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FTC Issues Final Rule Generally Banning All Noncompetes in the United States

Deb Lifshey

MANAGING DIRECTOR

Update: As of May 7, 2024, the Federal Trade Commission has published its rule in the Federal Register. Should the rule move forward, barring any stays as a result of pending lawsuits, it will become effective on September 4, 2024.

On April 23, 2024, the Federal Trade Commission (FTC) voted 3-2 to issue its final rule that bans, with very limited exceptions, employers' use of all noncompete agreements (the Final Rule). Barring any successful litigation impediments, this rule will go into effect 120 days after it is published in the Federal Register, meaning it would become effective by August or September 2024 (the Effective Date). The Final Rule has potentially broad and dramatic implications for almost all US employers which we detail below.

Background

Early in the Biden administration, an Executive Order was issued to promote competition in the workforce and directed the FTC to use rulemaking to curtail unfair use of noncompete clauses. By January 5, 2023, the FTC—which had never before addressed the field of noncompetes—published a broad and sweeping proposed rule. It subsequently received more than 26,000 comments from members of the public. The Final Rule substantively adopted the proposed rule with minor clarifications and exceptions. However, as discussed below, the Final Rule was met with legal challenges within hours of its release, and there remains an open question at this juncture as to whether a court will stay the implementation of the ban pending the outcome of any such litigation.

Which entities are subject to the ban?

The Final Rule applies broadly to any person or employer, including an individual, partnership, corporation, association, or other legal entity within the FTC's jurisdiction, including any person acting under color or authority of state law, which effectively includes all persons or businesses operating for profit. It does not apply to entities that are not subject to the FTC Act, including certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers, and nonprofit entities.

Which workers are protected by the ban?

The Final Rule broadly applies without regard to title or status to paid or unpaid individuals, employees, independent contractors, externs, interns, volunteers, apprentices, and sole proprietors who provide a service to an entity. It also applies to current and former workers. It excludes franchisees in a franchisee-franchisor relationship but not individuals who work for a franchisee or franchisor.

What exactly does the Final Rule prohibit? Does it treat executives differently?

The Final Rule asserts that with respect to workers who are not "Senior Executives" it is an unfair method of competition (and therefore illegal) for an entity to:

- Enter into or attempt to enter into a "noncompete clause";
- Enforce or attempt to enforce a "noncompete clause"; or
- Represent to a worker that the worker is subject to a "noncompete clause."

As such, existing and future noncompetes for all workers who do not qualify as "Senior Executives" are effectively banned.

While those in c-suites and executives are not exempt from the ban, the Final Rule provides some exceptions for existing arrangements with "Senior Executives." For such individuals, it is an unfair method of competition (and therefore illegal) for an entity to:

- Enter into or attempt to enter into a "noncompete clause";
- Enforce or attempt to enforce a "noncompete clause" entered into after the Effective Date; or
- Represent to a worker that the worker is subject to a "noncompete clause" where the noncompete clause was entered into after the Effective Date.

Who are "Senior Executives?"

Unlike the proposed rule, the Final Rule made special exception for existing noncompete clauses with "Senior Executives," defined as workers who are in a "policy-making position" and who earned more than $151,164 in the preceding year. A "policy-making position" is defined as a business entity's president, chief executive officer or the equivalent, and any other officer of a business entity who has "policy-making authority." "Officer" means a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any individual routinely performing corresponding functions with respect to any business entity whether incorporated or unincorporated. The Final Rule defines "policy-making authority" as final authority to make policy decisions that control significant aspects of a business entity or a common enterprise.

Significantly, Senior Executives do not include those with authority limited to advising or exerting influence over such policy decision for only a subsidiary of or affiliate of a common enterprise. As such, the carve-out for Senior Executives covers an extremely narrow category of workers that may include c-suite executives and those exerting policy-making authority over the entire entity (generally estimated to be fewer than 1% of all workers).

What exactly is a "noncompete clause" and what types of clauses would be banned?

The Final Rule defines a "noncompete clause" as a term or condition of employment that prohibits a worker from, penalizes 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. It includes, but is not limited to, a contractual term or workplace policy, whether written or oral.

While there are some clauses that are easily identifiable as noncompetes (e.g., those that prevent an individual from working at a competitor post-employment), there are other important restrictive covenants that may be prohibited under the Final Rule that are considered de facto noncompetes because they have the effect of prohibiting the worker from seeking or accepting employment or operating a business after termination with the employer. The FTC declined to provide specific carve-outs and instead maintained a "facts and circumstances" approach to determine if the covenant prohibits, penalizes, or functions to prevent someone from working post-employment. Below are important scenarios discussed in the release:

