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Client Alert Commentary

Latham & Watkins Antitrust & Competition and Executive Compensation, Employment & Benefits Practices

April 26, 2024 | Number 3254

FTC Issues Final Rule to Ban Most Non-Competes

The Final Rule declares most non-competes an unfair method of competition, in violation of Section 5 of the FTC Act.

In its April 23, 2024, open meeting, the Federal Trade Commission (FTC) voted 3-2 to issue a final rule (the Final Rule) effectively banning most non-compete clauses nationwide as an unfair method of competition. The Final Rule exempts non-compete clauses that are connected to a bona fide sale of a business and allows for continued enforcement of non-compete clauses entered into with senior executives prior to (but not those entered into after) the Final Rule takes effect. The FTC's vote on the Final Rule split along party lines, with both Republican commissioners voicing dissent.

The Final Rule would go into effect 120 days after publication in the Federal Register (the Effective Date), which is expected to occur within the next few weeks. However, the US Chamber of Commerce and private litigants have filed separate actions seeking to vacate the Final Rule under the Administrative Procedure Act, which have the potential to delay or halt implementation of the Final Rule.

The Final Rule follows President Biden's July 9, 2021, Executive Order on Promoting Competition in the American Economy, in which the Administration encouraged the FTC to use its rulemaking authority to "curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility." The FTC originally issued a proposed rule banning non-competes (the Proposed Rule) on January 5, 2023, which drew more than 26,000 public comments. The Final Rule departs from the Proposed Rule in certain ways discussed below, but, with limited exceptions, essentially bans non-compete clauses after the Effective Date.

In support of the Final Rule, the FTC argues that non-compete clauses allow businesses to exert leverage over employees to prevent worker mobility and thereby suppress wages. The FTC also contends that employers can rely on trade secret laws and non-disclosure agreements to protect proprietary and other sensitive information, without needing non-compete clauses. Critics of the rule-making argue that non-compete clauses are important tools for protecting confidential information and justifying investments in employee training and development, and that the FTC lacks the authority to issue the ban.

Key Elements of the Final Rule

The Final Rule, if it survives litigation challenges and goes into effect, will make it an unfair method of competition to enter or attempt to enter into any non-compete clause with a worker, enforce or attempt to enforce a non-compete clause, or represent that a worker is subject to such a non-compete clause, subject to limited exceptions. The exceptions are:

- A non-compete clause entered into with a "senior executive" prior to the Effective Date can remain in effect and enforceable;

- Businesses can enter into and enforce non-compete clauses entered into pursuant to a bona fide sale of (i) a business entity, (ii) a person's ownership interest in a business entity, or (iii) all or substantially all of a business entity's operating assets, with no express minimum ownership threshold; and

- To the extent a cause of action related to a non-compete clause otherwise banned by the Final Rule accrued prior to the Effective Date, such non-compete clause may continue to be enforced.

The Final Rule narrowly defines a "senior executive" as a worker earning at least $151,164 annually and who is in a "policy-making position." A "policy-making position" is also defined narrowly in the Final Rule as a business entity's president, chief executive officer or the equivalent, or other officer (as defined in the Final Rule, including a vice president, secretary, treasurer or principal financial officer, or comptroller or principal accounting officer) or person with "policy-making authority". "Policy-making authority" is further defined as final authority to make policy decisions that control significant aspects of a business entity or common enterprise, but specifically excludes authority that is limited to policy decisions for only a subsidiary or an affiliate of a common enterprise. The Proposed Rule did not include an exception for senior executives or make other exclusions based on the type of worker.

By contrast, "worker" is defined expansively in the Final Rule to include paid and unpaid employees, independent contractors, externs, interns, volunteers, apprentices, and sole proprietors who provide services to a person. The definition of "worker" specifically excludes a franchisee in the context of a franchisee-franchisor relationship.

Other key takeaways include:

The Final Rule Is Limited to Non-Competes That Restrict Competition in the United States, After Termination of Employment: The Final Rule defines a "non-compete clause" as 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." Based on this definition, employers may continue to restrict competition during employment or outside of the United States, subject to applicable state and foreign law restrictions.

