Kluwer Competition Law Blog

FTC Finalizes Rule Banning Post-Termination Non-Compete Clauses

Nicole Foster, Brandon Gantus, Bruce McCulloch, Jan Rybnicek, Angela Landry, Sam Fulliton, L.B. McCaskey, Jordan Riley (Freshfields Bruckhaus Deringer) · Friday, May 3rd, 2024

> The FTC first proposed to ban essentially all employer-employee non-competes throughout the US while I was a Commissioner. At that time, many — including me – expressed concern that the FTC did not have the authority to issue a broad rule overturning dozens of state laws and negating more than 30 million existing contracts. We have already seen several businesses and associations challenge the rule in federal court. We do not yet know how those court challenges will be resolved, so prudent businesses must begin planning for the possibility that the rule will go into effect.
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> What follows is a blog post prepared by my colleagues at Freshfields about the potential implications of the new rule.
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> *Christine Wilson, former FTC Commissioner*

On April 23, the Federal Trade Commission ("FTC") finalized a rule banning all new post-termination non-compete clauses between employers and workers, with a limited exception for non-competes that are entered into pursuant to a bona fide sale of a business. Existing post-termination non-competes will not require rescission, but employers must provide notice that those post-termination non-competes subject to the rule will not be enforced. The new rule will become effective 120 days after it is published in the Federal Register, which is expected within the next few days. The final rule largely resembles the proposed rule announced by the FTC on January 5, 2023 (see our analysis of the proposed rule here), which received more than 26,000 comments from members of the public.

The Commission approved the new rule in a 3-2 vote, with the newly confirmed Republican Commissioners Andrew Ferguson and Melissa Holyoak dissenting. The rule is already facing challenges from private companies and others in federal court, which may delay the effective date beyond 120 days, find the FTC's rule to be unconstitutional, or otherwise preliminarily or permanently enjoin its application. These legal challenges raise questions about whether the new rule will ultimately have any effect.

Scope of the FTC's Ban on Non-Competes

Who? Workers (with limited exceptions for Senior Executives)

The final rule bans (i) new post-termination non-competes for all "workers," and (ii) existing post-termination non-competes for workers other than "senior executives." "Workers" are defined as natural persons who work or have previously worked, regardless of whether paid or unpaid or their status under federal state law. This broad definition would pick up any current or former employees, independent contractors, interns, volunteers, sole proprietors, or other service providers, but excludes franchisees in the context of a franchisee-franchisor relationship.

Borrowing from the Securities and Exchange Act of 1934 and Department of Labor regulations, the rule uses a two-part test to define "senior executives" as those with both a policy-making position and total annual compensation of at least $151,164. While the rule is clear that total annual compensation may include salary, commissions, nondiscretionary bonuses and other nondiscretionary compensation, and excludes certain fringe benefits, an open question remains as to whether equity incentive compensation is considered compensation for purposes of this definition. It will be important for employers to identify their senior executives for purposes of this rule, which will require an analysis of who is in a policy-making position. Certain positions are easily identifiable – president and chief executive officer – but others are based on whether the executive has policy-making authority, which is a concept that should be somewhat familiar to U.S. publicly listed companies.

Under the rule, policy-making authority means "final authority to make policy decisions that control significant aspects" of an entire business entity (but not only authority over a subsidiary or affiliate of an entity) and excludes authority that is limited to advising on policy decisions. While there may be incentive for companies to cast a wide net when determining which executives have policy-making authority under the rule, it will be important for publicly traded companies to be mindful of potential unintended effects of applying this definition broadly, such as public disclosure implications for executive officers and application of SEC mandated clawback policies to executive officers.

What? Non-compete clauses

Under the rule, non-compete clauses generally mean terms and conditions (whether written or oral) applicable to workers following a termination of employment or service that prohibit or otherwise function to prevent the worker from, or penalize the worker for, seeking or accepting work with a different U.S. employer or operating a business in the United States.

The typical clause prohibiting a worker from working for a competing business for a period following employment is clearly a non-compete clause. The more difficult questions will be around when does a term or condition penalize the worker for competing or otherwise function as a non-compete. Some examples of "penalty" non-competes are liquidated damages, forfeiture-for-competition, and severance conditioned on a non-compete. Other restrictive covenants, including confidentiality agreements and employee and customer non-solicitation covenants, will need to be analyzed on a case-by-case basis to determine whether they are written so broadly that they

effectively prevent a worker from working for another business in the same field. For example, an NDA that restricts a worker from disclosing in a future job any information related to the industry in which they work might be considered the functional equivalent to a non-compete. Importantly, it appears that garden leave arrangements, where a worker continues to receive the same annual compensation and benefits, would not be considered a non-compete, even if the worker's duties and access to the workplace are significantly restricted.

When? 120 days after publication in the Federal Register

The ban on non-compete clauses kicks in on the effective date. If the final rule is published in the Federal Register in a few days, as expected, then it could become effective by the end of August. However, the effective date remains uncertain as a result of the lawsuits already filed and the many others that are expected to be filed. These challenges may delay the effective date beyond 120 days, find the FTC's rule is unconstitutional, or otherwise preliminarily or permanently enjoin its application.

