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FTC Bans Employee Noncompete Clauses

WRITTEN BY

Daniel N. Anziska | Julian Weiss | Matthew V. DelDuca | Barbara T. Sicalides | Drew Mann

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The Federal Trade Commission (FTC) voted along party lines (3 to 2) to ban all worker noncompetition provisions. The final rule applies to all employees, including senior executives, and will become effective on September 4, 2024.

The regulation deems employee noncompetes an "unfair method of competition," pursuant to Section 5 of the FTC Act. The majority believes that noncompete provisions exploit workers and that the federal ban will increase innovation, spur establishment of new businesses, and increase wages.

The two Republican commissioners dissented on the basis that they do not believe the FTC has the legal authority to issue the ban. Although the dissenting commissioners agreed with their Democratic colleagues' concerns for worker mobility, they explained that only elected representatives have the authority to enact such a sweeping ban.

Within hours of the FTC vote, a tax preparation and software firm announced that it filed a lawsuit challenging the agency's authority and structure. Separately, the U.S. Chamber of Commerce has reiterated its commitment to challenge the final rule.

Details of the Ban

The final rule applies to any written or oral employment term or policy that penalizes or prevents a worker from (a) seeking or accepting work in the U.S. with a different employer or (b) operating a business in the U.S. after the conclusion of the employment that includes the term or condition. The rule prohibits entering into new noncompete agreements on or after the effective date with any worker. The rule also prohibits enforcing or attempting to enforce a noncompete clause that existed before the effective date for any worker except for those who qualify as senior executives. The ban does not apply to confidentiality or agreements prohibiting solicitation of a former employer's customers or employees.

Key definitions: The term "worker" is defined broadly as a natural person who works or worked, including, but not limited to, independent contractor, extern, intern, volunteer, apprentice, or a sole proprietor who provides a service to a person. Although the term "worker" includes individuals who work for a franchisee or franchisor, it does not include a franchisee in the context of a franchisee-franchisor relationship.

"Senior executive" means a worker who (1) held a policy-making position and (2) received total annual or annualized compensation of at least $151,164 in the preceding year, or a portion of the preceding year, prior to the

worker's departure if the worker departed from employment.[1] Total annual compensation does not include board, lodging, meals, and other facilities as defined in 29 CFR 541.606, and excludes medical insurance, life insurance, retirement plans, and other similar fringe benefits.

"Policy-making position" means a president, chief executive officer, or any other officer or person with policy-making authority of the business entity. An officer of a subsidiary or affiliate that is part of a common enterprise who has policy-making authority for the common enterprise may also qualify.

"Policy-making authority" is the final authority to make policy decisions that control significant aspects of the company or common enterprise and does not include authority limited to advising or exerting influence over policy decisions or having final authority to make decisions for only a subsidiary of or affiliate of a common enterprise.

Notably, the final rule eliminates the ban of provisions that have the "de facto" effect of a noncompete. It does, however, expressly include in the definition of banned "noncompetition clause" employment terms or policies that "penalize" a worker for seeking or accepting work for a competitor. This addition is intended to capture "forfeiture for competition" clauses in benefit plans and contracts, which allow a worker to move to a competitor, but provide that the worker will forfeit equity grants, options, benefits, or contract rights if they compete against the employer.

The FTC specifically stated that nonsolicitation provisions "are generally not noncompete clauses under the final rule because, while they restrict who a worker may contact after they leave their job, they do not by their terms or necessarily in their effect prevent a worker from seeking or accepting other work or starting a business." The FTC, however, asserts that nonsolicitation agreements "can satisfy the definition of [a] noncompete … where they function to prevent a worker from seeking or accepting other work or starting a business after their employment ends." Whether a nonsolicit has the practical effect of a noncompete is a "fact-specific inquiry."

Notice requirement: Before the rule's effective date, employers are required to provide written notice to current or former workers that the worker's noncompete clause cannot legally be enforced and will not be enforced against the worker. Model (not mandatory) language is provided. The written notice can be delivered by mail, email, or text message.

Impact on State Law or Attorneys General

The federal ban supersedes any inconsistent state laws that are less protective of employees, while leaving intact state laws that provide employees greater protection.

The regulation expressly provides that it shall not be construed as altering, limiting, or affecting the authority of state attorney generals, agencies, or private persons to bring an action arising under any state law or regulation.

Exceptions to the Ban

The final rule provides for certain exceptions.

- Sale of business: The regulation does not apply to a noncompete clause entered into by a person pursuant to the sale of a company, a person's ownership interest in a business entity, or of all or substantially all of a company's operating assets. The 2023 proposed rule only excepted noncompetes connected to the sale of

ownership interests of 25% or more.

- Accrued claims: The ban does not apply where a cause of action related to a noncompete clause accrued prior to the effective date.
- Good faith: It is not considered an unfair method of competition to enforce a noncompete or to make representations about a noncompete where a person has a good-faith basis to believe the ban is inapplicable.

Additionally, although Section 5 of the FTC Act applies only to for-profit entities, the courts apply a fact-sensitive analysis that might muddy the waters for nonprofits with noncompete clauses. Accordingly, nonprofits should tread carefully and consider the use of confidentiality and nondisclosure agreements.

What Happens Next?

Legal challenges to the FTC's authority are already ongoing and there is a significant likelihood that the rule will not become effective or will be delayed. Regardless of the pending and future legal challenges, confidentiality and customer and employee nonsolicitation agreements continue to be important tools for employers to protect their valuable information as well as customer and employee relationships. Employers must assess their existing agreements imposing post-employment restrictions, including noncompetition agreements that would be banned under the FTC rule, and confidentiality and nonsolicitation agreements that are not. State law governing these post-employment agreements has recently and dynamically evolved. Legislators in many states have enacted bans or strict limits on these restrictive covenants, and courts have grown far more resistant to enforcing them. Clear and precise drafting is essential, and employers with workers in multiple states must account in their agreements for different state laws.

Employers also need to prepare to provide the required notice under the final rule. The notification must be made by the effective date, September 4, 2024. Even though there is a significant chance that the rule will not survive the legal challenges it faces, it could take significant time to identify the workers who are subject to oral or written noncompetes or equivalent employee policies, compile the relevant worker address information, and prepare to issue the notices, if necessary.

Troutman Pepper will continue to monitor the developments and progress concerning the rulemaking, the lawsuits challenging the ban, and its potential impact on employers and their operations. If you have any questions, comments, or concerns about the proposed rule and its implications, our Labor + Employment and Antitrust attorneys are available to guide you through these issues and evaluate the best strategy for your business.

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[1] Total annual compensation may include salary, commissions, nondiscretionary bonuses, and other nondiscretionary compensation earned during that 52-week period.

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