Patterson Belknap

Employment Law Alert
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FTC Approves Final Rule Banning Non-Compete Clauses

On April 23, 2024, the Federal Trade Commission ("FTC") issued a final rule ("Final Rule") broadly banning non-competition ("non-compete") agreements nationwide. With limited exceptions, the Final Rule prohibits employers from entering new non-compete agreements with workers and requires employers to notify workers with existing non-compete agreements that those agreements will not be enforced.

As discussed in an earlier client alert, the Final Rule was originally proposed in January 2023. In response, the FTC received more than 26,000 comments from the public—over 25,000 of which voiced support for the proposed non-compete ban. But public support has not been unanimous. Since publication of the Final Rule, three lawsuits have been filed challenging its legality, and more lawsuits may be forthcoming. The Final Rule was published in the Federal Register on May 7, 2024, and will become effective on September 4, 2024 (the "Effective Date"). Employers should therefore take steps to consider how the Final Rule, if it becomes effective, will impact their agreements with current and former workers.

Overview of the Final Rule

The Final Rule comprehensively prohibits the use of non-compete clauses in agreements between employers and workers in almost all circumstances. The Final Rule defines a "non-compete clause" as "a term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from (1) 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 (2) operating a business in the United States after the conclusion of the employment that includes the term or condition." The Final Rule prohibits employers from entering non-compete agreements with an expansive category of workers, including employees, independent contractors, externs, interns, and volunteers, among others.

The Final Rule provides that it is an "unfair method of competition"—and therefore a violation of Sections 5 and 6(g) of the Federal Trade Commission Act ("FTC Act")—for an employer to enter a non-compete agreement with a worker.[1] Thus, an employer's failure to comply with the Final Rule may subject the employer to an FTC enforcement action, potentially resulting in the imposition of penalties and/or injunctive relief.

Prohibitions on Existing and New Non-Compete Agreements

The Final Rule distinguishes between non-compete agreements entered *before* the Effective Date ("Existing Agreements"), and those entered *after* the Effective Date ("New Agreements"). The Final Rule broadly prohibits employers from entering New Agreements with workers. The Final Rule similarly provides that Existing Agreements will become unenforceable after the Effective Date.

[1] Under the FTC Act, the FTC's jurisdiction does *not* extend to entities that are not "organized to carry on business for [their] own profit or that of [their] members." Accordingly, the Final Rule will not apply to any such entities. Note, however, that the FTC's jurisdiction *does* extend to some entities that claim tax-exempt status. Indeed, obtaining tax-exempt status from the IRS is not dispositive of whether the FTC has jurisdiction over an organization. For example, the FTC expressed doubt as to whether tax-exempt hospital systems engaging in business on behalf of their physician members would be exempt from the FTC's jurisdiction. However, we expect more traditional public charities and grant making foundations would likely fall outside of the FTC's jurisdiction and, therefore, will be exempt from the Final Rule.

However, the Final Rule exempts Existing Agreements between employers and the limited category of workers who qualify as "senior executives." The Final Rule defines "senior executives" as workers who act in a "policy making position" and who received at least $151,164 in total compensation in the preceding year (or annualized if the worker was employed for a partial year). A "policy making position" is further 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;" and "policy-making authority" means "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 an affiliate of a common enterprise." The "senior executives" exception is applicable *only* to Existing Agreements.

Noteworthy Exceptions

Albeit limited, there are a few noteworthy carveouts from the Final Rule.

First, the non-compete prohibition does not apply to non-competes entered in connection with a "bona fide sale of a business entity." A "bona fide" sale is one made in good faith and not for the purpose of evading the Final Rule. The FTC noted that it considers a bona fide sale to be one that is made between two independent parties at arm's length, in which the seller has a reasonable opportunity to negotiate the terms of the sale. The FTC does *not* consider non-competes tied to stock repurchase rights or mandatory stock redemption programs as being entered into in connection with a bona fide sale because, in those situations, the employee/seller generally is not exchanging its good will in the business for a non-compete and generally does not have the ability to negotiate the terms of the sale at the time that these repurchase or redemption rights are entered. As originally proposed, the bona fide business exception was limited to situations where the restricted worker held at least 25% ownership in the business entity being sold. However, the Final Rule contains no such ownership requirement.

