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FTC Issues Final Rule Barring Employee Non-Compete Agreements

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This near categorical ban on non-compete agreements marks an abrupt departure from existing law in many jurisdictions and has drawn almost immediate legal challenges. On April 23, 2024, the FTC voted 3-2 to adopt a sweeping final rule banning the use of non-compete agreements nationwide, impacting 30 million workers by the FTC's own estimates.[1] The final rule is presently set to become effective 120 days after its publication in the Federal Register, which is expected to occur in the next two weeks, with the possibility that the effective date may be delayed or enjoined in light of the pending litigation challenging the rule. It prohibits any new non-compete agreements and renders existing non-compete agreements with workers unenforceable, with limited exceptions. In addition to banning new non-competes, the rule requires employers to provide workers with notice that their existing non-compete agreements are no longer enforceable, but employers are not required to formally rescind the agreements.[2] Employers should be aware that the rule defines "worker" broadly, encompassing persons working as employees, independent contractors, interns, externs, volunteers, and sole proprietors.[3] This near categorical ban on the non-compete agreements is an abrupt contrast from a regime in which these agreements had been recognized to have potential procompetitive value and therefore were reviewed for reasonableness. It also marks a sharp departure from the state law in many jurisdictions. **I. Narrow Exceptions** Notably, the final rule does not invalidate existing non-compete agreements with senior executives, one of the few changes from the proposed rule.[4] A "senior executive" is defined as a worker who: (1) earns more than $151,164 annually; and (2) is in a "policy-making position," which is defined narrowly to mean "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." The final rule also does not bar causes of action related to a non-compete that accrued prior to the effective date of the final rule. And enforcing or attempting to enforce a non-compete is not considered an unfair method of competition where an employer has a good-faith basis to believe the final rule is inapplicable. The final rule's general prohibition on non-competes is also not applicable to non-competes entered pursuant to the sale of a business. While the Commission had earlier proposed an exception for certain non-competes between the seller and the buyer of a business that applied only to a substantial owner, member, or partner, defined as an owner, member, or partner with at least 25% ownership interest in the business entity being sold, in response to public comments, the final rule no longer includes the proposed requirement that the restricted party be "a substantial owner of, or substantial member or substantial partner in, the business entity" to fall under the exception. **II. Functional Non-Competes** 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." In assessing the impact of the final rule on other kinds of restrictive covenants, the FTC emphasizes three prongs of the "non-compete clause" definition—"prohibit," "penalize," and "functions to prevent." Although the FTC declined to create a categorical prohibition on non-disclosure, non-solicitation, and similar restrictive covenants, it explained that the "functions to prevent" language applies to any term or condition of employment adopted by an employer that is so broad or

