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CORPORATE, EMPLOYMENT LITIGATION AND COUNSELING
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Q&A – FTC Rule Banning Non-Competes With Workers

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On April 23, the Federal Trade Commission (FTC) voted 3-2 to approve a Final Rule (the Final Rule) that, if allowed to take effect, would ban nearly all non-competes with employees and other workers and substantially change the way that employers and investors utilize restrictive covenants with corresponding impacts in several areas, including compensation, trade secret protection and deal dynamics. The following Q&A addresses the most significant and practically relevant points and provides insights on next steps.

What does the Final Rule prohibit?

The Final Rule prohibits entering into non-compete clauses with any workers after the effective date, as well as enforcing or attempting to enforce or representing that a worker is subject to any such non-compete clause.

Non-compete clause is defined broadly to include any term or condition of employment (including a contractual term or a workplace policy) 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."

The Final Rule also defines the term "worker" broadly to include not just employees but all types of workers, including independent contractors, externs, interns, volunteers, apprentices and sole proprietors who provide a service to a client or customer.

What types of restrictions on workers are prohibited?

It is clear that employers will be unable to prohibit individuals from working for or starting a competitive business if the Final Rule takes effect. What is less clear is whether and under what circumstances other types of restrictions will be permitted, though the FTC's commentary accompanying the text of the Final Rule is instructive (though not dispositive).

For example, the FTC lists liquidated damages provisions, forfeiture for competition provisions and provisions providing for the revocation of severance in the event of competition as examples of terms that would "penalize" a worker for competing and thus are prohibited by the Final Rule.

Provisions such as non-disclosure agreements, employee non-solicitation provisions, customer non-solicitation and non-service provisions, and training repayment agreements, by contrast, are not outright banned but may be prohibited by the Final Rule if they are so broad that they "function to prevent" competition.

The FTC also specifically indicates that the Final Rule does not prohibit fixed-term employment agreements, "garden leave" arrangements where an employee remains employed but is sidelined, or policies barring concurrent employment, as these approaches do not constitute "post-employment" restrictions.

What about non-compete clauses entered into prior to the effective date of the Final Rule?

With respect to non-compete clauses entered into prior to the effective date, these remain enforceable for "senior executives" but not other workers.

The Final Rule requires that, no later than the effective date, employers notify non-senior executive workers that the worker's non-compete clause will not be, and cannot legally be, enforced against the worker. The FTC provides model language to be used for such notice.

How does the Final Rule define "senior executive"?

"Senior executive" is defined narrowly to include only workers who earn more than $151,164 annually and are in a "policy-making position." To qualify, an individual must have "final authority to make policy decisions that control significant aspects of a business entity or common enterprise." An individual whose authority is limited to advising or influencing policy decisions or who has policy-making authority over only a subsidiary or affiliate of a business entity that is part of a common enterprise (as distinct from authority of the common enterprise as a whole) would not fall within the definition of a "senior executive." The FTC lists the following factors as relevant to determining whether affiliated companies constitute a "common enterprise": maintaining officers, directors, and workers in common; operating under common control; sharing offices; commingling funds; and sharing advertising and marketing.

Can non-competes still be used in connection with the sale of a business?

Yes. The Final Rule provides that a non-compete clause entered into by a person 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" is not prohibited. While the Final Rule does not include a minimum ownership percentage to fall within this exception, the FTC indicated in its commentary that it "considers a bona fide sale to be one that is 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." In contrast, "[s]o-called 'springing' non-competes and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale."

Does the Final Rule mean that an employer no longer can seek redress for a breach of a non-compete that occurred prior to the effective date?

No. The Final Rule includes an exception for causes of action that accrue (i.e., breaches that occur) prior to the effective date.

Does the Final Rule apply to all employers in all industries?

Certain entities, such as banks and non-profits, are not covered by the FTC Act and, therefore, are not subject to the Final Rule. The FTC declines, however, to clarify the scope of its jurisdiction and states that a non-profit's tax-exempt status is not dispositive as to its status as a non-profit outside the coverage of the FTC Act. If the Final Rule goes into effect, we anticipate further litigation testing the scope of the FTC's jurisdiction, especially over certain non-profit entities.

When will the Final Rule take effect?

The Final Rule provides that it will take effect 120 days after its publication in the Federal Register. As expected, however, legal challenges on the Final Rule have already begun. On April 24, the Chamber of Commerce of the United States of America filed a lawsuit against the FTC in federal court in Texas seeking declaratory and injunctive relief striking down the Final Rule on the grounds that the FTC lacks authority to issue the Final Rule and that the Final Rule violates the Fifth Amendment to the Constitution, which bars the federal government from interfering with private contracts. As has occurred with respect to other challenges on federal agency rulemaking in recent years, implementation of the Final Rule may be stayed while this and other legal challenges are pending.

What should employers do now?

Given pending legal challenges to the FTC's action, we do not recommend making significant changes to non-compete practices in deference to the Final Rule. Still, given the trendline of increased regulation and restriction on non-competes at both state and federal levels, employers would be well-advised to take stock of the non-competes they currently have in place to ensure they are narrowly tailored and fairly enforced. Employers also should evaluate their use of other tools, such as fixed-term employment agreements and confidentiality, intellectual property, customer non-solicitation and non-service provisions, to provide additional layers of protection over their legitimate competitive interests and to address potential impacts on labor force stability.

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