Second, the Final Rule does not explicitly apply to other types of post-employment restrictions, such as non-disclosure agreements, non-solicitation agreements, or Training Repayment Agreement Provisions ("TRAPs"), which require workers to reimburse employers for training expenses if they leave their job before a specified date. However, the Final Rule prohibits all forms of post-employment restrictions that effectively function as non-competes. Thus, these other types of restrictive covenants may run afoul of the Final Rule in some instances. Specifically, the comments that the FTC issued along with the Final Rule indicate that post-employment restrictions may, depending on the facts and circumstances, function as non-compete agreements where they prohibit a worker from seeking other work or starting a business, or if the restriction is "so broad or onerous in scope that it functionally has the same effect of preventing a worker from doing the same."

Third, the Final Rule clarifies that a "garden leave" arrangement may be permissible if it does not contain a post-employment restriction. Although "garden leave" can refer to a number of different types of arrangements and the FTC declined to address every potential scenario, in a typical "garden leave" agreement, a worker is still employed by the employer and receives the same total annual compensation and benefits on a *pro rata* basis and this type of "garden leave" is not prohibited by the Final Rule. But much like non-disclosure provisions, non-solicitation provisions, and TRAPs, employers should take care in drafting garden leave provisions and considering any unique facts and circumstances to ensure that they are not effectively functioning as non-competes.

Fourth, the Final Rule provides an exception for causes of action related to a non-compete agreement that accrue before the Effective Date. Accordingly, workers who breach non-compete agreements *before* the Effective Date may still be subject to liability *after* the Effective Date.

Notification Requirement

The Final Rule requires employers to individually notify all affected workers (both current and former) before the Effective Date that their non-compete provisions are no longer enforceable. The notices must be provided in writing and may be delivered by hand, mail, email, or text message. In addition, the notice must identify the person who entered the non-compete agreement with the worker. The FTC has published model notices which can be used to satisfy this notification requirement.

Ongoing Legal Challenges

Since publication of the Final Rule, three lawsuits have been filed in federal courts challenging the FTC's authority to ban non-compete agreements. Within hours of the Final Rule's publication, a tax services firm filed a lawsuit (*Ryan, LLC v. Federal Trade Commission*, Case No. 3:24-cv-986) in the United States District Court for the Northern District of Texas. Shortly thereafter, the Chamber of Commerce filed a lawsuit (*Chamber of Commerce v. Federal Trade Commission*, No. 6:24-cv-148) in the United States District Court for the Eastern District of Texas. Finally, a tree services company filed an action (*ATS Tree Services, LLC v. Federal Trade Commission*, No. 2:24-cv-1743) in the United States District Court for the Eastern District of Pennsylvania.

These lawsuits allege, among other things, that the FTC lacked constitutional and statutory authority to promulgate the Final Rule, and seek orders vacating it and setting it aside.

Most recently, the *Ryan, LLC v. Federal Trade Commission* court issued an expedited briefing schedule and announced its intention to issue a final ruling on the Plaintiffs' request for an emergency stay of the Final Rule by July 3, 2024—well in advance of the Effective Date. The second filed action, *Chamber of Commerce v. Federal Trade Commission*, was stayed pending resolution of the earlier filed action, *Ryan, LLC v. Federal Trade Commission*. However, the Chamber of Commerce successfully moved to intervene as a plaintiff in *Ryan, LLC v. Federal Trade Commission*. Numerous amici, including the National Retail Federation, the National Association of Manufacturers, The American Investment Council, the Society for Human Resource Management, and the Partnership for New York City, have filed briefs in support of Plaintiffs' request for an emergency stay of the Final Rule.

Finally, the court in *ATS Tree Services, LLC v. Federal Trade Commission* has announced its intention to issue a decision on Plaintiffs' request for a preliminary injunction by July 23, 2024.

Given the speed with which these actions have been filed, we expect more actions may be forthcoming.

Key Takeaways for Employers

Notwithstanding the uncertain legal landscape, employers should ensure that they are positioned to comply with the Final Rule if and when it becomes effective. Employers should comprehensively review relevant contracts to verify if any workers are affected. On or before the Effective Date, employers should prepare to distribute clear written notices to affected workers explaining that their non-compete provisions will not (and cannot) be enforced. Finally, employers should ensure that any other post-employment restrictions (such as garden leave, non-solicitation provisions, non-disclosure provisions, and TRAPs) are not effectively functioning as non-competes.

Because the Final Rule is a federal regulation, employers should be mindful that it preempts conflicting state laws, regulations, and rules. However, to the extent that state law provides *greater* protections to workers, employers should ensure compliance with those laws.

Patterson Belknap will monitor subsequent developments in connection with the Final Rule. For additional guidance, please contact our Employment Law Group.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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