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onerous as to have the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work or starting a business after their employment ends. The FTC explained its view that a "garden-variety NDA," in which a worker agrees not to disclose certain confidential information to a competitor, would not prevent that worker from seeking or accepting work with a competitor after leaving their job. However, the FTC would consider an NDA that spans such a wide swath of information so as to functionally prevent a worker from seeking or accepting other work to be a "non-compete clause." Examples of problematic NDAs provided by the final rule include: (1) an agreement barring a worker from disclosing any information "usable in" or relating to the industry in which they work; and (2) an agreement barring a worker from disclosing any information obtained during their employment, including publicly available information. Non-solicitation agreements and training repayment provisions are subject to the same fact-specific analysis. In particular, the FTC stated that agreements that impose substantial out-of-pocket costs upon workers for departing may effectively prevent them from seeking or accepting other work or starting a business and be functionally deemed a non-compete agreement. The FTC also clarified that in its view a "garden leave" agreement—where the worker is "still employed and receiving the same total annual compensation and benefits on a pro rata basis—is not a non-compete clause," since such an agreement does not restrict the worker post-employment. For the same reason, the FTC explained that the final rule is not meant to prohibit agreements under which a worker who does not meet a condition foregoes a particular aspect of their expected compensation, which would seemingly remove retention bonuses from the rule's purview. Similarly, the FTC stated that agreements requiring workers to repay a bonus or forfeit accrued sick leave after leaving a job would not meet the definition of "non-compete clause" under the final rule, so long as they do not penalize or function to prevent a worker from seeking or accepting work or operating a business after the worker leaves the job. **III. Republican Dissents** Yesterday's Special Open Commission Meeting marked the first for incoming Republican Commissioners Melissa Holyoak and Andrew Ferguson, who both dissented on constitutional and statutory grounds, among other reasons. Although their written dissents are not yet available, they stated in oral remarks[5] that the final rule exceeds the FTC's authority and is barred by the major questions doctrine because Congress did not authorize the FTC to promulgate legislative rules (much less rules of such sweeping consequence) through either Section 6(g) or Section 5 of the FTC Act. According to Commissioner Ferguson, the FTC majority relies on "oblique or elliptical language that cannot justify the redistribution of half a trillion dollars of wealth within the general economy by regulatory fiat." Commissioner Ferguson further stated the Rule is (1) unlawful under the non-delegation doctrine, and (2) arbitrary and capricious under the Administrative Procedure Act because the evidence on which the agency relies cannot justify the nationwide ban of non-competes irrespective of their terms, conditions, and particular effects. **IV. Immediate Legal Challenges** Within minutes of the vote, the final rule was the subject of a legal challenge filed by Gibson Dunn in the Northern District of Texas. Consistent with the dissenting views of Commissioners Holyoak and Ferguson, Gibson Dunn's complaint argues that the FTC lacks the statutory authority to issue the rule, that any such grant of authority would be an unconstitutional delegation of legislative power, and that the FTC is unconstitutionally structured. The U.S. Chamber of Commerce also filed a lawsuit today. These cases raise the substantial questions surrounding the FTC's authority to promulgate rules in this area and whether the agency's rulemaking complied with the Administrative Procedure Act. **V. Employer Considerations** The final rule is presently set to become effective 120 days after its publication in the Federal Register. Given the pending litigation challenging the rule, it is possible that this effective date may be delayed or enjoined, and that the rule may ultimately be invalidated and never take effect. Accordingly, employers have, at a minimum, several months before the rule takes effect and may find it appropriate to watch how the pending legal challenges develop. Notwithstanding that uncertainty, however, businesses subject to the final rule[6] should consider using this time to: (1) review their existing non-compete agreements and be prepared to provide the required notice to non-senior executive workers, in accordance with the rule's requirements, if and when necessary; (2) likewise, be prepared if necessary to amend existing antitrust compliance programs to provide guidance to avoid violating the rule; (3) consult with outside counsel; and (4) carefully consider the potential

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impact on future mergers and acquisitions, as the Hart-Scott-Rodino Act rules proposed by the FTC last year require disclosure of transaction-related agreements (including non-competes). Gibson Dunn attorneys are closely monitoring these developments and available to discuss these issues as applied to your particular business. _____ [1] The text of the FTC's "Non-Compete Clause Rule" is available here. [2] The rule includes model language that satisfies this notice requirement. [3] The definition also includes persons working for a franchisee or franchisor but does not extend to a "franchisee" in the context of a franchisee-franchisor relationship. [4] The FTC estimates that fewer than 0.75% of workers will qualify as senior executives according to the rule. [5] A recording of the Special Open Commission Meeting is available here. [6] The FTC stated that the "final rule applies to the full scope" of its jurisdiction, which it stated would exclude many non-profits. However, the preamble makes clear that the FTC will not treat an organization's tax-exempt status as dispositive for purposes of evaluating its authority. Section 5 of the FTC Act also does not apply to the following entities: banks, savings and loan institutions, federal credit unions, common carriers, air carriers, and persons and businesses subject to the Packers and Stockyards Act.

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