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Expert Q&A on the FTC's Final Rule Banning Post-Employment Non-Competes

by Practical Law Labor & Employment

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An Expert Q&A with Peter A. Steinmeyer and Erik W. Weibust of Epstein Becker & Green, P.C. regarding the Federal Trade Commission's (FTC) final rule banning post-employment non-competes.

On April 24, 2024, the Federal Trade Commission (FTC) announced the issuance of a final rule banning employers from entering into, enforcing, or attempting to enforce post-employment non-compete clauses with workers, subject to limited exceptions, and invalidating all existing non-competes with a narrow exception for certain senior executives (FTC: Non-Compete Clause Rule). If and when it becomes effective, the FTC's rule would create a new subchapter J, Part 910 of the rules promulgated under Section 5 of the Federal Trade Commission Act (16 C.F.R. §§ 910.1 to 910.6). The premise for the rule is that it "is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker" and therefore falls within the FTC's domain. The final rule broadly prohibits traditional post-employment non-competes and is a sea change for employers that routinely use non-competes to protect their valuable assets, including trade secrets and goodwill. The final rule is scheduled to be published in the Federal Register on May 7, 2024, and to become effective 120 days later (on or about September 4, 2024).

The Final Rule is being issued after a review and comment period on the FTC's notice of proposed rulemaking (NPRM), about which the FTC received thousands of public comments. The final rule largely tracks the NPRM, with a few significant modifications. For more on the NPRM, including grounds for legal challenges to the FTC's authority to issue this rule, see Article, Expert Q&A on the FTC's Proposed Rule Banning Employee Non-Competes.

Practical Law Labor & Employment reached out to Peter A. Steinmeyer and Erik W. Weibust of Epstein Becker & Green, P.C. for their insights about the final rule, changes from the FTC's proposed rule, legal challenges to the new rule, and what employers should be doing now to protect their trade secrets and other valuable assets amidst this uncertain legal landscape.

Pete and Erik are Members of Epstein Becker & Green, P.C. and Co-Chairs of the firm's Trade Secret & Employee Mobility practice group. They both focus on trade secrets and employee mobility issues and are two of the co-hosts of EBG's *Spilling Secrets* podcast on trade secrets and non-compete law. Pete also is a valued member of the Practical Law Labor & Employment Advisory Board.

What Are the Key Provisions of the Final Rule?

The final rule prohibits employers from entering into, enforcing, or attempting to enforce post-employment non-compete agreements with workers, with limited exceptions. Among other things, the final rule:

- Declares that an entity under the FTC's authority engages in unfair competition and therefore violates Section 5 of the Federal Trade Commission Act (FTC Act) if, regarding a worker, it:
  - enters into or attempts to enter into a non-compete clause;
  - enforces or attempts to enforce a non-compete clause; or
  - represents that a worker is subject to a non-compete clause.
- Creates a limited exception allowing for the enforcement of existing non-compete agreements with certain senior executives that were entered into

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before the rule's effective date, but prohibits employers from entering into new non-competes with all workers, including senior executives, after the effective date.

