LEGAL UPDATES

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FTC Votes to Issue Final Rule Banning Most Non-Compete Agreements Nationwide

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On April 23, 2024, the Federal Trade Commission (FTC) voted 3-2 to issue a final rule that would ban virtually all non-compete agreements for nearly all workers of for-profit employers. Commissioners Melissa Holyoak and Andrew N. Ferguson voted no on the issuance of the final rule, which is scheduled to become effective 120 days after publication in the Federal Register (which we expect to occur very soon).

Background

As discussed in our previous article, under current law, non-compete agreements are governed by state statute or common law. Some states, like California, have adopted statutes rendering non-compete agreements void for nearly all employees with limited exceptions. Other states have enacted restrictive covenant statutes rendering non-compete clauses unenforceable depending on the impacted worker's earnings, consideration, notice, and other factors.

In January 2023, the FTC issued a proposed rule which was subject to a 90-day public comment period, and the agency received more than 26,000 comments on the proposed rule, with over 25,000 comments in support of the FTC's proposed ban.

The final rule is expansive

The final rule distinguishes between new non-compete agreements and existing non-compete agreements. Specifically, the final rule bans **new** non-compete agreements with all workers, including senior executives, after the effective date. The final rule provides that it is an unfair method of competition—and therefore a violation of Section 5 of the FTC Act—for

employers to enter into or enforce non-compete agreements with any worker after the effective date. Employers are further prohibited from representing that a worker is subject to a non-compete clause.

For **existing** non-compete agreements, the final rule adopts a different approach for senior executives than for other workers. For senior executives, existing non-compete agreements can remain in force; however, existing non-compete agreements with workers other than senior executives are not enforceable after the effective date of the final rule. The final rule defines the term "senior executive" to refer to workers earning more than $151,164 annually who are in a "policy-making position—that is, those who have final authority to make policy decisions that control significant aspects of a business entity.

Further, the final rule does not apply to non-compete agreements if they restrict only work outside the U.S. or starting a business outside the U.S.

Non-compete agreements between businesses and franchisor/franchisee non-compete agreements not covered by the final rule

Under the final rule, the term "worker" is defined as a natural person who works or who previously worked, whether paid or unpaid, including not just employees but also independent contractors, externs, interns, volunteers, apprentices, and sole proprietors. Because workers are limited to natural persons, non-compete agreements between businesses are still enforceable—although no poaching agreements between businesses may be viewed by the Department of Justice (DOJ) as a violation of Section 1 of the Sherman Act.

It is unclear whether the definition of "worker" includes directors of a corporation, members of an LLC, partners of limited and common law partnerships, etc.; however, directors, members, and partners probably are excluded from the definition of "worker" unless they are also employees, officers, or executives of the business entity. When coupled with the bona fide sale of business exception found in the final rule, standard non-compete clauses within LLC and partnership agreements will probably remain enforceable.

The final rule further clarifies that the term "worker" does not include a franchisee in the context of a franchisee-franchisor relationship (although the final rule applies to workers working for a franchisee or franchisor). Accordingly, the final rule does not cover franchisor/franchisee non-competes. Non-compete agreements used in the context of franchisor/franchisee relationships remain subject to state common law and federal and state antitrust laws, including Section 5 of the FTC Act.

Nonprofit healthcare employers not covered by the final rule

Notably, the FTC Act does not apply to non-profit organizations not organized to carry on business for their own profit or that of their members such as 501(c)(3) organizations; however, not all entities

claiming tax-exempt status as nonprofits fall outside the FTC's jurisdiction. If entities claiming tax-exempt status are in fact profit-making enterprises based on their actual operations and goals, those 501(c) tax-exempt entities are still covered by the final rule.

Thus, while hospitals and healthcare entities claiming tax-exempt status as nonprofits do not necessarily fall outside the FTC's jurisdiction, the FTC's ban on non-compete agreements does not apply to hospitals and healthcare entities that are true "nonprofits." With respect to for-profit healthcare entities, these employers and their healthcare workers are subject to the final rule.

Notice requirements regarding existing non-compete agreements

Under the final rule, employers must provide "clear and conspicuous" notice by the effective date to workers bound to an existing non-compete agreement who are not senior executives that the non-compete agreement will not be, and cannot legally be, enforced against them in the future. The notice can be delivered via various methods, including (1) by hand to the worker, (2) by mail at the worker's last known personal street address, (3) by email at an email address belonging to the worker, including the worker's current work email address or last known personal email address, or (4) by text message at a mobile telephone number belonging to the worker. Employers may be exempt from the notice requirement with respect to the specific worker that they do not have any record of a street address, email address, or mobile telephone number. The FTC has included model language in the final rule that employers can use to communicate to workers.

