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Client Alert

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FTC Issues Near-Total Ban on Non-Competes in Final Rule, with a Narrow Exception for Existing Agreements with "Senior Executives"

On April 23, 2024, the Federal Trade Commission (FTC), in a party-line vote, approved its final rule banning most non-compete agreements.

The final rule bans all non-competes nationwide, including *de facto* non-competes, with narrow exceptions for (1) existing non-competes with "senior executives"; (2) non-competes entered into in connection with the sale of a business; (3) non-competes in franchisor/franchisee relationships; and (4) non-competes imposed by non-profits.

The final rule invalidates all other existing non-competes, prohibits enforcement of such non-competes, and prohibits entering into new non-competes with senior executives and all other employees.

Per the final rule, employers must inform all employees subject to non-competes (other than existing agreements with "senior executives") that such agreements are no longer valid.

The final rule will become effective 120 days from the date it is published in the Federal Register. While court challenges seeking to enjoin the final rule are inevitable (with some already having been filed), employers must prepare for a new legal landscape where non-compete agreements are largely prohibited.

BACKGROUND

On January 5, 2023, the FTC published a notice of a proposed rule effectively banning all non-compete agreements, nationwide. The proposed rule banned not just nominal non-compete agreements and clauses, but any agreement that "***effectively*** precludes the worker from working in the same field after the conclusion of the worker's employment with the employer."

Over the next 90 days, interested parties presented comments on the proposed rule. According to the FTC, they received "more than 26,000 comments from members of the public." According to the FTC, more than 25,000 comments were in support of the proposed ban.

On April 23, 2024, the FTC presented the final rule and the FTC commissioners voted 3 to 2, along party lines, to publish the final rule.

THE FINAL RULE: A BROAD PROHIBITION ON VIRTUALLY ALL EXISTING NON-COMPETES AND A NEAR-TOTAL BAN ON FUTURE NON-COMPETES

Subject to limited exceptions discussed below, the final rule has exceedingly broad reach, invalidating existing non-competes and prohibiting future non-competes, regardless of industry and regardless of whether a worker is an employee or an independent contractor.

Importantly, the rule is **not** limited to contractual agreements that expressly prohibit a worker from joining a competing business following their termination. Instead, the rule covers both agreements and "workplace policies" that "prohibit[] a worker from, penalize[] a worker for, or function[] to prevent a worker from[] seeking or accepting work" for another business or operating a business following the worker's termination.

The Limited Exceptions

The final rule contains four exceptions: (1) **existing** non-competes with "senior executives"; (2) non-competes in franchisor/franchisee relationships; (3) non-compete agreements entered into by individuals in connection with the sale of a business; and (4) non-compete agreements entered into by non-profit entities with their employees.

While the final rule **does not** invalidate or prohibit the enforcement of existing non-competes with "senior executives," employers are prohibited from entering into new non-competes with such "senior executives."

The final rule defines the term "senior executive" to encompass workers earning more than $151,164 annually who are in a "policy-making position."

- "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."
- "Policy-making authority" is defined as "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 of or affiliate of a common enterprise."
- The rule does not define "final authority," "policy decisions," or "significant aspects."

Non-Profits

The final rule does not cover non-profits, which includes many healthcare entities (*e.g.*, non-profit hospitals), with the FTC reiterating that it does not have jurisdiction to enforce Section 5 of the FTC Act against non-profit entities.

However, the FTC goes on to say that an entity "merely claiming tax-exempt status in tax filings is not dispositive" of non-profit status and that the FTC "looks to both the source of the income, *i.e.*, to whether the corporation is organized for and actually engaged in business for only charitable purposes, and to the destination of the income, *i.e.*, to whether either the corporation or its members derive a profit."

Staffing agencies and for-profit physician practices that staff employees at non-profit entities are subject to the final rule.

Rescission No Longer Required, But Clear and Conspicuous Notice Must Be Provided

In another departure from the proposed rule, the final rule no longer requires that employers formally rescind existing non-competes. Instead, by the rule's effective date, employers must notify employees who are subject to non-competes that such non-competes will not be, and cannot legally be, enforced against the worker.

The notice must:

- Be individually sent to the worker;
- Be delivered to the worker by hand, by mail to the worker's last known address, by email to the worker's work email or last known personal email address, or by text message; and
- Identify the non-compete and the parties to the non-compete.

The final rule provides model language that can be used to notify employees.

Intersection with State Law

The FTC's final rule supersedes any state law providing less protection to workers on the issue of non-compete agreements. However, state law providing more protection to workers than the proposed rule would survive.

For example, in states with total bans of non-competes (such as California, North Dakota, and Oklahoma), the exception for "senior executives" will prevent FTC enforcement, but it will not interfere with enforcement of state laws recognizing no such exception.

Open Questions Regarding the Scope of the Rule and Its Exceptions

Several questions remain regarding the scope of the final rule and how employers must interpret its exceptions.

Most notably, while the FTC claims that under the final rule other restrictive covenants are not, as a general matter, prohibited, the rule's broad prohibition of non-competes could be interpreted to prohibit employee non-solicits, customer non-solicits, and nondisclosure or confidentiality agreements under certain circumstances. Indeed, the FTC put great effort into explaining that the test for whether a covenant or policy constitutes a non-compete is functional, not based on express terms. As such, whether and to what extent other restrictive covenants may be banned by the rule remains an open question.

Additional open questions include the following:

- Are workplace policies concerning confidentiality implicated by the rule?
- What is considered a "penalty" for purposes of determining whether an agreement or policy "penalizes" an employee for allegedly competing following their termination?
- What is the test for determining whether an agreement or policy "functions to prevent" a worker from allegedly competing following their termination?
- Does the rule implicate agreements where the remedy for breach is the termination of ongoing benefits, payments, or vesting (such as conditions precedent in incentive or equity agreements)?

Answers to these questions will largely depend on the circumstances specific to an employer or even an individual agreement. However, it is unclear at present how the FTC intends to enforce the final rule in these circumstances.

Next Steps for Employers

While court challenges may delay implementation of the final rule, we recommend that employers develop an immediate plan for compliance. Suggested steps include:

- Identify all current and former workers who are subject to non-compete agreements (or similar post-employment restrictive covenants).
- Review existing agreements in their entirety to determine whether any post-employment restrictive covenants prohibit, penalize, or function to prevent a worker from seeking employment elsewhere or creating a competing business following termination.
- Review existing workplace policies to determine whether such policies prohibit, penalize, or function to prevent a worker from seeking employment elsewhere or creating a competing business following termination.
- Identify all current "senior executives" as defined in the final rule.
- Prepare notice language and develop a distribution plan to provide individual written notice to current and former workers regarding the rescission of non-compete clauses.

Plan for compliance going forward, including assessing and revising existing agreements/templates to eliminate non-compete clauses and *de facto* non-compete clauses.

The final rule, for example, advises that employers may rely on trade secret law, non-disclosure agreements, and invention and assignment agreements to protect such interests. However, to avoid running afoul of the final rule, employers should remain cautious about the breadth of any such agreements or policies.