- Defines non-compete clause as a term or condition of employment prohibiting a worker from, penalizing a worker for, or functioning to prevent a worker from:
  - seeking or accepting work in the US with a different person after the employment relationship ends; or
  - operating a business in the US after the employment relationship ends.
- Clarifies that a non-compete may be:
  - a contractual term or workplace policy; and
  - either written or oral.
- Broadly defines worker as including:
  - employees;
  - independent contractors;
  - externs, interns, volunteers, and apprentices;
  - sole proprietors who provides a service to a person; and
  - natural persons working for a franchisee or franchisor, but not including franchisees in the franchisee-franchisor relationship context.
- Defines senior executive as a worker who both:
  - is in a policy-making position; and
  - earned at least $151,164 in the preceding year (or the equivalent annualized for partial year employment).
- Narrowly defines policy-making position as a business entity's:
  - president;
  - chief executive officer or the equivalent;
  - any other officer 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.
- Defines policy-making authority as:
  - having final authority to make policy decisions that control significant aspects of a business entity or common enterprise;
  - not including authority limited to advising on or exerting influence over policy decisions or having final authority to make policy decisions for only a subsidiary or affiliate of a common enterprise.
- Requires that a covered entity, by the rule's effective date, provide notice to workers who are parties to a non-compete agreement that is prohibited by the rule (that is, any workers other than "senior executives") that the non-compete cannot and will not be enforced. Notice can be on paper, by mail, by email, or by text.
- Provides model language to be used when notifying workers about existing non-competes. The FTC published sample notices on its website in multiple languages, including:
  - Arabic;
  - English;
  - Korean;
  - Simplified Chinese;
  - Spanish;
  - Tagalog; and
  - Vietnamese.
- Includes limited exceptions for and does not apply to:
  - non-competes entered into in connection with a bona fide sale of business; or
  - causes of action regarding an existing non-compete that arose before the rule's effective date.
- Includes a good faith exception, which provides that it "is not an unfair method of competition to enforce or attempt to enforce a non-compete clause or to make representations about a non-compete clause where a person has a good-faith basis to believe that" the rule is inapplicable.
- Does not preempt state law, except to the extent state law allows conduct that is deemed a method of unfair competition under the final rule.
- Does not apply to industries over which the FTC does not have statutory authority, including nonprofits and certain banks, savings and loan institutions, and federal credit unions, among others (see Does the Final Rule Cover All Employers?).

(16 C.F.R. Part 910 (new).)

The final rule is also notable in that it is not limited to non-competes with employees, but includes all workers, including independent contractors, interns, externs, and volunteers.

The FTC has published frequently asked questions to help employers navigate the rule's scope of coverage, prohibitions, requirements, and exceptions (see FTC: Noncompete Clause Rule: A Guide for Businesses and Small Entity Compliance Guide).

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Does the Final Rule Make Any Changes from the Proposed Rule?

The final rule largely tracks the NPRM, with a few notable exceptions. Most significantly, the final rule expands the sale of business exception by eliminating the requirement that the sale must be for at least 25% ownership of the business. The rule now allows non-competes in connection with the "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" (16 C.F.R. § 910.3(a)).

Second, the final rule creates an exception allowing the enforcement of existing agreements with certain specified senior executives. The exception and the definition of senior executive, comprised of both a salary threshold and "policy-making" duties test, was not in the NPRM, and therefore was not subject to public comment.

Third, the final rule includes an exception for causes of action that accrued before the rule's effective date (meaning the breach occurred before that time). The FTC purportedly included this exception to address concerns about the rule being impermissibly retroactive (Final Rule, p. 344; but see Is the Final Rule Retroactive?). While this is a substantive change, its impact may be relatively minor given that there will be a finite number of accrued or pending claims as of the effective date.

Some other changes appear substantive but practically speaking may be merely semantic. For example, the NPRM would have:

- Banned both non-competes and "de facto" non-competes, without defining de facto non-competes. While the final rule eliminates the "de facto" language, it still incorporates a functional test and bans clauses that "function to prevent" a worker from seeking or accepting work or operating a business. As explained in the supplementary information, while non-solicits and confidentiality provisions are not per se banned by the final rule, they may be violative if "they restrain such a broad scope of activity" that they "function" like a non-compete (Final Rule, § III.D.2.b., p. 77). So this change from the NPRM is more of a distinction than a material difference.
- Required employers to rescind (that is, legally modify) existing agreements with prohibited non-compete clauses. While the final rule eliminates the rescission requirement, it still prohibits enforcing those clauses and requires that employers provide notice to workers who are subject to prohibited non-competes (except certain senior executives) stating that the agreements are not valid and will not be enforced. The final rule requires that the notice be sent by the effective date, rather than 45 days after rescinding the agreement, as provided in the NPRM. Other than the timing, eliminating the rescission requirement does not meaningfully alter the parties' rights, as it renders void nearly all non-compete agreements. (Final Rule, § IV.E, p. 324.)

Does the Final Rule Cover All Employers?

