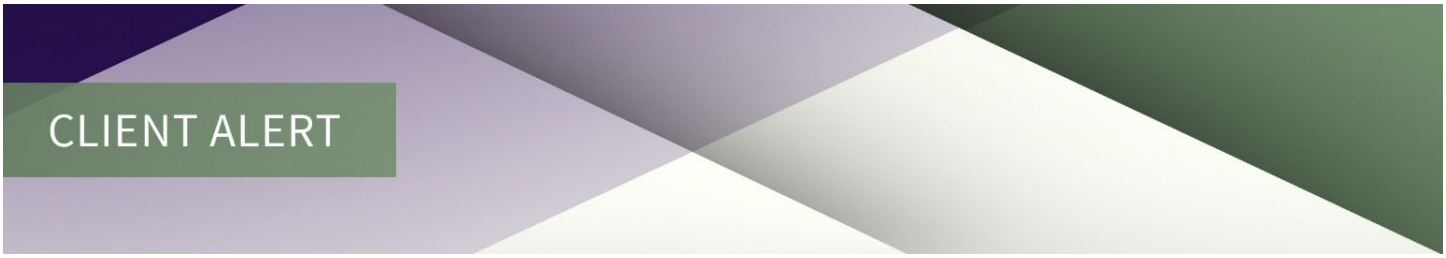

FTC Finalizes Rule Prohibiting Non-Competes

May 1, 2024

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On April 23, 2024, the Federal Trade Commission ("FTC") voted 3-2 to adopt a final rule ("Final Rule," available here)[1] prohibiting substantially all employee non-compete clauses in the United States.

The Final Rule is similar to the non-compete rule that the FTC initially proposed on January 5, 2023 ("Proposed Rule," available here), which we discussed in a previous client alert (available here). The Proposed Rule drew more than 26,000 public comments from individuals and institutions, which the FTC credits as the basis for changes reflected in the Final Rule, such as differential treatment of non-competes for "senior executives" and modifications of the "sale of business" exception to the non-compete ban, discussed below.[2]

The Final Rule becomes effective 120 days after it is published in the Federal Register ("Effective Date"), but its future is far from certain. The Chamber of Commerce and other organizations sued to block the Final Rule the day after it was issued, alleging that the FTC lacks the constitutional and legislative authority to issue rules purporting to ban a long-standing form of contractual provision used across the U.S. economy and traditionally regulated by the states.[3] The Chamber's

1 FED. TRADE COMM'N, Non-Compete Clause Rule, 16 C.F.R. Part 910 (2024). The Final Rule itself is embedded at pages 561-68 in a nearly 600-page document that includes supplementary information addressing the Proposed Rule, public comments to the Proposed Rule, and revisions reflected in the Final Rule. Our references to the Final Rule include both the Final Rule itself and the supplementary information.

2 Final Rule at 518-19.

3 Complaint at 29-36, *Chamber of Commerce of the U.S. v. Fed. Trade Comm'n*, No. 6:24-cv-00148 (E.D. Tex. Apr. 24, 2024).

allegations echoed the dissents of the FTC's recently confirmed Republican Commissioners, Andrew Ferguson and Melissa Holyoak.[4]

The Final Rule

A. Definition of "Non-Compete Clause"

The Final Rule defines a "non-compete clause" as a term or condition that bars a worker from, or penalizes a worker for, either (i) *seeking or accepting work* in the United States with a different employer, where the work begins after conclusion of the employee's job that is associated with the non-compete clause, or (ii*) operating a business* in the United States after the conclusion of the employee's job.[5] Importantly, the Final Rule *does not* categorically prohibit other common employment-related restrictive covenants, such as non-disclosure agreements or non-solicitation agreements, because they "do not by their terms or necessarily in their effect prevent a worker from seeking or accepting work with a person or operating a business after the worker leaves their job."[6] But these other covenants may be deemed a form of non-compete if they "function[s] to prevent a worker from seeking or accepting other work or starting a new business after their employment ends."[7]

