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# A Divided FTC Issues Final Rule on Non-Competes – Caution is Warranted Although the Rule May Not Survive Legal Challenges

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On Tuesday, April 23, 2024, the Federal Trade Commission (FTC) voted 3-2 along party lines to issue a Final Non-Compete Clause Rule ("the Final Rule") that will prohibit most employers under the FTC's authority[1] from enforcing, entering into, or attempting to enter into non-compete clauses, including functional non-compete clauses, against workers. Specifically, 120 days after being published in the Federal Register (*i.e.*, in or around the end of August or early September, 2024) the Final Rule will become effective and it will:

1. ban all existing "non-competes clauses" (which is broadly defined to include, among other things, forfeiture for competition provisions), except for those with "Senior Executives" as defined below.

2. ban entering into new non-competes with all workers, including the aforementioned narrow category of Senior Executives.

3. allow for non-competes in the context of a *bona fide* sale of business (this is the most significant change to the FTC's proposal that was published 16 months ago and covered in our earlier alert, which limited non-competes in the sale of a business to only those owning 25% or more of the entity, regardless of the entity's value).

4. require employers to notify their employees subject to non-competes that those non-competes are no longer enforceable (the rule provides a model form of notice provision for employers to distribute to employees to comply with this requirement).

5. purportedly preempt all state laws except for those more restrictive than the Final Rule.

Given that the Final Rule will not become effective until the late summer or early fall, there is nothing that employers need to do immediately. In the interim, the United States Chamber of Commerce and other organizations have already committed to imminently filing legal challenges to the Final Rule. This can and likely will further delay its implementation. We will keep you apprised of developments.

In this alert, we provide a high-level overview of the Final Rule.

## What is a Non-Compete Clause?

The Final Rule defines "non-compete clause" as a term or condition of employment that:

(i) *prohibits workers from competing* – this is a traditional contractual term expressly prohibiting a worker from seeking or accepting work or starting a business after employment.

(ii) *penalizes workers from competing* – this is a term or condition that requires a worker to pay a penalty for seeking or accepting work or starting a business after employment, *e.g.*, a forfeiture for competition clause or liquidated damages clause that imposes adverse financial consequences on a former employee, or a severance agreement where payment is conditioned on not competing.

(iii) *functions to prevent workers from competing* – while the Final Rule makes clear that NDAs and non-solicitations do not necessarily by their terms prevent a worker from seeking or accepting work, they could function as such if too broad in scope or onerous in practice, and ultimately whether any given provision is a non-compete clause is a fact-specific inquiry.[2]

The FTC also expressly addressed "garden leave" provisions in its commentary to the Final Rule.[3] Notably, "garden leave" provisions may now be a viable alternative to traditional non-competes. The FTC specifically acknowledged that "garden leave" provisions – where a worker is still employed and receiving the same total annual compensation and benefits on a pro rata basis – are not non-competes because they are not a *post-employment* restriction. The Final Rule would not prohibit these provisions even if the worker's job duties or access to colleagues or the workplace may be "significantly or entirely curtailed." Indeed, the commentary even went so far as to acknowledge that a garden leave provision would still be acceptable if the worker did not receive a particular aspect of their expected compensation, like a bonus, due to a failure to meet a condition of earning that aspect of compensation.[4]

Noticeably absent from the FTC's commentary to the Final Rule is any discussion of notice provisions. Given that notice provisions are not a post-employment restriction, it is likely that they would be treated in the same favorable fashion as garden leave provisions discussed above.

In defining covered "workers", the FTC also removed the reference to "for an employer" to close an unintended loophole for agreements between an individual and an entity that is not technically the employing entity of the individual subject to the contract.[5] The Final Rule also makes clear that a worker is covered without regard to the worker's title or status (*i.e.,* as an employee or independent contractor) under state or federal laws.[6]

## What are the Exceptions?

The ban contains a limited exception for non-competes entered into with Senior Executives (defined as workers earning more than $151,164 annually who are in policy-making positions) before the effective date.[7] Specifically, Senior Executives are limited to those who have "final authority" to make policy decisions that control "significant aspects" of a business entity or common enterprise. The Final Rule makes clear that it is not sufficient to merely advise or exert influence over such policy decisions or to have final authority over a subsidiary or affiliate. Furthermore, while non-competes entered into with Senior Executives prior to the effective date are not invalidated under the rule, the Final Rule does prohibit entering into new non-competes with Senior Executives after the effective date.