The final rule covers all employers within the FTC's jurisdiction, which includes most for-profit entities. Certain employers are not subject to the FTC's rulemaking jurisdiction under the FTC Act, including:

- Certain banks.
- Savings and loan associations.
- Federal credit unions.
- Common carriers.
- Air carriers.
- Persons covered by the Packards and Stockyards Act of 1921 (15 U.S.C. § 45(a)(2)).
- Non-profit organizations.

(15 U.S.C. §§ 44-45; see also NPRM, 88 Fed. Reg. 3482, 3509 (Jan. 5, 2023).)

While the precise boundaries of the FTC's jurisdiction and rulemaking authority is subject to debate, it appears that the FTC is taking a broad view of its own authority. For example, in the supplementary information accompanying the final rule, the FTC recognizes it lacks jurisdiction over any corporation "not organized to carry on business for its own profit or that of its members." However, after an extensive discussion of the health care industry and, among others, non-profit hospital systems, the FTC warned that "not all entities claiming tax-exempt status as nonprofits fall outside the [FTC's] jurisdiction." The FTC noted that in making this determination it looks to both:

- The source of the income, such as "whether the corporation is organized for and actually engaged in business for only charitable purposes;" and
- The destination of the income, such as "whether either the corporation or its members derive a profit."

(Final Rule, p. 52.)

The FTC takes the position that an organization must satisfy both elements of this two-prong test to be exempt

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from coverage under the final rule, regardless of its claimed tax-exempt status. In comments at the hearing in which the FTC adopted the final rule, Commissioner Slaughter drew a similar distinction between "true non-profits," which are beyond the FTC's jurisdiction, and organizations nominally claiming tax-exempt status but operating for the profit of their members, which are within FTC jurisdiction (see Remarks of Commissioner Rebecca Kelly Slaughter Supporting the Final Rule Banning Non-Compete Agreements, Apr. 23, 2024) ("If you claim non-profit tax status but are really organized for the profit of your members, you are within our jurisdiction and covered by the rule. But true non-profits are not.")

Is the Final Rule Retroactive?

In effect, yes. The final rule invalidates all existing non-competes other than those with certain specified senior executives.

Presumably to bolster its assertion that "the final rule is not impermissibly retroactive" (Final Rule, p. 344), the FTC made some changes to the NPRM by:

- Eliminating the proposed rule's requirement that employers affirmatively rescind existing non-competes (though employers still must notify current and former employees who are not senior executives that their non-competes cannot and will not be enforced).
- Providing that the final rule does not apply where a cause of action related to a non-compete accrues (that is, the provision has been breached) before the rule's effective date.

Can Employers Still Use Non-Solicits and Other Restrictive Covenants?

Yes, generally, unless they have the functional effect of preventing a person from seeking or obtaining other employment. For example, the final rule **does not** purport to ban:

- **Restrictive covenants other than "pure" non-competes**. The final rule is limited to traditional "pure" non-competes. It does not per se prohibit other restrictive covenants, such as customer or employee non-solicits, unless they are so broad that they have the effect of preventing a worker from seeking other employment or starting a business. However, the final rule is ambiguous about precisely how the FTC will make that determination.
- **Confidentiality agreements**. The final rule similarly does not per se prohibit confidentiality agreements, unless they are so broad that they functionally prevent a worker from working in the same field for another employer or in business for themselves.
- **Fixed-term employment contracts**. In the supplementary information, the FTC notes that fixed-term employment contracts remain an available tool to protect an employer's trade secrets and investment in employee training and development. This is consistent with California law, where employment contracts for fixed durations are permitted, even though post-employment non-competes are not. If an employee with a fixed-term employment agreement leaves for a competitor before the contract term ends, the former employer can sue the departing employee for damages arising from the contract breach, but cannot bar them from taking the new job.
- **Concurrent employment restraints.** In the supplementary information regarding the final rule, the FTC specifically "declines to extend the reach of the final rule to restraints on concurrent employment" (Final Rule, p. 92). The non-compete ban therefore only applies to post-employment restraints, leaving employers free to impose restraints on workers' activities during the employment relationship.
- **Garden leave provisions.** The supplemental information also explains that a "garden leave" clause, where the worker remains employed and is being paid, but may be relieved of some or all of their duties during a specified garden leave period, is not governed by the non-compete rule because it is not a post-employment restriction. Although the "functional" noncompete test would still apply to garden leave clauses, the supplementary information states that "where a worker does not meet a condition to earn a particular aspect of their expected compensation, like a prerequisite for a bonus, the Commission would still consider the arrangement 'garden leave' that is not a non-compete clause under this final rule even if the employer did not pay the bonus or other expected compensation." (Final Rule, p. 83.)

