FAQs on Federal Trade Commission's Rule Banning Worker Noncompete Clauses

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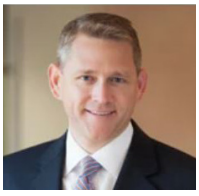

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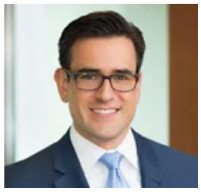

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On April 23, the Federal Trade Commission (FTC), by a 3-2 vote, approved a Final Rule banning almost all worker noncompetes. The Final Rule will go into effect 120 days following its publication in the *Federal Register*. In this article, we answer several frequently asked questions related to the Final Rule's applicability and anticipated impact, as well as what businesses can do to prepare.

1. What Can Employers / The Business Community Do to Challenge or Support on the FTC's Final Rule?

As the time to provide comments to the FTC has passed, the only way to challenge or support the Final Rule is through litigation against the FTC. Within hours of the FTC's vote to adopt the Final Rule, the first challenge was filed, in the US District Court for the Northern District of Texas, by tax services firm Ryan LLC. (Ryan LLC v. Federal Trade Commission, 3:24-cv-986 (N.D. Tex., Apr. 23, 2024). The U.S. Chamber of Commerce filed its legal challenge against the FTC's Final Rule on April 24, 2024, and moved for a preliminary injunction to stay the enforcement of the Final Rule on April 25. (Chamber of Commerce of the United States of America v. Federal Trade Commission, 6:24-cv-00148 (E.D. Tex., Apr. 24, 2024).A third lawsuit was filed against the FTC on April 25 by ATS Tree Services LLC in the US District Court for the Eastern District of Pennsylvania. (ATS Tree Services LLC v. Federal Trade Commission, 2:24-cv-01743 (E.D. Pa. Apr. 25, 2024)).

2. Does the Final Rule Apply to Noncompetes that Existed at the Time of the Rule's Effective Date?

Yes, the Final Rule provides that nearly all existing worker noncompetes are not enforceable. The Final Rule provides that it is an unfair method of competition for persons to, among other things, enter into noncompete clauses with workers on or after the Final Rule's effective date. However, there are three important carveouts:

- **Existing senior executive noncompetes.** Existing noncompetes with "senior executives" who are in "policy-making positions" with respect to the entire business enterprise and earn more than $151,164 annually will remain in force.
- **Noncompetes under pending litigation.** The Final Rule does not apply where a cause of action related to a noncompete accrued prior to the effective date.
- **Good-faith basis to believe the Final Rule is inapplicable.** The Final Rule provides that it is not an unfair method of competition to enforce or attempt to enforce a noncompete or to make representations about a noncompete where a person has a good-faith basis to believe the Final Rule is inapplicable.

3. Does the Final Rule Apply to Provisions Requiring Employees or other Workers to Forfeit Stock or other Equity as a Consequence of Competition?

Yes, the FTC's commentary on the Final Rule clarifies that "forfeiture-for-competition" clauses, where the agreement imposes adverse financial consequences on a former worker as a result of competition with the employer following termination of the employment relationship, is unlawful under the Rule. The FTC's clarification hinges on its expansive definition of "noncompete clause." The Final Rule defines "noncompete clause" as a term or condition of employment that either "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." Thus, the definition in the Final Rule is clarified to go beyond express noncompetes to cover a broader range of provisions.

4. Does the Final Rule Provide an Exception for Noncompetes Tied to a Sale of Business?

Yes. The prohibition against noncompete clauses does not apply to a noncompete clause that is entered into pursuant to 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.

While the proposed rule only provided an exception for noncompetes tied to the sale of a business for owners who held a 25% ownership interest in the business being sold, the Final Rule removed that ownership threshold in response to comments made during the rulemaking process.

5. Are Partners or Members with an Ownership Stake in a Business Considered "Workers" Covered by the Final Rule?

The Final Rule's definition of "workers" does not specifically address whether partners or members with an ownership stake in a business are included in the definition, other than to state that "sole proprietors" can be considered workers. However, the FTC's comments to the Final Rule indicate that such partners, members, or other holders of ownership stakes may be covered by the sale-of-business exception, assuming their noncompete agreements are tied to the sale of their ownership stake in the business. Whether or not a partner or business owner who retains their ownership stake in the business can be subject to a noncompete after they stop working for the business is unclear and likely to be a highly litigated issue should the Final Rule become effective.

