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A Deep Dive Into the FTC Ban on Non-Compete Agreements

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On April 23, 2024, following a 90-day public comment period generating more than 26,000 comments, the Federal Trade Commission (FTC) voted to adopt a final rule banning non-compete agreements for most workers in the United States. The final rule, set to take effect 120 days from the date it is published in the Federal Register, will have broad implications on businesses and an estimated 30 million U.S. employees and independent contractors alike.

The final rule provides that it is an unfair method of competition, and therefore a violation of Section 5 of the Federal Trade Commission Act (the "Act"), for employers to enter into non-compete agreements with workers and from enforcing existing non-compete agreements with most workers. The rule requires that employers rescind most existing non-compete agreements and restrictions on workers, and it prohibits businesses from entering into non-compete agreements with workers in the future.

In the wake of the FTC's announcement, countless questions arise for those businesses struggling to better understand the implications of the new rule. The deep dive summary below follows a comprehensive review of the FTC's 570-page release accompanying the final rule.

What the New FTC Ban Requires

Upon the effective date of the rule, businesses generally will no longer be able to do the following:

- Enter into or attempt to enter into non-compete agreements or clauses;
- Enforce or attempt to enforce existing non-compete agreements or clauses (except as to "senior executives". The FTC has adopted a two part test to determine who is a senior executive. The test, as noted below, significantly narrows the number of executives that would be exempt from the rules protection.); or
- Represent to a worker that the worker is subject to a non-compete agreement (except as to "senior executives").

Employers are required to notify any workers and former workers with existing non-compete agreements that the agreements are no longer valid under the new rule and that the non-compete provision has been rescinded. Notice must be delivered in writing via letter, email, or text message no later than the rule's effective date. The FTC rule provides a model notice that can be used for this purpose.

The effective date of the new rule is 120 days after it is officially published in the Federal Register. It is anticipated that the rule will be published in the Federal Register sometime within the next 30 days or so. The FTC currently expects the rule to take effect in early September 2024.

Covered Workers

The FTC takes the position that non-competes are largely exploitative and coercive and has banned almost all non-compete agreements and clauses between employers and workers. The rule clarifies that the term "worker" broadly includes any employee, independent contractor, extern, intern, volunteer, apprentice, or sole proprietor, whether the individual presently works for or previously worked for the business and whether the individual was paid or unpaid.

However, the FTC created an exception from the rule for *existing* non-compete agreements with "senior executives." Existing non-compete agreements with such personnel are enforceable, to the extent they are enforceable under applicable state law. To qualify as a "senior executive," a worker must pass both an earnings test and a job duties test. Specifically, the worker must earn total annual compensation of at least $151,164 and be in a "policy-making position." A "policy-making position" includes a president, CEO, or someone else with authority to make policy decisions for the entire company. A worker must pass *both* tests to qualify for the exception for "senior executives" — one alone will not suffice.

Jurisdictional Limitations for Certain Non-Profits

Congress empowered the FTC to "prevent persons, partnerships, or corporations" from engaging in unfair methods of competition. To qualify as a "corporation" under the Act, an entity must be "organized to carry on business for its own profit or that of its members." Through FTC precedent and judicial decisions, this language has been consistently interpreted to mean that while the FTC has jurisdiction over for-profit entities in nearly all industries (other than some businesses expressly outside the FTC's jurisdiction such as most financial institutions, common carriers, and air carriers), the FTC lacks jurisdiction to regulate Section 5 violations by a corporation not organized to carry on business for its own profit. Thus, in addition to certain for-profit entities as noted above, the FTC ban on non-compete agreements does not apply to non-profit entities, as defined by the FTC.

However, not all entities claiming tax-exempt status as non-profits fall outside the FTC's jurisdiction. To qualify as a non-profit entity for purposes of application of the Act, the FTC looks to both "the source of the income, *i.e.*, to whether the corporation is organized for and actually engaged in business for only charitable purposes, and to the destination of the income, *i.e.*, to whether either the corporation or its members derive a profit." A non-profit that passes this two-part test is considered outside the FTC's jurisdiction and will not be impacted by the new rule banning non-compete agreements.