  It is unclear what remedies would be available for breach of a garden leave provision if the final rule becomes effective. Traditionally, courts have been reluctant to specifically enforce garden leave provisions because doing so requires the court to order employees to continue an at-will employment relationship against their will (see, for example, *Bear, Stearns & Co., Inc. v. Sharon*, 550 F. Supp. 2d 174 (D. Mass. 2008)). However, courts have been willing to issue an injunction prohibiting competition during the garden

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leave period (see, for example, *Smiths Grp., plc v. Frisbie*, 2013 WL 268988, at *3 (D. Minn. Jan. 24, 2013) and *Ayco Co., L.P. v. Feldman*, 2010 WL 4286154, at *10 (N.D.N.Y. Oct. 22, 2010) (issuing preliminary injunction enforcing a combined 90-day notice and non-compete period but acknowledging that the court would not issue an injunction forcing the employee to continue working for the employer)). But issuing an injunction against competition would render the garden leave the functional equivalent of a non-compete, and therefore likely be void under the final rule. Nonetheless, even if injunctive relief were unavailable, an employer could still sue the worker for breach of contract for violating the garden leave clause and potentially sue the hiring employer for tortious interference.

- **Sale of business non-competes.** The final rule includes an express carve-out for non-competes entered into in connection with a person:
  - selling a business entity;
  - otherwise disposing of all of the person's ownership interest in the business entity; or
  - selling all or substantially all of a business entity's operating assets.

  The final rule eliminates the requirement in the NPRM that the seller must own at least 25% of the equity in the company at the time of entering into the non-compete.

Does the Final Rule Address Non-Competes in Benefit Plans and Other Agreements?

The final rule does not expressly discuss non-competes in benefit plans or other agreements other than in connection with the sale of a bona fide business. According to the FTC, however, an example of a contractual term that "penalizes" a worker, and is thus an impermissible non-compete, may include:

- A forfeiture for competition clause which gives an employee the choice of receiving a defined benefit and refraining from competition or opting to compete and forfeiting the benefit. Because these clauses impose "adverse financial consequences on a former employee" for seeking or accepting other work post-termination, they are impermissible.
- A severance agreement which conditions the right to severance on compliance with a non-compete clause.

According to the FTC, "[t]he common thread that makes each of these types of agreements non-compete clauses . . . is that on their face, they are triggered where a worker seeks to work for another person or start a business after they leave their job" and they therefore "prohibit or penalize" the employee from working for another employer or business.

Moreover, the FTC makes it clear that employers should not attempt to use the sale of a business exception to impose non-competes on workers. As explained in the supplementary information, "[s]o-called 'springing' non-competes [where a worker must agree at the time of hire to a non-compete if there is a future sale] and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale because . . . 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." (Final Rule, p. 342.)

How Will the Final Rule Be Enforced?

If and when it goes into effect, the rule can be enforced in two ways -- through FTC enforcement actions and civil litigation.

First, the FTC could initiate either an administrative proceeding or seek an injunction in federal district court against any defendant that "is violating, or is about to violate" the final rule where an injunction is in the public's interest. The FTC is unlikely to be able to seek monetary relief for violations of this rule because, under the FTC Act, it may not have the authority to seek penalties for unfair method of competition. The FTC can, however, obtain civil penalties in court if a party fails to cease and desist from a violation after being ordered to do so.

