Insights: Alerts

FTC Passes Rule Banning Post-Separation Non-Competes Nationwide

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As we have reported on previously, efforts to limit or outright prohibit the use of employee non-compete agreements have gained considerable momentum in the past year with several states, including California, Minnesota, North Dakota, and Oklahoma, banning non-competes entirely.

Now, earlier today, the Federal Trade Commission ("FTC") voted 3-2 to adopt a rule banning non-compete agreements nationwide. The vote marks the first time in several decades that the FTC has issued a regulation to mandate a nationwide change in how companies compete. While largely consistent with the proposed rule the FTC issued in January 2023, the final rule contains several material changes that will impact the enforceability of existing agreements and how employers try to protect their legitimate business interests in the future.

A summary of the final rule's key provisions is provided below. However, in short, the FTC's rule makes it unlawful for employers to: enter into a non-compete clause with a worker; attempt to enter into a non-compete clause with a worker; or enforce, or attempt to enforce, currently existing non-compete clauses with a worker, except for pre-existing agreements with "senior executives." The new rule also requires employers to send a notice to workers with existing non-competes—who are not "senior executives"—that communicates to the worker that their non-compete is no longer effective and may not be enforced against them.

While enforcement will likely be delayed by legal challenges—indeed the U.S. Chamber of Commerce has already stated its intention to file a legal challenge as early as tomorrow—companies that have traditionally used non-competes should begin preparing for the final rule's effectiveness. This would include identifying existing agreements affected by the final rule, identifying which of the existing agreements will require rescission, and which will remain enforceable. Companies should also begin exploring alternatives to non-competes that may satisfy the company's legitimate business objectives, including the protection of trade secrets and other confidential information, without violating the FTC's rule.

The Ban Applies to Non-Compete Clauses For All Workers, Except Pre-Existing Non-Competes With "Senior Executives"

The FTC's rule broadly prohibits employers from imposing non-compete clauses on workers with just two narrow exceptions discussed below. The FTC's rule declares that it is an "unfair method of competition" for an employer to:

- Enter into or attempt to enter into a non-compete clause with a worker after the effective date of the rule;
- Enforce or attempt to enforce non-compete clauses with a worker, except for pre-existing agreements with "senior executives"; or
- Represent to a worker that they are subject to a non-compete clause, except for pre-existing agreements with senior executives.

In addition to employees, the rule's definition of "worker" includes independent contractors, consultant, interns, and volunteers.

Definition of "Senior Executive"

The FTC explained its belief that non-competes previously entered into with "senior executives" (as compared to lower level employees) were not exploitive or coercive, given their relative sophistication and bargaining power in comparison to that of their employer. However, the FTC has banned companies from entering into future noncompete agreements with "senior executives," claiming the practice has the propensity to unduly suppress competition and innovation given the outsized role "senior executives" play in establishing new firms and setting businesses' strategic direction with respect to innovation.

The final rule adopts a two-part test for determining whether a worker is a "senior executive." The test consists of both a compensation threshold and job duties test, similar to the United States Department of Labor's regulations defining and delimiting the executive employee exemption under the Fair Labor Standards Act.

First, to be deemed a "senior executive", the worker must have been in "a policy-making position" when the non-compete was executed. The rule defines "policy-making position" as an entity's president, chief executive officer or the equivalent, any other officer of a business entity who has "policy-making authority", or any other person with policy-making authority for the entity similar to an officer. The final rule further defines "policy-making authority" as "final authority to make policy decisions that control significant aspects of a business entity or common enterprise...."

Second, to satisfy the definition of "senior executive" under the final rule, the worker must have received for their employment:

- Total annual compensation of at least $151,164 in the preceding year;
- Total compensation of at least $151,164 when annualized if the worker was employed during only part of the preceding year; or
- Total compensation of at least $151,164 when annualized in the preceding year prior to the worker's departure if the worker departed from employment prior to the preceding year and the worker is subject to a non-compete.