The Final Rule does not apply to non-compete clauses in industries outside of the FTC's jurisdiction, e.g., certain banks and nonprofit organizations.[8] While the rule will not apply to banks and other exempted entities, many of the regulating agencies have what they consider Section 5 authority. In particular, the banking agencies, specifically the FDIC, FRB, and OCC, have asserted authority to enforce Section 5 for the institutions that they supervise and other institution-affiliated parties.[9] To the extent that a non-compete is considered an "unfair practice," under the Final Rule, stakeholders should continue to monitor agency guidance on these subjects.

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4 Oral Statement of Commissioner Andrew N. Ferguson, In the Matter of the Non-Compete Clause Rule Delivered at the Open Commission Meeting (Apr. 23, 2024), which can be found here; Oral Statement of Commissioner Melissa Holyoak, In the Matter of the Non-Compete Clause Rule Delivered at the Open Commission Meeting (Apr. 23, 2024), which can be found here.

5 Final Rule § 910.1.

6 Final Rule at 80.

7 Final Rule at 77.

8 The Final Rule states that it "applies to the full scope of the Commission's jurisdiction." Final Rule at 51. "[T]he [FTC Act] exempts, inter alia, 'banks,' 'persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act of 1921' as well as an entity that is not 'organized to carry on business for its own profit or that of its members.'" Final Rule at 371. However, the FTC "decline[d] to exclude bank holding companies, subsidiaries, and other affiliates of Federally regulated banks that fall within the Commission's jurisdiction." Final Rule at 371.

9 *See, e.g.*, Federal Deposit Insurance Corporation, FDIC Consumer Compliance Examination Manual, at VII-1.1 (June 2022).

B. Prohibited Conduct

The Proposed Rule would have prohibited enforcement of non-compete clauses for all workers regardless of position or seniority. But the Final Rule takes a different approach — distinguishing between *senior executives* and *all other workers*. As of the Effective Date, the Final Rule *both* bars *new* non-competes and renders *existing* non-competes unenforceable with respect to workers who are not senior executives. By contrast, the Final Rule bars non-competes for senior executives *only to the extent implemented after the Effective Date*; pre-Effective Date non-competes for senior executives remain enforceable.

With respect to non-executive workers, the following conduct is an "unfair method of competition" in violation of Section 5 of the Federal Trade Commission Act:

1. To enter into or attempt to enter into a non-compete clause;
2. To enforce or attempt to enforce a non-compete clause; or
3. To represent that the worker is subject to a non-compete clause.[10]

With respect to senior executives, the following conduct is an "unfair method of competition" in violation of Section 5 of the Federal Trade Commission Act:

1. To enter into or attempt to enter into a non-compete clause;
2. To enforce or attempt to enforce a non-compete clause entered into after the Effective Date; or
3. To represent that the senior executive is subject to a non-compete clause, where the non-compete clause was entered into after the Effective Date.[11]

Workers are defined as natural persons who are employees, independent contractors, externs, interns, volunteers, apprentices, or sole proprietors.[12] A *senior executive* is defined as a worker with a policymaking position whose annual compensation was at least $151,164 during the prior year. Persons with a "policymaking position" include a company's CEO, President, or any other person who has "final authority to make policy decisions that control significant aspects of a

[10] Final Rule § 910.2(a)(1).

[11] Final Rule § 910.2(a)(2).

[12] The definition of "worker" does not include a franchisee. Final Rule § 910.1. Though the Final Rule does not cover franchisor/franchisee non-competes, the FTC "continues to believe that, as many commenters attested, franchisor/franchisee non-competes may in some cases present concerns under section 5 similar to the concerns presented by non-competes between employers and workers." Final Rule at 388.

business entity or common enterprise," not including subsidiaries or affiliates. Merely advising or having influence over a policy decision does not make a person a senior executive.[13]

The Final Rule leaves room for interpretation as to who is a "senior executive" with a "policy-making role," which turns on whether the executive has authority to make "significant decisions." This could extend below the C-suite via delegated authority.

