GROOM LAW GROUP

Publications

FTC Issues Final Rule Banning Non-Compete Clauses for Employees

ATTORNEYS & PROFESSIONALS

William Fogleman
wfogleman@groom.com
202-861-6619

Emily Gerard
egerard@groom.com
202-861-9375

Jeffrey W. Kroh
jkroh@groom.com
202-861-5428

PUBLISHED
04/26/2024

SOURCE
Groom Publication

SERVICES
Employers & Sponsors
- Executive Compensation Programs
- Fringe Benefits & Payroll

Health Services
Retirement Services

On April 23, 2024, the Federal Trade Commission ("FTC") voted 3-2 to issue a final rule that prohibits most employers and workers from entering into non-compete clauses. The rule is slated to go into effect 120 days from the date it is published in the Federal Register.

Non-compete clauses have long been a prominent feature of the employment landscape. While courts and state legislatures have increasingly limited the breadth and scope of these provisions over the years, non-compete clauses can be found in a variety of compensation arrangements, including employment agreements, severance plans, and incentive awards. Thus, the FTC took employers and practitioners by surprise in January 2023 when it proposed a nationwide non-compete ban that applies generally to all workers, including executives and other high-earners (see Groom's article).

The proposed rule attracted significant criticism from business groups, who claimed the rule was overbroad and outside the bounds of the FTC's authority. Nevertheless, the final rule largely preserves the proposed rule's sweeping scope, while incorporating a narrow legacy exception for existing non-compete clauses with senior executives. Assuming it survives court challenges, the rule will transform employee compensation arrangements in the United States, forcing many employers to rethink how they incentivize, retain, and part ways with their employees.

Scope of the Final Rule

The final rule generally deems "non-compete clauses" to be "an unfair method of competition." The rule prohibits employers from entering into non-compete clauses in the future, and invalidates existing non-compete clauses, with the exception of existing clauses applicable to "senior executives." The rule also imposes a requirement on employers to notify applicable employees and former employees that their existing non-compete clauses are no longer enforceable.

"Non-Compete Clause" Broadly Defined. The rule defines a non-compete clause generally to include any employment term or condition that "prohibits a worker from, penalizes a worker for, or functions to prevent a worker from" seeking or accepting work in the United States with a different person or entity, or operating a business in the United States, after the conclusion of the worker's employment with his or her current employer. The ban applies to any contractual term or workplace policy, whether written or oral.

Under the rule, employers can no longer contractually prohibit employees from post-employment competition. In addition, the ban on "penalizing" competition means that employers will no longer be able to pay workers not to compete after separation, such as through a severance agreement. Under these "forfeiture-for-competition" clauses, an employee can choose whether to receive post-employment compensation from his or her former employer or forfeit the amounts in order to work for a competitor. In the preamble to the final rule, the FTC specifically notes that forfeiture-for-competition clauses are prohibited.

The rule also applies to provisions that "function" to prevent competition even if they do not expressly restrict or penalize competition. The FTC notes in the preamble that the rule does not categorically prohibit non-solicitation agreements or non-disclosure agreements. However, the FTC warns that if the restriction is so broad that it has the same functional effect as a prohibition or penalty for competition, then it is prohibited under the rule. For example, the FTC indicates a non-disclosure agreement that prohibits an employee from disclosing any information that is "usable in" or "relates to" the employee's industry would effectively prevent the employee from working for another employer. However, the FTC provides little additional guidance for evaluating whether a non-solicitation or non-disclosure agreement is too broad under the rule.

Narrow Exception for Existing Non-Compete Clauses for "Senior Executives." The rule prohibits employers from entering into non-compete clauses in the future. It also invalidates existing non-compete clauses, with the exception of existing clauses applicable to "senior executives."

A "senior executive" is an individual who earns more than $151,164 in the preceding year (an amount based on the 85th percentile of earnings for full-time salaried workers nationally) *and* is in a "policy-making position." Under the rule, an individual is in a "policy-making position" if he or she (1) is the president or chief executive officer (or equivalent) of a business entity, (2) is an officer of the entity who has policy-making authority, or (3) has policy-making authority for a business entity similar to an officer with policy-making authority. Significantly, the definition excludes an officer with policy-making authority for a subsidiary or affiliate, unless the officer has policy-making authority over the entire common enterprise. The rule further defines "policy-making authority" as final authority to make policy decisions that control significant aspects of a business entity or common enterprise. It does not include authority limited to "advising or exerting influence" over policy decisions or authority limited to making policy decisions for a subsidiary or affiliate.

The legacy exception for existing "senior executive" non-compete clauses will be helpful for employers as they transition into a business environment where non-compete clauses are a thing of the past. However, the narrow definition of "senior executive" excludes many potential high-earners, such as sales and investment professionals or leaders of subsidiaries. Because the FTC has now released these employees from their existing non-compete obligations, employers in competitive markets for talent may need to act quickly to adjust their retention strategies.

Notice Requirement. The rule requires employers to notify employees (other than senior executives) with existing non-compete clauses that such clauses are now unenforceable and provides model language for such notice. Employers may deliver the notice by hand, mail, email, or text message. The notice requirement appears to apply to both current and former employees, though an employer is not required to deliver notice to an employee for whom it has no record of a street address, email address, or mobile phone number. The employer must provide the notice by the effective date of the rule.

Exception for Sale of Business. The rule does not ban a non-compete clause that is entered into by a person pursuant to a bona fide sale of a business entity, the person's ownership interest in a business entity, or of all or substantially all of the business entity's assets. Notably, unlike in the proposed rule, the final rule does not limit the exception to "substantial owners" of the business at issue. While the preamble to the rule suggests that the clause is intended to apply to non-compete clauses between buyers and sellers of a business, it appears that the exception may apply to employees in certain circumstances.

Questions Over FTC Authority

Since the FTC issued the proposed rule last year, some commentators have been skeptical of the FTC's authority in this area. Within a day of the FTC's release of the final rule, the Chamber of Commerce and several business groups sued to block the rule from taking effect. The cases are *Ryan LLC v. Federal Trade Commission et al*, No. 24-cv-00986, (N.D. Tex., Apr 23, 2024) and *Chamber of Commerce of the United States of America et al v. Federal Trade Commission et al*, Docket No. 6:24-cv-00148 (E.D. Tex. Apr 23, 2024).

The FTC appears to have anticipated litigation over the rule based on the lengthy preamble discussion in support of the agency's constitutional and statutory authority to adopt the rule. In addition, the rule contains a "severability" clause that would sever any part

of the rule that is held to be invalid or unenforceable, while construing any surviving portions of the rule to the maximum effect permitted by law.

Considerations for Employers & Next Steps

Given the impact of the final rule, employers may want to review all employment, compensation, and severance arrangements to identify any non-compete clauses. This review should include all agreements, plan documents, and policies because non-compete clauses can be found in a variety of documents. Employers should pay particular attention to employee handbooks, employment agreements, severance plans, separation agreements, equity and incentive plans, and award agreements.

Employers must act quickly to prepare for compliance with the notification requirements because the deadline for compliance could be as early as August 2024. Going forward, employers will need to revisit their standard forms of agreement and eliminate provisions prohibited under the rule.

The attorneys at Groom Law Group will continue to monitor the litigation concerning the final rule and will provide updates as they become available.