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FTC Issues Final Rule Banning Employer-Worker Non-Competes and Is Immediately Challenged in Court

- **The FTC's final non-compete clause rule would ban all new and nearly all existing employer-worker non-competes.** The ban would go into effect 120 days after publication in the *Federal Register*.
- **The final rule is only slightly narrower in scope than the initial proposed rule.** The final rule does not ban existing non-compete agreements with "senior executives," and it retains and expands upon an exemption for non-compete agreements related to sale of a business.
- **There is significant uncertainty as to when, if ever, the final rule would become effective and enforceable.** One lawsuit seeking to set aside the rule has already been filed against the FTC and more are expected. These challenges could delay or even permanently enjoin enforcement of the rule.

In a Special Open Commission Meeting held on April 23, 2024, the Federal Trade Commission (FTC) voted 3-2 along party lines to promulgate a final rule that broadly prohibits the use of non-compete clauses in employment and worker contracts, with only narrow exceptions for the sale of a business and for existing agreements with senior executives. This action comes more than one year after the FTC issued a proposed non-compete clause rule. There has been immense interest in the FTC's proposed rule, which garnered more than 26,000 comments from a wide range of individuals, businesses, trade and industry associations, bar associations and politicians during an extended comment period.

Scope of Final Rule

The FTC's non-compete clause rule would ban almost all existing non-compete clauses and prohibit all new non-compete clauses. For purposes of the rule, a non-compete clause is a "term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from: (i) 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 (ii) operating a business in the United States after the conclusion of the employment that includes the term or condition."

Note that "garden leave" arrangements whereby a worker continues to receive compensation during employment do not appear to be covered by this definition of a non-compete clause. Such an agreement is not a post-employment restriction, even when a worker's job duties may be significantly or entirely curtailed.

For workers who are *not* senior executives, the FTC's rule is fairly straightforward: entering or attempting to enter into, enforcing or attempting to enforce, or representing that a worker is subject to a non-compete clause are all unfair methods of competition and therefore would be illegal under Section 5 of the FTC Act.

The rule for "senior executives" is also fairly straightforward: everything that is an unfair method of competition vis-à-vis workers who are *not* senior executives is also an unfair method of competition when a senior executive is involved, except that it is *not* an unfair method of competition to enforce or attempt to enforce a non-compete against a senior executive that was entered into *prior to the effective date* of the rule.

The central task for many companies and their counsel will be to determine who qualifies for this narrow but important group – the "senior executives" – against whom existing (but not future) non-competes can be enforced. The first criterion is that the worker earn "total annual compensation of at least $151,164." The definition of compensation refers to Department of Labor standards, which will introduce some interpretive questions as to how to treat equity awards and on its face excludes fringe benefits which can be meaningful.

The second criterion for a worker to be classified as a "senior executive" for purposes of the rule is that the person be in a "policy-making position." Some "policy-making positions" are obvious or intuitive, such as a company's president and chief executive officer "or the equivalent." Other policy-making positions sensibly include positions which carry "policy making authority," i.e., "final authority to make policy decisions that control significant aspects of a business entity or common enterprise." Workers who merely advise or exert influence over policy decisions do not have "policy-making authority." The FTC release indicates that the definition for determining which workers have "policy-making authority" used here is similar to the SEC standard used to identify executive officers.

In addition to exempting existing non-compete clauses for senior executives, the final rule exempts non-competes "in connection with 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" from the ban. This expands a similar exemption in the initial proposal, which would have applied only to sellers with a 25% or greater ownership stake.

Effective Date Uncertain

By its terms, the final rule becomes effective 120 days after it is published in the *Federal Register*. The effective date of the rule is important because that is when existing non-compete clauses covered by the rule would become retroactively void and new non-compete agreements covered by the rule would be prohibited. In the earliest publication scenario, the FTC will have already submitted the rule to the *Federal Register* once it was approved by the Commission and, following a typical timeline, publication in the *Federal Register* would occur on Friday, April 26, 2024. In this scenario, the rule would become effective on **Monday, August 26, 2024**.

However, as discussed below, legal challenges to the rule will likely include requests that a court postpone the effective date and preliminarily enjoin enforcement of the rule until after the court decides the ultimate issue of its legality. A court may postpone the effective date under the Administrative Procedure Act "[o]n such conditions as may be required and to the extent necessary to prevent irreparable injury." 5 U.S.C. § 705. And a court may issue a preliminary injunction if a plaintiff establishes that it "is likely to succeed on the merits, that [it] is likely to suffer irreparable harm in the absence of preliminary relief, that the balance of equities tips in [its] favor, and that an injunction is in the public interest." *Winter* v. *Natural Resources Defense Council, Inc.*, 557 U.S. 7, 20 (2008).

The timing of federal court challenges to administrative actions varies considerably and can depend on a number of factors, including the venue and judge. If recent judicial review actions commenced in federal court in Texas are a guide, a challenge to the non-compete rule – including proceedings in district court, the court of appeals and the Supreme Court – could take one and a half years or longer.

