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FTC Issues Final Rule Banning Non-Competition Clauses in Employment Agreements; Legal Challenges Filed

Summary

On April 23, 2024, the Federal Trade Commission ("FTC") issued a final rule that prohibits employers from entering into new non-compete agreements with their workers *and* prohibits employers from enforcing existing non-compete agreements with all but the most senior executives (as defined in the rule). FTC jurisdiction, and thus the new rule, covers for-profit corporations.

Under the new rule, employers must notify in writing all workers other than "senior executives" by the rule's effective date that their existing non-competes will no longer be enforced. The effective date could be late August or early September depending on the rule's publication date in the Federal Register and barring a court stay or other change.

Legal challenges may impact the effective date or enforceability of the rule. The U.S. Chamber of Commerce, the Texas-based tax firm Ryan, and other business groups have already filed lawsuits, arguing that the FTC does not have the authority to issue rule. Although it remains to be seen whether the rule will survive the legal challenges, employers should consider strengthening permissible restrictive covenants with their workers and otherwise develop a plan to comply with the new rule should it become effective.

The Final Rule

On January 19, 2023, the FTC proposed for public comment a new rule that would prohibit employers from entering into non-compete agreements with their workers, based on a preliminary finding that non-compete agreements constitute an unfair method of competition in violation of Section 5 of the Federal Trade Commission Act. After receiving more than 26,000 comments, the final rule was approved by a Commission vote of 3-2 (along party lines) on April 23, 2024.

Under the final rule, existing non-compete agreements for the vast majority of U.S. workers will no longer be enforceable after the rule's effective date. For purposes of the 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: (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." 16 CFR § 910.1. A "term or condition of employment" includes, but is not limited to, a contractual term or workplace policy, whether written or oral. *Id.*

The final rule applies to all workers who provide a service to a person or company, whether paid or unpaid, and includes employees, independent contractors, interns, volunteers, apprentices, externs and sole proprietors. The rule does not apply to a franchisee in a franchisor-franchisee relationship or to a person who entered into a non-compete agreement pursuant to a *bona fide* sale by the person 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.

The final rule preempts any conflicting state law, but employers must continue to comply with state laws that are more favorable to employees.

Existing non-compete agreements for senior executives, defined as workers who earn more than $151,164 annually *and* who are in policy-making positions, may remain in force, but employers may not enter into new non-compete agreements with such individuals after the effective date. The compensation threshold for senior executives includes traditional bonuses or similar contractually based compensation, but it is not yet clear how equity awards would be factored into the calculation. A "policy-making position" includes a business entity's president, chief executive officer or the equivalent, any other officer 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.

For all workers bound by existing non-compete agreements other than "senior executives," employers must provide notice by the rule's effective date that the non-compete agreement will not be enforced against them in the future. The final rule provides model language for the notice, which includes, without limitation, "As of [date], [employer] will not enforce any non-compete clause against you." To streamline compliance, the final rule allows employers to send mass notifications to all employees rather than individualized notices to only those employees who are bound by a non-compete agreement. The effective date is 120 days from the date when the rule is published in the Federal Register.

The new rule does not specifically address agreements that prohibit the post-employment solicitation or servicing of an employer's customers or the solicitation or hiring of an employer's employees. Similarly, it is silent regarding confidentiality and non-disclosure agreements. However, FTC commentary reminds employers that such agreements, if written broadly enough, could bring their terms under the "functions to prevent" prong of the "non-compete clause" definition, and that all such agreements remain subject to section 5's prohibition on unfair methods of competition.

Conclusion

In light of the potential challenges to the FTC rule and some ambiguities about its scope, employers should work with employment counsel to determine the impact of the rule on

their agreements, policies and workforce, and how best to prepare should it become effective.

Employers should also evaluate their existing non-compete agreements under state law or in light of proposed state legislation. Numerous states prohibit or limit an employer's use of non-compete agreements, including California, Massachusetts, North Dakota, Oklahoma, Virginia, and Washington. Other states and localities, including New York State and New York City, have seen legislative bills introduced to prohibit or limit the use of non-compete agreements.

Given the trend toward limiting or barring the use of non-competes, employers should develop alternative strategies to protect their business interests, including the use of NDA's and, if lawful, strengthening their non-solicitation agreements with employees.

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