Impact on non-disclosure agreements, non-solicitation agreements, training-repayment agreements, severance agreements, and other restrictive employment agreements

The final rule defines a "non-compete clause" as a term or condition of employment that either "prohibits" a worker from, "penalizes" a worker for, or "functions to prevent" a worker from (1) seeking or accepting work in the U.S. with a different person where such work would begin after the conclusion of the employment that includes the term or condition; or (2) operating a business in the U.S. after the conclusion of the employment that includes the term or condition. Accordingly, the following types of restrictive covenants are prohibited by the final rule:

Non-compete agreements that expressly prohibit a worker from seeking or accepting other work or starting a business after their employment ends;

Non-compete agreements that require a worker to pay a penalty or lose certain promised benefits for seeking or accepting other work or starting a business after their employment ends.

Agreements that restrain such a large scope of activity that they function to prevent a worker from seeking or accepting other work or starting a new business after their employment ends.

The "functions to prevent" prong of the definition of the non-compete clause does not categorically prohibit other types of restrictive employment agreements, such as nondisclosure agreements (NDAs), client or customer non-solicitation agreements, or training-repayment agreements. The final rule purports to only restrict non-compete clauses and their functional equivalents; however, if the NDAs or non-solicitation agreements are so broad or onerous that they have the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work or starting a business after their employment ends, such restrictive covenants will be viewed by the FTC as a non-compete clause under the final rule. In other words, confidentiality agreements, NDAs, non-solicitation of employees, and non-solicitation of customers will likely remain enforceable so long as they are not too broad.

The sale of business exception

The final rule continues to recognize an exception to non-compete agreements entered into in a "bona fide" sale of a business, which is defined as a sale made in good faith versus one whose sole purpose is to avoid the non-compete rule. The final rule eliminates the 25 percent ownership threshold that appeared in the proposed rule. In other words, non-compete agreements entered into in a "bona fide" sale of a business, even with individuals who own less than 25% of a company, will remain viable.

Interactions with state non-compete laws

The final rule clarifies that state laws restricting non-compete agreements that do not conflict with the final rule are not preempted. In other words, states may continue to enforce state laws that restrict non-compete agreements and do not conflict with the final rule, even if the scope of the state restrictions is narrower than that of the final rule. Thus, employers must continue to comply with both the FTC's final rule as well as applicable state non-compete laws.

FTC's legal authority and likely challenges

As discussed by dissenting FTC commissioners and numerous commentators, the final rule may rest on questionable legal authority. The substantial impact of the implementation of the final rule in an area of the law that has long been regulated by states is vulnerable to challenges for regulatory overreach. As result, the final rule will face immediate legal challenges under the Administrative Procedure Act by affected businesses and trade associations.

The dissenting FTC commissioners and numerous commentators identified several grounds for possible legal challenge including (1) that the FTC lacks authority to engage in "unfair methods of competition" rulemaking; (2) that the FTC lacks clear congressional authorization to issue the final

rule based on the "major questions doctrine"; and (3) that the FTC's action here constitutes an impermissible delegation of legislative authority under the non-delegation doctrine. In fact, one Texas employer has already filed a lawsuit in the Northern District of Texas challenging the final rule. *See Ryan, LLC v. Federal Trade Commission*, No. 3:24-cv-986 (N.D. Tx. April 23, 2024). The U.S. Chamber of Commerce also announced plans to challenge the final rule as soon as April 24, 2024.

It is possible that a federal district court that hears one of these lawsuits may issue a temporary restraining order or preliminary injunction delaying the effective date of the final rule while the challenge plays out in court. In other words, the final rule could be challenged in the federal courts for years to come before it takes effect. The current composition of the U.S. Supreme Court suggests that the final rule and the FTC's purported authority to issue and enforce the final rule will be heavily scrutinized. Thus, employers should expect an extended period of uncertainty with respect to the validity of the final rule.

What this means to you

For now, we recommend that employers wait and see how the legal challenges proceed over these next few weeks—the final rule could be enjoined by a federal district court. If no court enjoins the final rule, employers will have 120 days after publication to comply with it. In the meantime, employers who wish to be proactive can begin reviewing their non-compete agreements and consider entering into narrower restrictive employment agreements, such as NDAs and client or customer non-solicitation agreements, to protect their legitimate business interests. We will continue to monitor the developments relating to the final rule.

Contact us

If you have questions regarding the FTC's final rule on non-compete agreements, please contact Randall Thompson, Chris Ottele, Kevin Koronka, Erik Eisenmann, Wendy Arends, Scott LeBlanc, Chengzhuo He, or your Husch Blackwell attorney.