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Labor & Employment Update

FTC Non-Compete Rule: Now What?

The Federal Trade Commission (FTC) has issued a nationwide ban on covenants not to compete. This long-awaited Rule was announced on April 23 and is intended to take effect 120 days after publication in the Federal Register, which is expected in the coming days.

Biden's Promise and FTC's Strategy

The Rule fulfills a longstanding promise of President Biden that took root in a 2021 Executive Order for the FTC to address "agreements that may unduly limit workers' ability to change jobs." Eventually, following various initiatives, that ripened into a Proposed Rule in January 2023, but then languished for another fifteen months in the final stages of the rulemaking process. While it is still breathtaking in its scope, the Final Rule veers away from some of the more onerous provisions of the Proposed Rule.

In short, the FTC formally declared its view that "non-compete clauses" are an "unfair method of competition," citing authority that in the past was reserved principally for antitrust concerns. With this Rule, the FTC is endeavoring to do by regulation what it was unable to accomplish through litigation, which may not bode well for defending the Rule in court.

Court Challenges Already Filed

The Rule already has been challenged in multiple federal lawsuits—filed within hours of its announcement. Those include a 52-page Complaint by the U.S. Chamber of Commerce that begins with the premise that "[t]he true strength of a company lies in its people." The lawsuit goes on to argue that the new Rule desecrates the sacred trust that places a company's competitive secrets in the hands of those people, and it does so based on what the Chamber derisively calls "newfound regulatory authority."

The lawsuit attacks the validity of the Rule in six separate claims brought under the Administrative Procedure Act, the law that governs rulemaking by federal administrative agencies. However, the first order of business for that and other lawsuits is to delay the effective date of the Rule until the lawsuits are decided.

What is A Non-Compete Clause?

The Rule targets what it calls "non-compete clauses," but that term has been used by employers, lawyers, and courts to refer to various types of employee restrictions for many years, and that often has clouded discussions in this area of law and business. For the sake of clarity, therefore, we note there are basically four types of post-employment restrictions: non-competition clauses, customer non-solicitation clauses, employee non-recruitment clauses, and non-disclosure clauses.

On its face the FTC Rule prohibits non-competition clauses, but in some circumstances it may also capture one or more of the other types, as discussed further below. In part, this is because the Rule does not define "non-compete clauses" in terms of a contract provision, *per se*, but more broadly as "a term or condition of employment" that prohibits an individual from going to work for another person or leaving to operate his or her own business—even if the new job or business "competes with" the previous employer.

It also includes more creative provisions that do not prohibit such activities, but penalize an individual for them. This would appear to capture such things as forfeiture clauses that show up in many deferred compensation and similar plans, whereby the employee forfeits his or her incentive payments if he or she competes with the employer. It may also include "garden leave" provisions, depending on how they are drafted, that have made inroads in American businesses in the last decade or so.

Who is Covered?

The Rule distinguishes between "senior executives" and other workers. The former had total compensation the previous year of at least $151,164, using the employer's choice of a rolling, fiscal, or calendar year, and excluding the value of most forms of benefits. He or she also must be in a "policy-making position," which means one with final authority to make decisions that affect "significant aspects" of the business. However, this does not include someone who can merely influence such decisions or who makes them for a subsidiary of a common enterprise.

Note also that the Rule refers generically to all covered individuals as "workers" and "natural persons," avoiding the legal morass of whether someone is an "employee." The FTC intends to capture all clauses by individuals who "work for" others—regardless of whether they are paid or unpaid and regardless of their job title or status under other laws. Indeed, the Rule explicitly states that this includes a worker who is "an employee, independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service."

What is Prohibited?

To begin with, the Rule prohibits employers from entering into new non-competes with anyone going forward (senior executives or others). However, it also effectively invalidates existing non-competes for workers other than senior executives. For senior executives, employers may still enforce a non-compete clause if it is in place prior to the effective date of the Rule (but no new covenants may be entered into after the effective date).

Finally, there are exceptions, discussed below, that can affect those definitions in significant ways, and infuse considerable uncertainty into which non-competes can be enforced and which cannot, and against whom. The bottom line, however, is that once an employer figures out which covenants and workers are covered, and when, the employer may not: (1) enter into such a covenant (or attempt to do so); (2) enforce or attempt to enforce such a covenant; or (3) represent that an employee is subject to such a covenant.

Are There Exceptions?

The Rule has three exceptions that rescue a non-compete clause from invalidation under this rule. **First**, the Rule does not apply to non-competes entered into "pursuant to a bona fide sale of a business entity" or equivalent transaction. In view of the tenor of the Rule, one might expect this to cover only business owners who are the sellers, but the language of the exception appears to provide a blanket exception for all such agreements.

Second, the Rule also carves out non-competes if a legal claim has accrued under that clause prior to the effective date of the Rule. This is sure to spawn litigation over when claims arose, and likely also will lead to uncertainty for employers and employees alike over which covenants remain enforceable and against whom. The corollary in that scenario is whether or when the employer is required to give the mandatory notice, with the result that employers may be required to give the notice to some employees, but not others, for the same clause.

Third, it is not an unfair method of competition under the Rule for an employer to attempt to enforce a non-compete clause if the employer has a good-faith belief that the clause is not covered by the Rule. Hence, the same non-compete clause is considered unlawful for some employers and not for others, depending on the good faith belief of the employer in question, including a good faith belief as to whether or when a clause was breached.

Notice to Employees

Finally, employers must inform covered individuals in writing, in detail, and in clear and conspicuous language, that their existing non-compete clauses are no longer enforceable. Moreover, they must deliver that notice on or before the effective date of the Rule, and in accordance with quite specific rules relating to delivery. The Rule includes "model language" for this notice, which it would be advisable to use.

An unspoken problem presented by the notice requirement is that an employer must discern which contract provisions, among the many agreements it may have with current or former employees, require the notice. That must take into account not only the language and period of the agreements—whether they fit the definition of a "non-compete" under the Rule—but also whether they fall within any of the exceptions. As discussed below, that very well may require different treatment for the same clause with different individuals.

Are Any Restrictions Still Allowed?

This Rule does not explicitly affect customer non-solicitation or employee non-recruitment clauses, and in theory such covenants remain enforceable, subject as always to state law. However, it is unclear whether courts will interpret the Rule to ban those clauses in some circumstances. For instance, a former employee may argue that a prohibition on soliciting customers effectively bans him or her from working for a particular company or in a particular industry. Similarly, a former employee of a staffing company may argue, as some already have, that an employee non-recruitment clause does the same thing for a recruiter.

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