Non-competes related to the *bona fide* sale of a business (without a requirement that the seller have at least a 25% ownership interest) are also exempted.[8] The Final Rule provides that generally, a *bona fide* sale is one 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. The Final Rule also does not apply to non-compete agreements between franchisors and franchisees, but it does apply to those agreements between those entities and their employees.[9]

The Final Rule also includes an express exemption for existing causes of action related to a non-compete that accrued prior to the effective date.[10] This preserves ongoing litigation seeking to enforce non-compete clauses based on events that occurred prior to the effective date.

The Final Rule also does not require employers to rescind their existing non-competes, but instead provides model language for employers to send to their workers with existing non-competes, explaining that they are no longer in effect and cannot be enforced.[11]

## How Did the FTC Reach the Final Rule and What Will Happen Next?

The Final Rule was approved by a 3-2 party line vote[12], with Commissioners Khan, Slaughter, and Bedoya voting for, and Commissioners Ferguson and Holyoak voting against and dissenting. The FTC press release regarding the Final Rule provides that the Commissioners' written statements will follow at a later date. In the meantime, the Commissioners' statements at the special Open Commission Meeting shed some light into the Commission's internal debate. The agency's staff delivered opening remarks, and asserted that of the 26,000+ comments received during the public comment period, over 25,000 comments supported a non-compete ban. Staff reported that the Commission considered justifications offered by commenters in support of non-compete agreements, most notably the protection of confidential information and intellectual property rights, but found that those justifications were not compelling and could be protected by less restrictive means. Staff claims that the Final Rule would provide an estimated $400-$488 billion in increased wages to workers over the next ten years, as well as benefits to consumers from increased innovation and improved products and services.

Commissioners Ferguson and Holyoak delivered remarks summarizing their position that the Final Rule extended beyond the FTC's authority under FTC Act Section 5[13], which authorizes the FTC to prohibit unfair methods of competition, and FTC Act Section 6(g)[14], which authorizes the FTC "from time to time [to] classify corporations and . . . make rules and regulations". The dissenting Commissioners believe that the Final Rule was an unconstitutional assertion of the FTC's authority that violates the major questions doctrine, the non-delegation doctrine, and the Administrative Procedures Act. Chair Khan and Commissioner Bedoya disagree, citing to *National Petroleum Refiners Assn v. FTC*, 340 F. Supp. 1343 (D.D.C. 1972) as support for the proposition that the FTC has authority to issue the Final Rule. Commissioner Slaughter notes that, although the Final Rule only extends to companies under the FTC's authority and does not apply to agreements between franchisees and franchisors and their employees, other agencies and states have the authority to regulate the types of non-competes that are beyond the FTC's jurisdictional reach.

One or more legal challenges to the FTC's ban on non-compete agreements is imminent. The Chamber of Commerce has announced its intention to challenge the Final Rule as soon as today, April 24th. This challenge will likely address the constitutional and procedural concerns raised by the Final Rule and could trigger a stay, further delaying implementation of the Final Rule past the August 2024 timeframe. Given the impeding legal challenge, the Final Rule may not be implemented until after the 2024 election cycle, even if it survives the legal challenge.

Finally, a political change with the upcoming election resulting in a new administration (or Congress) could lead to modifications or rescission of the Final Rule. Notably, there has been a trend in recent years of different administrations taking varying approaches to Section 5 enforcement, including enforcement guidance or policies being withdrawn following changes in leadership. Indeed, the current FTC recently rescinded its previous Section 5 guidance that had more narrowly construed the FTC's authority under the Act to be consistent with how courts have interpreted the Sherman Act.

## Federal and State Action on Non-Compete Clauses

Even absent the Final Rule, employers should carefully consider the increasing hostility non-compete agreements are facing from federal enforcement agencies and from state legislatures.

**Federal Activity**: Since the FTC promulgated the proposed rule in early 2023, the agency ordered a glass manufacturer to drop non-compete restrictions it imposed on workers in a variety of positions, citing concerns for both workers and competing businesses. On April 19, 2023, the Department of Justice (DOJ) issued a comment supporting the proposed rule and showing its alignment with the FTC. On August 20, 2023, the FTC and the Department of Labor (DOL) signed a memorandum of understanding providing that the two agencies "share an interest in protecting workers who have been harmed or may be harmed as a result of unfair methods of competition and unfair or deceptive acts or practices", including one-sided and restrictive contract provisions, such as noncompete[s]". This memorandum of understanding sends a signal that additional non-compete enforcement actions may come from the DOL.