6. Does the Final Rule Apply to Customer or Worker Nonsolicitation or Confidentiality Agreements?

The Final Rule does not categorically ban other types of restrictive covenants such as nonsolicitation or confidentiality agreements. However, the FTC clarifies that the rule can apply to these covenants when they restrain such a large scope of activity that they function to prevent a worker from seeking or accepting other work or starting a new business after their employment ends. For example, confidentiality agreements and nondisclosure agreements (NDAs) may be noncompetes under the "functions to prevent" prong of the definition where they span such a large scope of information that they function to prevent workers from seeking or accepting other work or starting a business after they leave their job. Examples of such an agreement may include a confidentiality agreement or NDA that bars a worker from disclosing, in a future job, any information that is "usable in" or "relates to" the industry in which they work, or which bars a worker from disclosing any information or knowledge the worker may obtain during their employment whatsoever, including publicly available information.

7. Will Noncompetes that Provide Termination Notice Requirements and/or Garden Leave Payments also be Unenforceable?

The FTC received comments using the term "garden leave" for a wide variety of agreements, so it declined to opine on how the definition of "noncompete clause" applies to every potential iteration of a "garden leave" agreement. The FTC also declined to include an exception for noncompetes made in exchange for receiving compensation. Consequently, a post-employment noncompete clause, for a worker that does not fit within any of the Final Rule's exceptions, is likely prohibited by the Final Rule even if the worker would receive payments throughout the noncompete period.

The FTC did note, however, that a situation in which a worker is *still employed* and receiving the same total annual compensation and benefits on a pro rata basis, while having their job responsibilities and access to the workplace restricted, would not qualify as a prohibited noncompete clause because such an agreement is not a *post-employment* restriction. Such commentary on garden leave suggests that noncompetes with termination notice requirements or garden leave payments, in which a worker remains employed but is restricted from continuing their normal job duties, is permitted. That being said, it could also be argued that an extended termination notice requirement or garden leave period lasting several months or more is prohibiting or preventing a worker from accepting work and is, therefore, a prohibited noncompete clause as defined by the Final Rule. We expect this to be a highly litigated issue if the Final Rule becomes effective.

8. How Will the Final Rule Affect Noncompetes that are Used to Reduce the Value of Parachute Payments for Purposes of Section 280G of the Internal Revenue Code?

Sections 280G and 4999 of the Internal Revenue Code impose tax penalties in circumstances where the value of compensation that is contingent on a change in control equals or exceeds three times the average annual compensation of certain employees and other service providers. The value of noncompete agreements is often used to reduce the value of parachute payments for purposes of Section 280G calculations because payments for noncompete agreements can be considered reasonable compensation for refraining from performing services.

To the extent that noncompetes are unenforceable, this significant tool used to reduce parachute tax penalties will cease to be available.

This is particularly salient because of the two narrow exceptions under the Final Rule. First, Sections 280G and 4999 of the Internal Revenue Code rely on a definition of "officer" that is based on a facts and circumstances test that is broader than the definition of "senior executive" under the Final Rule. As a result, a noncompete that was used to calculate reasonable compensation for an "officer" may no longer be enforceable if the individual does not meet the "senior executive" test. Second, because the Final Rule does not prohibit enforcement of noncompete clauses that are entered into pursuant to a bona fide sale of a business entity, noncompete clauses that were used to calculate reasonable compensation, and the facts surrounding the entering into the agreement that includes the noncompete clause, should be carefully reviewed and considered to determine whether the noncompete clause satisfies the requirements of this exception.

9. Are There Statutory Exemptions beyond the Specific Exemptions Provided in the Final Rule?

Yes. In addition to the specific exceptions provided in the Final Rule, such as the sale of business or franchisee exceptions, there are categories of business exempt from the FTC's jurisdiction, and therefore, exempt from the FTC's Final Rule. Specifically, in Section 5 of the FTC Act (15 U.S.C. § 45(a)(2)), there is an exemption for banks, savings and loan associations, credit unions, air carriers, common carriers, firms governed by the Packers & Stockyards Act, and most nonprofits—except trade associations with for-profit members. However, FTC Commissioner Slaughter noted potential application of the ban to certain nonprofits that benefit their for-profit members, adding a layer of complexity.

10. What are the Penalties for Not Complying with the Final Rule?

The FTC Act allows the FTC to obtain equitable remedies using:

- Cease-and-desist orders issued by the FTC after an administrative hearing
- Consent orders settling administrative complaints
- Judicial orders

The FTC is also entitled to seek monetary remedies in some situations, including:

- Civil fines for failure to comply with orders or statutory requirements
- Equitable remedies, such as disgorgement or restitution

The FTC can impose a civil penalty amount of up to $51,744 for violations of orders issued under the FTC Act. Moreover, each day of continuance of such failure or neglect shall be deemed a separate offense.