Because some non-profit healthcare organizations may fall outside the FTC's jurisdiction under this two-part test, and thus would escape the FTC's ban on non-competes, while other healthcare organizations would remain within the FTC's jurisdiction and therefore would remain subject to the

ban, the FTC considered whether to exempt *all* healthcare organizations, or at least a broader class of healthcare organizations, from the ban. Ultimately, however, the FTC concluded that it "is not persuaded that the healthcare industry is uniquely situated in a way that justifies an exemption from the final rule." Despite arguments from commentators relating to the equal treatment of nonprofit and for-profit healthcare organizations, patient hardship, increased costs for employers, and decreased incentive for employee training, the FTC steadfastly declined to exempt the healthcare industry from the rule. The FTC clarified that healthcare entities claiming tax-exempt status will be met with the same level of scrutiny as other organizations under its adopted two-part test for non-profit entity status if challenged in administrative or judicial proceedings. Learn more about the affects to the health care industry in our advisory, Healthcare Implications of the FTC's Non-Compete Ban.

Other Forms of Restrictive Covenants May be Permissible

While non-compete language is strictly prohibited, the final rule does not categorically prohibit other types of employment agreements that contain restrictive covenants, such as non-disclosure or confidentiality agreements, training repayment agreement provisions, and non-solicitation agreements. The FTC noted that these types of agreements do not by their terms ordinarily prohibit a worker from or penalize a worker for seeking or accepting other employment or starting their own business after they leave their current position, and thus are permissible.

However, if an employer adopts a term or condition that is so broad in scope that it has the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work, or from starting a business after they leave a position, such a term will be viewed as an impermissible non-compete clause. Thus, other restrictive covenants such as non-disclosure and non-solicitation agreements must be carefully drafted to ensure that they do not run afoul of the FTC's ban on non-competes.

Limited Exceptions

As noted above, the FTC's ban on non-compete agreements does not apply to *existing* non-compete agreements with "senior executives." In addition, the final rule carves out three other specific scenarios where the ban does not apply:

- First, the rule does not apply to non-competes entered into by a person pursuant to a bona fide sale of a business entity. The FTC 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 noted that, pursuant to this "bona fide" condition, any "springing" non-compete (in which a worker must agree when hired to a non-compete in the event of a future sale) and repurchase rights, mandatory stock redemption programs, or similar stock-transfer schemes are prohibited by the rule. Additionally, the FTC clarified that, while a seller can agree to a noncompete individually, this sale-of-business exception does not extend to the business entity's workers who are not sellers. Moreover, because the rule requires the sale of a business entity, including by way of asset sale, this exception does not apply to the sale of a sole proprietorship or assets of a business that has not been incorporated.
- Second, the rule does not apply where a cause of action related to a non-compete agreement or clause accrued *prior* to the rule's effective date. According to the FTC, this means that employers may still enforce a claim that a noncompete was breached before the effective date.
- Lastly, the rule provides that it is not an unfair method of competition to enforce or attempt to

enforce a non-compete or to make representations about a non-compete where a person has a good-faith basis to believe that the FTC's rule banning non-competes is inapplicable to the situation.

Litigation to Block the FTC's New Rule

Legal challenges to the FTC's new rule banning almost all non-compete agreements have already been filed. On April 23, 2024 — the same day the rule was issued — an initial challenge was filed in the U.S. District Court for the Northern District of Texas. The next day, on April 24, 2024, the U.S. Chamber of Commerce filed a complaint in the U.S. District Court for the Eastern District of Texas. Both cases argue that the FTC lacks the constitutional and statutory authority to advance this sweeping regulation and seek to block implementation of the rule. These cases are likely just the beginning of the flood of litigation that will arise in response to the FTC's new rule.

Conclusion

Businesses and professionals are encouraged to consult with legal counsel to discuss their options and strategies for addressing the FTC's final rule, including possible revisions to existing restrictive covenant agreements, the required notices under the rule, and updates on the status of the pending litigation.

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