C. "Bona Fide" Sale-of-Business Exception

The Final Rule excludes non-compete agreements with workers "pursuant to a bona fide sale 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."[14] A "business entity" is defined as a "partnership, corporation, association, limited liability company, or other legal entity, or a division or subsidiary thereof."[15]

The requirement that the sale be "bona fide" was not included in the Proposed Rule and appears to have been added in response to public comments that employers may engage in "sham transactions" as an end run around the non-compete ban.[16] The Final Rule commentary explains that a bona fide sale is

> [O]ne made in good faith as opposed to, for example, a transaction whose sole purpose is to evade the final rule. In general, the Commission considers a bona fide sale to be one that is made between two independent parties at arm's length, and in which the seller has a reasonable opportunity to negotiate the terms of the sale. So-called 'springing' non-competes and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale because, in each case, the worker has no good will that they are exchanging for the non-compete or knowledge of or ability to negotiate the terms or conditions of the sale at the time of contracting. Similarly, sham transactions between wholly owned subsidiaries are not bona fide sales because they are not made between two independent parties.[17]

While adding this "bona fide" qualification to the sale exemption, the Final Rule eliminates a key limitation found in the Proposed Rule – i.e., the requirement that the selling employee must hold a "substantial" interest (25% or greater) in the applicable business entity immediately prior to the sale or disposition. There is no such interest threshold in the Final Rule.

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13 Final Rule § 910.1.

14 Final Rule § 910.3(a).

15 Final Rule § 910.1.

16 Final Rule at 339-40.

17 Final Rule at 342.

The Final Rule and related commentary leave considerable uncertainty as to what kinds of business sales will be deemed bona fide and therefore exempted from the non-compete ban. For example, while one-on-one, arm's-length negotiations of a single shareholder's sale of its shares accompanied by a non-compete provision appear well within the exception, in many instances employers simultaneously negotiate stock redemptions or repurchases (with related non-competes) with multiple employees. Employers in such circumstances may have to demonstrate that negotiations with each employee were sufficiently independent and at arm's length to be "bona fide" within the meaning of the Final Rule.

D. Notice

For any non-compete rendered unenforceable by the Final Rule, the employer must notify the impacted employee that the non-compete clause is no longer enforceable.[18] The notice must be given before the Effective Date."[19] The Final Rule details the required features of the notice and provides model language. Unlike in the Proposed Rule, the Final Rule does not require formal rescission of the non-compete clause.

The Final Rule does not preempt existing state laws banning/regulating non-competes; however, it would control to the extent there is a conflict between it and state law.

Legal Challenges

On April 24, 2024, the Chamber of Commerce, along with the Business Roundtable, Texas Association of Business, and Longview Chamber of Commerce, filed suit in the Eastern District of Texas seeking a permanent injunction against implementation of the rule based on constitutional and other grounds.[20] A tax services firm, Ryan LLC, filed a separate action in the Northern District of Texas.[21] Plaintiffs' claims are consistent with the dissenting commissioners' objections to the Final Rule.

As these and potentially other cases progress, a key question will be whether any court issues a nationwide preliminary injunction of the Final Rule. Absent a nationwide injunction, there could be significant confusion as to whether an employer is bound by the Final Rule pending the constitutional challenge. We will monitor this litigation.

18 § 910.2(b).

19 Final Rule § 910.2(b).

20 *See* Complaint, *Chamber of Commerce of the U.S. v. Fed. Trade Comm'n*, No. 6:24-cv-00148 (E.D. Tex. Apr. 24, 2024).

21 *See* Complaint, *Ryan, LLC v. Fed. Trade Comm'n*, No. 3:24-cv-00968 (N.D. Tex. Apr. 23, 2024).

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