Beyond penalties issued by the FTC, many states have "mini-FTC Acts" that provide rights for private litigants and theoretically allow treble damages. Although the viability of a private claim under a mini-FTC Act is speculative, it is an enforcement avenue employers should be aware of.

11. Practically Speaking, When Should We Expect Some More Clarity on Whether the Final Rule will Actually Be Enforceable?

It is difficult to predict how the legal challenges to the Final Rule will impact the ultimate enforceability of the rule and when those challenges will result in more clarity. However, the rule faces strong challenges on both statutory and constitutional grounds, notably from the Chamber of Commerce. Critics of the rule focus on three core arguments.

First, the FTC lacks the statutory authority to legislate substantive rules entirely. In critics' view, canons of statutory interpretation and the limited way in which the agency historically exercised its alleged rulemaking authority indicates the FTC does not have the authority to promulgate substantive rules such as the noncompete rule.

Second, even if the FTC does have rulemaking authority, the "major questions" doctrine prohibits the promulgation of the noncompete rule. The "major questions" doctrine requires "clear congressional authorization" when an agency claims power to regulate in an area of tremendous "economic and political significance." Some argue that noncompetes fall under this category. Moreover, FTC Commissioners Holyoak and Ferguson highlighted in the open commission meeting the long history of state-level regulation of employee restrictive covenants, implying a lack of clear federal mandate.

Third, even if Congress did grant the FTC this authority, that conferral is an unconstitutional delegation of legislative power. Because "unfair methods of competition" is not an "intelligible principle" sufficient for rulemaking delegation, Congress did not have the authority to grant FTC rulemaking responsibility on the topic. These arguments underscore the potential overreach of administrative power in enacting the rule.

12. What Should Employers and Businesses Do Prior to the Final Rule's Effective Date and in the Event the Final Rule Becomes Effective?

Employers and businesses should consider the following to prepare for the Final Rule:

- **Monitor the legal challenges to the Final Rule.** Given that there are already a few legal challenges to the Final Rule that could result in an injunction that pauses the enforcement of the rule, employers should closely monitor those matters before taking any action as they could result in the Final Rule becoming enjoined or invalidated.
- **Audit existing noncompetes and determine which workers are "senior executives" or otherwise exempt from the Final Rule's prohibition on noncompete clauses.** Prior to the effective date, the Final Rule requires employers and businesses to provide notice to current and former workers who are not senior executives and who are bound by existing noncompetes that they will not be enforcing any noncompete restrictions against them. Accordingly, employers should determine which current and former workers subject to noncompetes may need to receive the notice required by the Final Rule. The Final Rule does not provide a specific deadline on when the required notices need to be provided, other than stating that they need to be provided before the effective date. As mentioned above, employers should monitor the legal challenges to the Final Rule before providing any notices.
- **Determine whether any "senior executives" are currently not subject to noncompetes, and consider negotiating with such individuals to enter into noncompetes prior to the Final Rule's effective date.** The Final Rule's exception for noncompetes signed by senior executives prior to the effective date gives employers a relatively short window to execute noncompetes with such individuals, and employers should consider taking advantage of that window in the event that all legal challenges to the Final Rule are unsuccessful and the rule becomes effective.
- **Consider implementing employment agreements with termination notice requirements.** The FTC's commentary on garden leave provisions suggests that noncompete restrictions that run concurrent with ongoing employment are still permitted, even if a worker's job duties or access to colleagues and the workplace is significantly or entirely restricted, provided that the worker continues to receive their normal wages and benefits during the notice period. Accordingly, employers can consider including termination notice requirements in their agreements that prohibit competition during the notice period. However, as noted above, a notice and concurrent noncompete period in which a worker is sidelined for several months or more could be argued to be a prohibited noncompete clause.
- **Consider alternative retention strategies with deferred compensation.** Employers could implement retention bonuses or deferred compensation plans or adjust equity vesting schedules to encourage long-term and ongoing employment.
- **Review other restrictive covenants, such as confidentiality agreements and nonsolicitation clauses.** Employers can continue to implement non-solicitation and confidentiality restrictions where legally permissible by applicable state law, but they should review those restrictions to ensure they are narrowly tailored and revise them as necessary to mitigate the risk of such restrictions being deemed functional noncompete clauses prohibited by the Final Rule or state law. Employers should identify, classify, and protect their confidential, proprietary, and trade secret information and review their onboarding and offboarding protocols to ensure they are taking reasonable measures to protect such information.

How Can We Help?

Our lawyers regularly assist clients with audits of their restrictive covenants and trade secret protection plans. We are also available to assist with preparing any employee communications necessary as a result of the Final Rule.

