as outside employment or moonlighting policies.

The final rule does offer protection for some non-compete clauses already in place and distinguishes enforceability based on the worker's status. For senior executives (as defined in the final rule), existing non-compete clauses are left intact and may be enforced. In contrast, non-compete clauses already in place for other workers will become unenforceable as of the effective date. At that time, employers may not enforce or attempt to enforce the non-competition agreement, nor may they represent that the worker is subject to a non-competition agreement.

Senior Executives, Banks and Nonprofits

For purposes of the continuing enforceability of an existing non-competition agreement under the final rule, a senior executive must satisfy a two-part test: 1) be a worker who has policy-making authority and 2) receive total annual compensation of at least $151,164. These senior executive workers may still be subject to non-competition agreements entered into prior to the effective date of the final rule.

The two-part test for senior executives was developed as an effort to identify employees who likely have bargained over being subject to the non-competition terms. Nonetheless, this means that high ranking employees who earn less than the threshold compensation level will have their pre-final rule noncompetition agreement invalidated. This result may create a significant exposure issue for small, new, and struggling businesses that may already face challenges with hiring, retaining, and compensating critical employees and high level management employees.

Notice Requirement

The final rule requires employers who have non-compete clauses in effect to provide a clear and conspicuous written notice to former and current workers subject to the non-compete clause that the non-compete clause will not be enforced against the worker and that it would be illegal to do so. This notice is required to be provided on or before the effective date of the final rule and may be provided by mail, email, or text message. The final rule also provides model language that is presumed to be compliant and allows the notice to be sent as a mass communication, rather than individualized communications to each employee who is subject to a non-competition obligation. Please note that the notice of unenforceability is not required to be provided to senior executives who may continue to be subject to an existing non-competition agreement.

Exceptions

The final rule does not apply to a non-compete clause that 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 of all or substantially all of a business entity's operating assets. These agreements will continue to be enforceable and are free to be entered into, and enforced, after the effective date of the final rule.

The final rule also provides that it is not an unfair method of competition, or a violation of the final rule, to enforce or attempt to enforce a non-compete clause, or to make representations about the enforcement of a non-compete clause where a person has a good-faith basis to believe that the final rule is inapplicable. Exactly what constitutes "good faith" is unclear at this point in time and will likely be developed by enforcement actions.

Because the FTC does not regulate charitable and other 501(c)(3) organizations, or banks, savings and loan institutions, and credit unions, the final rule will not apply to employees of these organizations. However, the FTC warned that nonprofit organizations should be sure they are following the IRS requirements for nonprofit organizations, namely, that they are actually engaged in business for only charitable purposes, and that the income derived from the business is not for the profit of members. von Briesen will provide additional guidance for employers not subject to the FTC final rule in a separate *Legal Update*.

Next Steps and Considerations for Employers

As we continue to monitor developments in legal challenges to the final rule, employers should take the following steps to prepare for compliance, if and when it becomes necessary:

- **Evaluate existing contracts and policies.** Employers should review any handbook policies and agreements that impose restrictions on workers, including but not limited to NDAs, TRAPs, non-solicitation agreements, confidentiality agreements and severance arrangements to determine whether the provision could be considered a non-compete that is subject to the final rule. Although the final rule does not require rescission or legal modification of existing non-competition arrangements, identifying which policies and provisions are prohibited under the final rule is essential to avoid implementing, enforcing, or representing a non-competition agreement or provision is enforceable in violation of the final rule going forward.
- **Consider which workers are senior executives.** Employers should also evaluate their work staff to determine which employees are categorized as "senior executives" under the final rule. Based on this determination, employers can prepare to comply with the rule by discerning which prohibitions and obligations apply to different worker categories. Also evaluate if individuals are not covered by restrictive employment provisions when they should be for the protection of the business.
- **Prepare for the notice requirement.** The final rule requires that, on or before the effective date, employers provide notice to current and former workers subject to a non-compete clause that is barred by the final rule and will not, and cannot, be legally enforced. To assist with the facilitation of this obligation but without jumping too far ahead as we monitor the legal challenges, employers can gather relevant contact information for current and former workers and prepare a template notice using the FTC's Model Language. The "generic" notice obligation should be considered in communication of the FTC expectations.
- **Consider other protective measures.** In light of this attack on non-competition provisions, employers should consider whether other restrictive covenants and policies may be necessary to protect business interests. Unless such measures are overly broad and being used as de facto non-competes, NDAs, confidentiality policies, and non-solicitation agreements may be beneficial measures to implement or further develop to defend company resources and investments. The California approach to addressing "non-competition" obligations should be closely considered. Further, trade secret laws and other state protections on the use and disclosure of confidential information may assist to safeguard proprietary and other sensitive information.