- **Non-Disclosure Agreements (NDA):** If a non-disclosure agreement "functions to prevent" subsequent work, it may be deemed to violate the Final Rule. For example, if an NDA does not apply to information that: (i) arises from the worker's general training, knowledge, skill, or experience, gained on the job or otherwise; or (ii) is readily ascertainable to other employers or the general public, the NDA would not violate the Final Rule. In contrast, 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, would likely violate the Final Rule.
- **Non-Solicitation Agreements (NSA):** As a general matter, NSAs would not violate the Final Rule because while they restrict who a worker may contact after they leave their job, 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, non-solicitation agreements may violate the Final Rule where they function to prevent a worker from seeking or accepting other work or starting a business after their employment ends. Whether an NSA meets this threshold remains a fact-specific inquiry.
- **Forfeiture for Competition Agreements:** Severance, equity, or other employment benefit arrangements conditioning payment of money or vesting of equity upon compliance with noncompetition are deemed a penalty and constitute noncompete clauses prohibited by the Final Rule.
- **Liquidated Damages Agreements:** Any agreement that would require that a worker not compete within a certain geographical area unless the worker pays the employer liquidated damages would violate the Final Rule. In contrast, requiring a worker to repay a bonus if the worker leaves before a certain period of time, or forfeiture of accrued sick leave when employment ends, would not violate the Final Rule so long as it is not tied to preventing the worker from seeking or accepting work with a future employer or operating another business after leaving their job.
- **Training for Repayment Agreements (TRAPs):** TRAPs may, depending upon the terms of the agreement, constitute noncompete clauses, if they have the effect of penalizing or functioning to prevent a worker from seeking or accepting work. This may include, for instance, repayment obligations for training that are highly onerous or conditioning repayment upon whether or not an employee goes to work for a competitor. Examples provided that would violate the Final Rule included a TRAP that required entry-level workers at an IT staffing agency who were earning minimum wage or nothing at all during their training periods to pay over $20,000 if they failed to complete a certain number of billable hours, or a TRAP requiring nurses to work for three years or else repay all they have earned, plus paying the company's "future profits," attorney's fees,

and arbitration costs. These types of TRAPs may be functional noncompetes because, faced with significant out-of-pocket costs for leaving their employment—dependent on the context of the facts and circumstances—workers may be forced to remain in their current jobs, effectively preventing them from seeking or accepting other work or starting a business.

- **Garden Leave Arrangements:** An agreement whereby the worker is still employed and receiving the same total annual compensation and benefits on a pro rata basis would not violate the Final Rule because such an agreement is not a post-employment restriction. Instead, the worker continues to be employed, even though the worker's job duties or access to colleagues or the workplace may be significantly or entirely curtailed.

What are employers required to do now with existing noncompete agreements?

If the Final Rule is not delayed due to pending legal actions, employers would be required to provide "clear and conspicuous notice" to all workers whose agreements have been declared unenforceable by the Final Rule. It must notify workers by the Effective Date that noncompete clauses will not be, and cannot legally be, enforced against the worker. Such notice would not be required for Senior Executives with existing noncompetes. This notice must be in written form and delivered by hand, mail, email, or text message. The Final Rule provides model language for this notice.

Are there other exceptions to the rule?

- **Sale of Business Entities:** The Final Rule does not ban noncompete clauses entered into with a seller of a business entity, so long as the sale involves the disposition of the person's ownership interest in the business entity, or all of or substantially all of a business entity's operating assets. This exception reflects a material change from the proposed rule, under which the sale-of-a-business exception required at least a 25% ownership interest in the business entity being sold. In the Final Rule, there is no percentage cut-off (nor any minimum sales proceeds) for this exemption to apply.
- **Existing Causes of Action:** The Final Rule does not apply to a cause of action accrued prior to the Effective Date related to a noncompete clause (i.e., currently ongoing litigation seeking to enforce a noncompete is not unlawful).
- **Good Faith:** Entities may enforce or attempt to enforce a noncompete clause or make representations about a noncompete clause where the entity has a good-faith basis to believe that the noncompete ban is inapplicable.

What about existing noncompete state laws?

The Final Rule supersedes all state laws, regulations, orders, and interpretations of them that are not consistent with the new FTC rule. States could still impose requirements and restrictions with respect to noncompete clauses if they afford greater "protections" than those provided by the final rule. For example, certain states including California, Colorado, Minnesota, North Dakota, and Oklahoma currently have an outright ban on virtually all noncompetes. It is anticipated that other states may use the FTC Final Rule as a framework to enhance their own noncompete rules, regardless of whether the Final Rule is ultimately allowed to move forward.

How likely is it that the Final Rule will be challenged?

It already has been. Within hours of the Final Rule release, a suit was filed by a tax services and software provider in the Northern District of Texas, and the following day the US Chamber of Commerce, joined by the Business Roundtable, Texas Association of Business, and Longview Chamber of Commerce, initiated litigation. There are countless other suits that are anticipated to be filed based on myriad legal theories including challenges to the FTC's rulemaking authority and process, impermissible delegation of authority to the FTC, and retroactivity of the rule, among others. How long it may take courts to determine whether the regulation is lawful is unclear.

What should we be doing now?

It is unclear if and exactly when the Final Rule will become effective in light of ongoing litigation. Nonetheless, companies should be prepared in the event the Effective Date remains. We would recommend and can assist with the following:

- **Inventory:** Take inventory of all existing noncompete clauses in the workforce. This will involve a review of many documents: employment contracts, equity plans and agreements, NDAs, stand-alone non-solicit agreements, severance plans, and any other policies or plans that may contain restrictive covenants that may fall under the Final Rule's reach.
- **Determine Senior Executives:** Determine which individuals may fall under this definition by title and authority.
- **Develop Talking Points and/or FAQs:** Prepare leaders with talking points and/or FAQs to address potential questions that may arise from employees.
- **Notices:** While the form of notice has been provided by the FTC, have lists ready of those to whom notice would be required. Notice will be required to all current and former non-Senior Executives.
- **Alternative Protections:** Analyze other ways in which interests can be protected and exempt from the regulation. Properly drafted trade secret agreements, non-solicitations, NDAs, confidentiality agreements, garden leave agreements, etc. should be considered.

About the Author

Deborah Lifshey is a managing director at Pearl Meyer, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters.

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Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.