The Final Rule Covers De Facto Non-Competes: The FTC modified the definition of non-compete clause from the Proposed Rule and no longer specifically refers to "de facto" non-competes, but, nonetheless, the Final Rule still prohibits contractual terms that function as *de facto* non-competes that prohibit a worker from seeking or accepting employment or operating a business after the conclusion of the worker's employment. The FTC stated in its comments to the Final Rule that contractual language that is so broad or onerous such that it has the same functional effect as a term or condition prohibiting or

penalizing a worker from seeking or accepting post-employment work would constitute a non-compete clause under the Final Rule.

The Final Rule Appears Applicable to Forfeiture-for-Competition Clauses: Some state courts have declined to apply state rules of reasonableness applicable to non-compete clauses to forfeiture-for-competition clauses, citing the employee's ability to choose to compete and forego the incentive as the basis for not analyzing a forfeiture-for-competition clause under the standard applicable to non-compete clauses. The Final Rule's definition of a non-compete clause refers to any term that "penalizes" a worker for competing, and the FTC states in its comments to the Final Rule that a forfeiture-for-competition clause is an example of a term of employment that "penalizes" a worker.

The Final Rule Does Not Extend to Reasonable Non-Solicitation Agreements: The Final Rule does not expressly prohibit non-solicitation agreements. However, non-solicitation agreements, like non-disclosure agreements, could be viewed as unlawful *de facto* non-compete clauses if they are too broad.

The Final Rule Exempts Non-Competes in Connection With Bona Fide Sales of a Business: The Final Rule adopts a "sale of business" exception for "bona fide" sales. Unlike the Proposed Rule, the Final Rule does not require someone selling their interest in a business to have at least a 25% ownership interest in the business entity for a business to be able to enter into a non-compete clause with them. The removal of this requirement will allow this exception to be more broadly applied than originally proposed by the FTC. The FTC decided that the percentage threshold failed to account for the lower ownership interest held by individuals with "significant goodwill in their business." However, the Final Rule adds a "bona fide" requirement to clarify that the Final Rule cannot be skirted via a sham transaction.

The Final Rule Creates an Exception for Existing Non-Competes With Senior Executives, While Requiring Notice to Other Workers: The Final Rule does not ban non-compete clauses entered into with senior executives prior to the Effective Date. However, for non-senior executive workers, the Final Rule provides that, by the Effective Date, the person who entered into a non-compete with such a worker must notify the worker that such non-compete clause will not and cannot legally be enforced. The Final Rule provides a model notice form that complies with such notice obligation and outlines the permitted methods of sending notice.

The Final Rule Does Not Apply to Undertakings Outside of the FTC's Jurisdiction: The FTC Act expressly excludes certain industries from the FTC's jurisdiction, including banks, Federal credit unions, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers, and undertakings that are subject to the Packers and Stockyards Act, 1921. The FTC's Final Rule would not reach to businesses active in these areas.

The Final Rule Would Supersede Applicable State Laws: Should the Final Rule become effective, it will provide a federal overlay to the current state-level patchwork of non-compete laws. State laws can supplement the Final Rule — for example, by prohibiting nonprofits from instituting non-compete clauses — but cannot authorize clauses that the Final Rule would prohibit. Therefore, existing prohibitions against non-compete clauses continue to be in force in California, Minnesota, North Dakota, and Oklahoma, among others.

Timing Remains Uncertain: Litigations challenging the FTC's rulemaking authority have the potential to delay or potentially halt implementation for the Final Rule for some time.

What Can Employers Do to Prepare for the Final Rule?

Immediate changes to non-compete practices may not be necessary in light of the uncertainty of pending litigation. However, employers may wish to start preparing for the Effective Date by:

- Taking inventory of any existing non-compete clauses that would become unenforceable, and preparing a list of any current or former workers who would require notice, should the Final Rule take effect.
- Reviewing existing agreements with workers that contain non-compete clauses to ensure such agreements have appropriate severability language.
- Reviewing existing agreements with workers to ensure the agreements have robust non-solicitation clauses and covenants protecting trade secret and other proprietary information, and to ensure such covenants are not drafted too broadly such that under the circumstances they could be viewed as an impermissible non-compete clause under the Final Rule.
- Considering entering into reasonable non-competes with "senior executives" before the Effective Date, except in California and certain other states where non-competes are prohibited.

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