Where? The United States

The rule applies to post-termination non-compete clauses that prevent workers from working or operating a business in the United States. It does not extend to non-competes that restrict activities outside the United States, which will be subject to the laws of the applicable jurisdiction. It should also be noted that the rule will supersede any state non-compete laws that are less restrictive, but employers will still be required to comply with applicable state laws that impose greater restrictions than the new rule.

Exceptions to the Rule

Pre-Existing Non-Competes with Senior Executives

As noted above, post-termination non-competes with senior executives entered into prior to the effective date will remain enforceable. In addition to making a determination of who the senior executives are based on the considerations outlined above, companies should take stock of arrangements with their senior executives, including whether it would be beneficial to enter any restrictive covenant agreements in the short term, to the extent permissible under applicable state law.

Bona Fide Sale of Business

The final rule does not apply to post-termination non-competes entered into pursuant to a bona fide sale of (i) a business entity, (ii) the worker's ownership interest in a business entity, or (iii) all or substantially all the business entity's assets. And while the proposed rule applied this exception only to owners with at least a 25 percent ownership interest in the business being sold, the final

rule was issued with no minimum ownership threshold, which will give it much more utility in M&A transactions. For example, non-competes imposed on seller workers in an arm's length business sale transaction that are used to protect the goodwill and ownership interest being acquired by the buyer remain enforceable because the seller has had a reasonable opportunity to negotiate the terms of the transaction.

Existing Causes of Action

The final rule does not apply where a cause of action related to a post-termination non-compete was initiated prior to the effective date.

Non-Profit and Certain Other Business Entities

The FTC does not have jurisdiction over non-profit businesses. Consequently, the rule only applies to businesses organized for-profit. Non-profit businesses, including many healthcare providers, can continue to enforce post-termination non-competes. The rule similarly does not apply to businesses outside the scope of the FTC Act, including banks and insurance companies, and it does not apply to other restrictions on franchisees by franchisors, including no-poach provisions.

Violations

A violation of this rule will be deemed a violation of Section 5 of the FTC Act, which prohibits "unfair methods of competition." The FTC, however, cannot obtain civil penalties or other monetary relief against parties for using an unfair method of competition. The FTC can initiate an administrative proceeding under Section 5(b) of the FTC Act or seek an injunction in federal court against a party that has engaged in an unfair method of competition. The FTC can obtain civil penalties in court if a party is ordered to cease and desist from a violation and fails to do so. In short, the consequences of violating the new rule will be the same as the consequences of violating Section 5 of the FTC Act prior to the effective date, which will likely mean a significant uptick in FTC enforcement actions and settlements.

Challenges to the Validity of FTC's Rule

Two FTC Commissioners dissented from the FTC's decision to adopt the rule. In their dissents, Commissioners Ferguson and Holyoak questioned whether the FTC has legislative rulemaking power under the FTC Act. They each noted that Section 6(g) of the FTC Act was originally understood to give the FTC power to make procedural rules only – not legislative rules like a ban on non-competes. In Commissioner Holyoak's view, which was shared by Commissioner Ferguson, "a reviewing court would interpret Section 6(g), as supported by the text and structure of the FTC Act, to authorize only *procedural* or internal operating rules" and the caselaw used by the majority to support the final rule would be approached differently by a court today. They also consider the FTC to lack statutory authority under the Major Question Doctrine, as they believe

there to be “no clear congressional authorization” under Section 5 of the FTC Act to issue the rule. To emphasize the significance of the rule, Commissioner Ferguson highlighted that the rule regulates “nearly the entire economy,” nullifying more than thirty million existing contracts and costing employers an estimated $400 to $488 billion in additional wages and benefits over ten years.

Lawsuits filed in federal court echo the criticisms of the dissenting Commissioners. In the two days since the FTC finalized the rule, Ryan, LLC, a global tax services and software provider, and several business groups led by the U.S Chamber of Commerce, have filed separate lawsuits in federal courts in Texas challenging the FTC’s rule. The Chamber argues that the FTC Act does not grant the FTC the authority to promulgate legislative rules related to competition. The Chamber further asserts that a rule that will impact millions of contracts in every state violates the Major Question Doctrine, which the current Supreme Court has repeatedly invoked to prevent administrative agencies from using ambiguous statutory language to implement regulatory initiatives with substantial economic and political significance. As a result, the Chamber is asking, in part, for the court to find that the FTC’s promulgation of the rule violated the standards of the Administrative Procedure Act. If successful, this would effectively repeal the rule. In the meantime, the Chamber is seeking a preliminary injunction that would temporarily halt the rule from taking effect until the court enters a final ruling.

Impact of the Rule

The ultimate impact of the FTC’s final rule is uncertain. With ongoing litigation and the potential for a preliminary injunction or other relief, it may be premature for employers to begin taking any meaningful steps in response; the rule may not come into effect until after the resolution of ongoing private litigation, which presents substantial issues of constitutional and administrative law. However, employers may wish to begin identifying which of their workers qualify as “senior executives” under the final rule and assessing existing arrangements with those senior executives.

In the interim, we expect the FTC to continue challenging non-competes on an ad-hoc basis, consistent with its recent challenges to several companies enforcing non-compete clauses. In those cases, the FTC ordered the companies to cease enforcing, threatening to enforce, or imposing non-compete restrictions on relevant workers and required them to notify all affected workers that they are no longer bound by the non-compete restrictions.

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This entry was posted on Friday, May 3rd, 2024 at 9:00 am and is filed under Non-compete clauses, United States of America
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