The final rule defines "preceding year" as meaning any of "the most recent 52-week year, the most recent calendar year, the most recent fiscal year, or the most recent anniversary of hire year." It defines "total annual compensation" as including salary, commissions, non-discretionary bonuses, and other non-discretionary compensation earned during the preceding year. The definition specifically excludes board, lodging, payments for medical or life insurance, contributions to retirement plans, and the cost of other similar fringe benefits.

Sale of Business Non-Competes Exempted

As mentioned above, the FTC's rule contains an extremely narrow exception for non-competes entered into in connection with the "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."

The FTC's proposed rule limited this exception to "substantial" owners, members, or partners, which it defined as those possessing at least a 25 percent ownership interest in the business sold. Based on a number of comments objecting to the high ownership threshold, the 25 percent ownership threshold was removed from the final rule.

The FTC explained in the final rule that non-competes allowed under the sale of business exception will continue to be governed by state law. While more than a dozen states have laws either banning or limiting the use of non-competes, none of them have limited non-compete agreements as drastically as the FTC has in the context of the sale of a business. Even those states with laws banning non-compete agreements entirely —California, Oklahoma, Colorado, North Dakota, and Minnesota—have exceptions for non-compete agreements involved in the sale of a business, regardless of ownership stake.

Non-Competes Between Franchisor-Franchisee Exempted

Under the final rule, the term worker does not include a franchisee in the context of a franchisor-franchisee relationship. Thus, franchisors will be allowed to continue to include non-compete provisions in their agreements with their franchisees. However, the rule specifically provides that "worker" does include individuals working directly for a franchisee or franchisor.

Notice of Rescission of Banned Non-Competes

As mentioned above, the FTC's rule takes a retroactive approach and prohibits employers from maintaining pre-existing non-compete clauses, except for those with senior executives. In accordance with this prohibition, the rule requires employers to send a notice to workers with existing non-competes, who are not senior executives, that communicates to the worker that their non-compete is no longer effective and may not be enforced against them. The required rescission notice must be sent no later than 120 days after the final rule is published in the Federal Register. The State of California recently amended state law to similarly require employers to notify all current and certain former employees with non-compete agreements of the fact that their agreements were void and unenforceable.

While the proposed rule sought to obligate employers to provide notice of the rescission in individualized communications, the final rule permits employers to comply by sending a mass communication such as a mass e-mail to current and former workers.

The FTC included model safe harbor language with its final rule. Employers are not required to use the model form, or the specific language contained therein. However, the content of the notice must communicate to the worker that their non-compete clause is no longer in effect and may not be enforced against them.

The rule provides that notices of rescission must be sent "in an individualized communication." As a result, employers cannot satisfy the notice requirement, for example, by posting a notice in the workplace stating that

workers' non-compete clauses are no longer valid. The individualized communication cannot be provided verbally. It must be provided on paper or in a digital format such as an e-mail or text message.

Employers Excluded From Coverage Under the Rule

The FTC cites Section 5 of the Federal Trade Commission Act as the source of its power to promulgate its new rule. The following categories of employers are exempted from the FTC's authority under Section 5:

- Non-profit employers;
- Banks, savings and loan institutions;
- Federal credit unions;
- Common carriers;
- Air and foreign air carriers; and
- Persons, partnerships, or corporations subject to the Packers and Stockyards Act, 1921, subject to certain exceptions.

While the FTC lacks authority to regulate these employers, many of them actively compete with employers who do fall within the FTC's jurisdiction. As a result, the final rule creates an uneven playing field in certain industries. For example, for-profit hospitals will be prohibited from entering into non-compete agreements with physicians, while non-profit hospitals will not, provided they do so in accordance with applicable state law.

Next Steps

Before the FTC can enforce the ban, the final rule must be published in the Federal Register. The final rule will become effective 120 days after it is published in the Federal Register.

Still, enforcement is expected to be further delayed by legal challenge from business groups, including the U.S. Chamber of Commerce. Such groups will likely raise federalism issues and challenge the FTC's "unfair methods of competition" rulemaking authority, as well as the agency's authority more generally to make a rule with such broad-based economic and political consequences.

The attorneys at Kilpatrick will have more to report on this substantial shift in non-compete law in the coming days and will continue to provide guidance to its clients as they seek to comply with all applicable laws while endeavoring to protect their legitimate business interests.

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