Related Content

Resource Kits

- Restrictive Covenants Resource Kit

Practice Notes

- Garden Leave Provisions: Negotiation, Drafting, and Legal Issues

Templates

- Executive Separation Agreement (Pro-employer)
- Executive Employment Agreement (Pro-employer)

Statutes & Regulations

- 89 Fed. Reg. 38342 (May 7, 2024)

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Eric C. Kim has a diverse practice representing employers in complex litigation involving wage and hour, systemic discrimination, whistleblower retaliation, and hostile work environment claims, as well as helping employers obtain injunctive relief in high-profile restrictive covenant and trade secret cases. Using his experience as a litigator, Eric also counsels clients on employment-related matters in connection with mergers, acquisitions, investments, and joint venture transactions.

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Seth M. Gerber is an accomplished lead trial lawyer who focuses on trade secret, restrictive covenant, and employee mobility matters. Seth has been recognized by the *Daily Journal* four times as one of California's Top Trade Secrets Lawyers and named as a Leading Lawyer nationally for his trade secrets practice. According to *The Legal 500*, Morgan Lewis's "trade secrets working group head Seth Gerber enjoys a stellar reputation in the space for his work as a trial lawyer, prosecuting and defending claims for misappropriation and mass raid cases."

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Debra Fischer has practiced employment law and unfair competition/trade secret litigation for over 30 years, successfully trying cases in both California state and federal courts as well as in arbitration. Debra regularly counsels employers in all aspects of employment law compliance, risk avoidance, and crisis management. She is regularly called upon to give advice on trade secret and unfair competition issues that arise when employees change employment and handles the litigation that often ensues from such departures.

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J. Clayton "Clay" Everett, Jr. counsels clients on a range of antitrust issues. These include civil and criminal antitrust litigation, as well as merger and nonmerger investigations by the Federal Trade Commission (FTC) and the US Department of Justice (DOJ), and securing merger approvals. He has represented clients in more than 100 antitrust class actions in federal and state court. Clay also counsels clients and litigates issues at the intersection of antitrust and intellectual property law.

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Mims Maynard Zabriskie advises on complex executive compensation and employee benefit plan matters, including the design, negotiation, and implementation of executive compensation, equity compensation, and tax–qualified retirement plans and shareholder approval of equity plans. She counsels large publicly and privately owned businesses, including Fortune 500 enterprises, as well as technology companies, colleges and universities, and other non-profit entities, on a range of legal issues related to executive compensation governance, and employee benefit plans.

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Zachary M. Johns represents US and international clients in a variety of high-stakes complex commercial matters with a focus on civil and criminal antitrust and class action litigation. Zak also counsels businesses on antitrust and litigation risks and advises on antitrust training and compliance programs. Zak represents companies across a broad range of industries, including pharmaceutical, healthcare, financial services, commodity merchandising, technology, and consumer products. Zak is also a member of the firm's litigation Mass Arbitration Working Group.

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Michael P. Jones, a partner in the firm's labor and employment practice, focuses his practice on high-stakes cases involving restrictive covenant agreements and trade secrets, including noncompete, nonsolicitation, nondisclosure, and related post-employment obligations, in state and federal courts throughout the country. As co-leader of the Trade Secrets and Unfair Competition Task Force, Mike stays abreast of the latest developments in restrictive covenant and trade secret law, including the recent rulemaking by the Federal Trade Commission, and uses his knowledge to litigate on behalf of, advise, and counsel clients in nearly every industry, including the automotive, banking, energy, healthcare, insurance, life sciences, retail, and technology industries.

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Michael Weil represents employers in a wide range of employment disputes, with a focus on class and representative actions asserting multimillion dollars in damages and high stakes noncompete, employee mobility, and trade secrets matters arising from a variety of industries, including life sciences, technology, retail, and financial services, throughout the United States. He also regularly handles complex single- or multi-plaintiff matters involving independent contractor status, wrongful termination, discrimination, harassment, and retaliation. Michael has a deep background in trade secrets and noncompete cases involving a variety of intellectual property, including organic chemistry, genetic sequencing, chemistry lab processes, client lists, and shipping cost information, among many others.

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John P. Bramble litigates complex cases in US state and federal court involving unfair competition, trade secret misappropriation, employee departures, employee terminations, and other labor and employment matters. A detail-oriented and creative advocate, John is frequently called upon to draft and argue significant, case-altering motions throughout Texas and the United States. John draws on his litigation experiences in advising clients about a day-to-day labor and employment matters, including employment agreements and workplace policies.

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John Ceccio focuses his practice on antitrust and competition, representing companies before competition authorities in transactions and conduct investigations and litigation. John also has experience in product counseling on competition and consumer protection issues. He works with clients in the technology, life sciences, and financial services industries, using his experience and understanding of the business dynamics in these spaces to achieve favorable results.