Second, although there is no private right of action under the FTC Act, an aggrieved employee can file an action seeking a judgment from the court declaring that any illegal non-compete is unenforceable. There may also be other potential claims, including claims for actual and punitive damages, depending on whether an employer attempts to enforce an illegal non-compete.

Does the FTC Even Have the Authority to Make This Rule?

Unclear, but two FTC commissioners and the US Chamber of Commerce, among others, think the answer is no, and the issue is currently being litigated, as described below.

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Section 5 of the FTC Act empowers the FTC, among other duties, to prevent unfair methods of competition and unfair or deceptive acts or practices affecting interstate commerce. It gives the FTC authority to investigate possible violations, seek monetary damages, prescribe rules to prevent unfair or deceptive practices, and make reports and recommendations to Congress and the public. (15 U.S.C. §§ 41-58). The final rule purports to ban non-competes as an "unfair method of competition" under Section 5. But the FTC's rulemaking authority is limited to prescribing rules and policy statements regarding unfair or deceptive acts or practices, not unfair methods of competition. For more on the FTC Act, see Practice Note, FTC Act Section 5: Overview.

For over 200 years, non-compete agreements have been governed by state laws that vary widely across jurisdictions. Until recently, the FTC has not actively engaged in regulating non-compete agreements between employers and their workers. That changed in late 2022 with the FTC's policy announcement about non-competes, followed by its announcement that it had entered into consent decrees arising out of two enforcement actions accusing employers of engaging in unfair methods of competition by using non-competes, and capped off with the NPRM in January 2023 that ultimately led to the final rule.

Since the NPRM's publication, there have been questions about the FTC's authority to issue a rule of this scope. Commissioners Melissa Holyoak and Andrew N. Ferguson dissented from the issuance of the final rule, expressing the view that this "broad rulemaking exceeds congressional authorization and will likely not survive legal challenge" (Oral Statement of Commissioner Holyoak in the Matter of Non-Compete Clause Rule, Apr. 23, 2024; see also Oral Statement of Commissioner Andrew N. Ferguson In the Matter of the Non-Compete Clause Rule, Apr. 23, 2024 ("I do not believe we have the power to nullify tens of millions of existing contracts; to preempt the laws of forty-six States; to declare categorically unlawful a species of contract that was lawful when the Federal Trade Commission Act (FTC Act) was adopted in 1914; and to declare those contracts unlawful across the whole country irrespective of their terms, conditions, historical contexts, and competitive effects.")).

And as predicted, almost immediately after its issuance, three lawsuits have been filed challenging the FTC's authority to issue and enforce the final rule, especially given its breadth and scope.

In the first suit, Ryan, LLC, a global tax services and software provider that uses non-competes with its shareholder principals and certain other employees with access to particularly \ sensitive business information, filed a challenge to the final rule on April 23, 2024 in the Northern District of Texas (*Ryan, LLC v. Fed. Trade Comm'n*, Case No. 3:24-cv-00986-E (N.D. Tex. Apr. 23, 2024)). The Ryan lawsuit alleges that the final rule:

- Contravenes the FTC Act.
- Violates the US Constitution.
- Is arbitrary, capricious, and otherwise unlawful.

In the second suit, the US Chamber of Commerce and other business associations seek a declaration that the FTC's final rule is unlawful and an injunction against its enforcement (*U.S. Chamber of Commerce v. Fed. Trade Comm'n*, Case 6:24-cv-00148 (E.D. Tex. Apr. 24, 2024)). The lawsuit alleges that the FTC's promulgation of the final rule should be set aside and enjoined because it is:

- Not in accordance with law because:
  - the FTC lacks the authority to issue binding regulations regarding "unfair methods of competition;"
  - the rule exceeds the FTC's authority under Section 5 of the FTC Act;
  - Section 5 of the FTC Act violates the US Constitution's nondelegation principle; and
  - the FTC lacks the authority to issue retroactive regulations.
- Arbitrary and capricious because the FTC:
  - does not support its decision to categorically ban all noncompete agreements;
  - relied on a flawed cost-benefit analysis; and
  - failed to consider alternate proposals.