**State Activity**: Since early 2023, state enforcers have continued to take interest in non-compete legislation across the country. For example, on July 1, 2023, Minnesota joined California, North Dakota, and Oklahoma and became just the fourth state to impose a near-total ban on non-compete agreements. On June 20, 2023, the New York State Legislature passed a bill that would have prohibited almost all new non-competes in New York and created a private right of action enabling workers to void their non-competes and recover up to $10,000 in liquidated damages, in addition to lost wages, damages, and reasonable attorneys' fees and costs. Although Governor Hochul vetoed the bill, calling for a carve-out to the ban for high-wage workers, the bill's sponsor in the state senate said he would re-introduce the bill in 2024. In January 2024, California also enacted two new laws that bolstered its prohibition of non-competes in the state. These laws (SB-699 and AB-1076) created a private right of action for workers to sue employers who enter into or attempt to enforce a non-compete, required employers to notify employees subject to unlawful non-competes that these agreements are void, and codified California Supreme Court precedent prohibiting the use of non-competes in the state. On March 13, 2024, Washington State Governor Inslee signed into law a new bill expanding an existing Washington statute governing the enforceability of noncompetition covenants by, among other things, including within the definition of "noncompetition covenant" covenants restricting an employee's ability to accept or transact business with a customer.

## What Should Companies Do in the Face of This Uncertainty?

Although the Final Rule is a significant development and departure from existing federal antitrust law by treating most non-competes as *per se* illegal or automatically unlawful, we advise caution before reacting too soon or too dramatically. Employers have 120 days from the rule's publication in the Federal Register to comply, which could potentially be extended further if the rule is stayed pending a constitutional and procedural challenge. While any legal challenge to the Final Rule plays out, companies should be cautious when it comes to non-competes. They should be able to answer the following types of questions to ensure their non-competes would withstand scrutiny from a traditional antitrust challenge under the Sherman Act.

- Legitimate Business Reason – Have a credible and straightforward explanation for why a contract has a non-compete. For example, will the company make substantial investments in training the covered employees? Will those employees have access to trade secrets and other sensitive information that the company safeguards and that could be misused by competitors? Do the covered employees possess significant goodwill with clients and customers? Would a confidentiality agreement or customer non-solicit be insufficient to protect these investments and information? Answering yes to these types of questions will put the company on safer ground to defend such non-competes under existing law.
- Reasonable Scope – Ensure that the non-compete is reasonably tailored in terms of geographic scope and duration and that it does not unduly limit the pool of competitors for which the employee would be restricted from working. Be able to show why the terms of the non-compete are needed and not overbroad.

Going forward, companies should work with counsel to ensure their non-competes comply with state antitrust and employment laws, and should consider using in-term employment restrictions to protect their confidential and proprietary information and relationships. Companies should also work with counsel to audit existing non-competes and other restrictive covenants in their employment and equity agreements to ensure they know what type of agreements they have, and whether those agreements comply with not only the Final Rule but also with the many new state laws enacted over the last several years. For example, investigate whether any former employees are still subject to non-competes or if they have expired. For current employees, assess whether the non-competes are based on position, pay scale, or access to certain types of information. It is also important to evaluate any non-competes with independent contractors, externs, interns, volunteers, apprentices, or sole proprietors, as they are all subject to the Final Rule as well.

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[1] Some employers are outside the FTC's jurisdiction and therefore not subject to the Final Rule. This includes banks, savings and loan institutions, federal credit unions, common carriers, air carriers, and certain non-profits.
[2] *Final Rule* at 3-4.
[3] *See Id*. at 83-84.
[4] *Id*. at 83.
[5] *Id*. at 100.
[6] *Id*. at 4.
[7] *Id*. at 219.
[8] *Id*. at 4.
[9] *Id*. at 388-89.
[10] *Id*. at 343.
[11] *Id*. at 325-26.
[12] Commissioner Wilson voted against the Notice of Proposed Rulemaking in January 2023, indicating a clean 3-3 party line split on approval of the rule.
[13] 15 U.S.C. § 45.
[14] 15 U.S.C. § 46.

If you have questions concerning the Final Rule or non-compete agreements more generally, please speak to your regular contact at Weil or to any of the following:

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