Key Compliance Requirements and Deadlines

If the final rule eventually does become effective, employers would be required to provide written notice to covered workers that their non-compete clauses are no longer in force by the effective date, which is 120 days after *Federal Register* publication. A court's injunction orders may affect this timeline. After the effective date, new non-compete clauses would be banned and

failure of an employer to comply with the rule could result in the FTC bringing an enforcement action against the employer for violating Section 5 of the FTC Act. There is no private right of action under Section 5, though employees may have other avenues of recovery in certain circumstances.

Legal Challenges

At least one lawsuit seeking to set aside the rule has already been filed, and more are expected. The complaint in *Ryan, LLC* v. *FTC*, No. 24-cv-986 (N.D. Tex. Apr. 23, 2024), asserts that the FTC lacks statutory authority to issue the rule; that if the FTC did have authority to promulgate the rule it would be an impermissible delegation of Congressional power; and that the structure of the FTC is unconstitutional because the FTC exercises executive power, yet there are impermissible restrictions on the ability of the President to remove commissioners. The United States Chamber of Commerce is also planning to sue "as early as" April 24, 2024, according to an mLex report.

The legal challenges to the non-compete rule were previewed in the comments submitted to the FTC.

Many comments in opposition to the rule – including comments from Republican members of the House Judiciary Committee, the New York City Bar Association and the U.S. Chamber of Commerce – asserted that the rule exceeds the FTC's authority and improperly imposes a "one-size-fits-all approach." A number of these arguments are likely to appear in expanded form in federal court challenges to the rule. The U.S. Chamber of Commerce and many others have argued that the proposed rule is legally invalid because the FTC lacks the authority to promulgate rules regarding "unfair methods of competition."

As background, the FTC has a dual mission to protect against "unfair and deceptive acts or practices" and "unfair methods of competition." In this rulemaking, the FTC is asserting that Section 6(g) of the FTC Act authorizes its ability to issue rules specifically relating to "unfair methods of competition." The FTC has only once attempted to engage in "unfair methods of competition" rulemaking in 1968, promulgating a rule related to the Robinson-Patman Act "concerning the need for a written plan to guide a seller's promotional allowances in the men's and boys' tailored clothing industry." This rule was never enforced and later repealed by the FTC in 1994.

Moreover, the only precedent on the FTC's "unfair methods" rulemaking authority is a 1973 decision by the District of Columbia Circuit, *National Petroleum Refiners Association* v. *FTC*, 482 F.2d 672 (D.C. Cir. 1973), which dealt with an FTC rule regarding the posting of octane ratings on gasoline pumps. In that case, the court considered the FTC's rulemaking authority vis-à-vis "unfair and deceptive acts or practices" and "unfair methods of competition" as a whole, without distinguishing between the two. Subsequent legislation dealt in detail with "unfair and deceptive acts or practices" rulemaking but was silent on "unfair methods of competition" rulemaking. This legislative silence has continued. The Supreme Court has not addressed the issue but many administrative law scholars are skeptical that today's Court would agree that the FTC has authority to promulgate such a rule.

Opponents might also argue that the FTC lacks clear Congressional authorization to undertake this rulemaking on an issue of national significance, in violation of the "major questions doctrine." This doctrine was applied recently in cases such as *West Virginia* v. *EPA*, 142 S. Ct. 2587 (2022), where the Court found that the Environmental Protection Agency lacks authority to regulate greenhouse gas emissions.

Finally, as some comments noted, opponents might challenge the rule as an "arbitrary and capricious" agency action, arguing that there is no rational connection between the facts found and the "one size fits all" blanket-ban choice made by the agency, that the FTC had faulty or insufficient empirical evidence to support the rule, did not consider all the relevant factors and made a clear error in judgment by promulgating a broad ban on non-competes. Indeed, the Chamber argued in its comment that non-compete clauses have procompetitive effects that are recognized by the courts and that non-compete agreements should be evaluated on a case-by-case basis. Although the FTC presented data on the economic cost of non-competes, the dissenting Commissioners raised questions as to the validity of that data.

Notably, many submissions during the comment period supported the FTC's issuance of the rule. For example, the Attorneys General of California, New Jersey and the District of Columbia, among others, expressed support for the proposed rule based on the "need for a uniform, national rule." A group of Democratic senators and members of Congress also supported the proposed rule, especially the prohibition of non-competes that restrict low-wage workers from those applicable to highly compensated executives. The Department of Justice Antitrust Division submitted a comment asserting that non-compete clauses harm competition and are "too pervasive" for case-by-case adjudication.

Other commenters urged a less sweeping rule. The American Bar Association Antitrust Section recommended the FTC adopt different standards for low-wage workers. The American Investment Council, which represents private equity interests, submitted a comment outlining "reasonable ways for the FTC to address the concerning practices that are the focus of the [proposed rule] while still permitting procompetitive non-compete clauses to be used to address the legitimate concerns and business realities that the law today permits, including in the context of investments of the sort that private equity firms typically make."