The plaintiffs filed a motion asking the court to stay the effective date of the final rule or preliminarily enjoin its enforcement, or both.

On April 25, 2024, ATS Tree Services sued the FTC in the Eastern District of Pennsylvania. As alleged, "ATS uses reasonable non-compete agreements to ensure that it can provide its employees with necessary and valuable specialized training while minimizing the risk that employees will leave and immediately use that specialized training and ATS's confidential information to benefit a competitor." ATS challenges the final rule on similar grounds to the other lawsuits and is represented by a public interest law firm. (*ATS Tree Servs, LLC v. Fed. Trade Comm'n*, Case 2:24-cv-01743 (E.D. Pa. Apr. 25, 2024)).

We believe that legal challenges to the final rule are likely to succeed and that the final rule will most likely be enjoined before it ever goes into effect.

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What Should Employers Do Now?

While the ultimate fate of the final rule remains uncertain, there are several steps employers should consider taking during this period of flux:

- **Determine the company's approach to compliance before the effective date.** While expected legal challenges play out, employers are not legally required to make any immediate changes in their non-compete practices. Many employers are taking a "wait-and-see" approach before making sweeping changes to their agreements and plan documents.
- **Review existing non-compete agreements and plans and policies with restrictive covenants.** While no immediate changes are required, employers generally should take stock of their existing agreements, plans, and policies that contain non-competes and other restrictive covenants. Determine whether the company has entered into non-competes with any senior executives or wants to enter into agreements with those individuals before the final rule's effective date.
- **Consider entering into garden leave agreements with key executives and sales personnel**. Because "pure" garden leave provisions are not covered by the non-compete ban, employers may consider entering into these agreements with certain key employees and sales personnel who do not qualify as "senior executives" under the final rule. Employers should balance the cost of these agreements with the benefit they are seeking to protect their valuable assets. For more on garden leave, see Practice Note, Garden Leave Provisions in Employment Agreements: Advantages and Disadvantages of Garden Leave Provisions.
- **Be prepared for continued regulatory activity.** Even if the final rule never becomes effective, the FTC may continue to flex its regulatory muscle with enforcement actions on a case-by-case basis, likely targeted at companies that use non-competes with low wage workers or in other ways that the FTC may consider to be abusive. Given the current climate, employers should review and evaluate the nature and scope of their non-compete agreements and ensure they are being used to protect legitimate business interests and comply with applicable state laws.
- **Monitor and comply with evolving state law.** Employers should focus on compliance with state non-compete laws, which have been evolving substantially over the past few years and are increasingly restricting the enforceability of non-competes. Many states now include compensation thresholds and notice requirements, among other due process-type protections. Employers should ensure that they are in compliance with all applicable laws and pay particular attention with their remote workers who may be entitled to greater protections than those available where the business is primarily located. To view and customize an up-to-date comparison of state non-compete laws, see Quick Compare Chart, State Non-Compete Laws.
- **Consider a trade secret audit.** Employers should evaluate what they are doing to protect their trade secrets and what they can do better, for example, by:
  - identifying and labelling trade secrets;
  - securing them through limited access and contractual protections; and
  - training employees about the importance of protecting them.

  For more on trade secret audits, see Practice Note, Trade Secret Audits. For customizable training materials, see Standard Document, Protecting a Company's Confidential Information and Trade Secrets: Presentation Materials.
- **Take a holistic approach.** Non-competes are just one tool employers can use to protect confidential information, customer relationships, and workforce stability. Employers should consider alternative methods, including:
  - garden leave clauses;
  - confidentiality agreements;
  - non-solicitation agreements;
  - employee training; and
  - employee onboarding and offboarding procedures.
- **Don't panic.** Although the announcement of the final rule brings us one step closer to the FTC's desired ban, given the current and expected future legal challenges, the final rule is unlikely to become the law of the land, at least not any time soon. But employers should use this opportunity to stay ahead of the legal and regulatory trend toward limiting when and against whom non-competes are enforceable and use their non-compete agreements wisely.

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