What Employers Can Do Now

Given that the FTC's final non-compete rule has already been challenged, and the significant uncertainty as to when, if ever, the final rule may become effective and enforceable, we recommend that clients utilize the period prior to the rule's proposed effective date to evaluate their existing and proposed non-compete agreements, and to reach out to your contacts at Paul, Weiss to discuss questions that arise related to how to treat non-competes in the ordinary course and in the M&A context, including for tax planning purposes where non-competes have been a useful mitigation tool.

- **Audit non-competes for your senior executives and make sure you have sufficient coverage prior to the effective date**. In light of the FTC's exception that permits non-competes that apply to "senior executives" (as discussed above) to be grandfathered and continue to be enforceable if they are entered into prior to the final rule's effective date, companies who rely on non-competes as a method to protect business interests should utilize this period to consider structuring and implementing non-compete arrangements that are likely to continue to be enforceable under the FTC's proposed final rule grandfather provisions. For example, we recommend that companies perform an audit of who is reasonably considered to be a senior executive under the proposed final rule, and if their non-competes have lapsed or have not been signed or put in place, consider doing so prior to the final rule's effective date. Also, because there is a minimum compensation standard to be deemed a "senior executive" under the final rule, companies may consider how to address this issue for executives whose compensation arrangements may not clearly fall within the requirements of the rule.

Additionally, companies may wish to consider the following items in connection with the review of their current approaches to employer-worker non-compete clauses in light of the FTC's final rule.

- **Assess existing non-compete clauses and the goals the clauses are intended to address and consider additional methods by which those interests might be protected**. In certain circumstances, the protection of a company's intellectual property, trade secrets, proprietary information and goodwill might be well served by garden leave policies (which have survived the final rule) and extended notice provisions (see our FAQs for further discussion), as well as by non-disclosure agreements or customer non-solicitation agreements that are narrowly tailored. Employers could also consider using contractual provisions that incentivize an employee not to compete by offering benefits or give the employee the option to forfeit benefits if they choose to compete. Such provisions may have a better chance of not being deemed de facto non-compete clauses.

- **Be aware that broad-based non-compete agreements that impact low-wage and middle income workers may continue to be an enforcement priority regardless of the fate of the final FTC rule**. In January 2023, before the proposed rule was announced, the FTC settled enforcement actions it brought against companies and individuals, requiring them to remove non-compete restrictions imposed on thousands of workers. The FTC asserted that the non-competes at issue were "an unfair method of competition under Section 5 of the FTC Act." The FTC resolved a similar enforcement action in June 2023. Particularly if a court stays the effectiveness of the final rule, the FTC might continue to bring, or even increase enforcement

actions against, certain businesses that subject middle-income and low-wage workers to non-competes on a widespread basis.

- **Consider whether the company may be subject to the non-compete policies of other government agencies**. In May 2023, the general counsel of the National Labor Relations Board sent a memorandum to regional officials asserting that employer-employee non-compete agreements could violate the National Labor Relations Act, which generally protects employees' right to organize. Additionally, in recent Proposed Revisions to the Statement of Policy on Bank Merger Transactions, the Federal Deposit Insurance Corporation said that in a bank merger requiring divestitures, it would "generally require that the selling institution will not enter into non-compete agreements with any employee of the divested entity nor enforce any existing non-compete agreements with any of those entities."

- **Monitor non-compete developments in all states where employees are located**. Currently, and until the final rule takes effect, the legality of non-competes is determined by the laws of the individual states. Certain states prohibit non-compete clauses, while others permit them only in limited contexts, including for employees earning more than a certain salary. Recently, some states have been developing new legislation on non-competes:

  In June 2023, the New York State Assembly passed a bill that proposed to broadly ban nearly all new worker non-compete agreements. Governor Hochul vetoed the bill in December 2023 and called for modifications to protect "middle-class and low-wage workers" from non-compete agreements, while balancing companies' interests "to retain highly compensated talent." In 2024, the New York City Council introduced bills that would broadly ban existing and future employer-worker non-compete agreements.

  In California, on January 1, 2024, two new non-compete laws, Senate Bill 699 and Assembly Bill 1076 went into effect. These laws expand the ability of employees to challenge non-competes in California and add a requirement that employers provide affirmative notice to employees that are parties to non-compete agreements that are void under California law. These and other recent non-compete developments are discussed in our February 2024 publication.

If the final non-compete rule ultimately takes effect, it would displace less restrictive state laws and effectuate a fundamental change in federal antitrust law, which for decades has required a fact-specific analysis into the effects of non-compete agreements. This would be a significant shift for many employers.

Final Takeaway

There remains substantial uncertainty as to whether and when the FTC's final rule will come into effect. Given the significance of the final rule and its impact on a broad range of employers who rely on non-competes, and while waiting for legal challenges to run their course, employers would be well-advised to assess their current uses of non-compete clauses and monitor federal and state developments.

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