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Federal Trade Commission Issues Final Rule Banning Most Non-Compete Agreements with Workers

Final Rule Largely Implements January 2023 Proposed Rule, but Adopts Different Approach for Senior Executives that Allows Existing Non-Compete Clauses to Remain in Effect

SUMMARY

On April 23, 2024, the Federal Trade Commission issued the final text of its "Non-Compete Clause Rule" (available here).[1] The final rule bans most employers from entering into new—or enforcing existing—non-compete agreements with workers, with limited exceptions for agreements connected to the sale of a business and certain pre-existing agreements with senior executives, including agreements executed before the effective date. The final rule states that it will become effective 120 days after its publication in the Federal Register, which is expected shortly. However, court challenges to the final rule have already been filed, and are expected to seek a stay of that scheduled effective date.

The Non-Compete Clause Rule reflects a significant expansion of the Commission's interpretation of its authority to promulgate substantive antitrust regulation. The final rule relies on Section 5 of the FTC Act, which prohibits "unfair methods of competition,"[2] and also on Section 6(g), which grants the Commission the power to "make rules and regulations for the purpose of carrying out the provisions of" the FTC Act.[3] Many have argued that the Commission lacks the authority to issue rules to address "unfair methods of competition," and now that the final rule has been issued, multiple litigations have already been filed challenging the scope of the FTC's exercise of its authority. Sullivan & Cromwell represents the U.S. Chamber of Commerce, Business Roundtable, the Texas Association of Business, and the Longview Chamber of Commerce in a lawsuit filed on April 24, 2024 challenging the Commission's authority under the FTC Act to promulgate the Non-Compete Clause Rule.[4]

BACKGROUND

On January 5, 2023, the Commission proposed new "Rules Concerning Unfair Methods of Competition" that would prohibit most non-compete clauses in employment agreements and agreements with independent contractors, with limited exceptions for agreements connected to the sale of a business.[5] The Commission argued that the rules were necessary because "research has shown that the use of non-compete clauses by employers has negatively affected competition in labor markets, resulting in reduced wages for workers across the labor force—including workers not bound by non-compete clauses."[6] Although the Commission's proposal noted that worker non-competes may provide some benefits, it concluded that those benefits could be achieved through other means, such as non-disclosure agreements or trade secret law, and that any benefits from non-compete agreements are outweighed by their costs.[7]

The proposed rule did not include a carve-out for highly skilled or highly paid workers, including senior executives. But the Commission expressly sought comments on whether senior executives should be subject to a different set of requirements and, if so, how that category of workers should be defined.[8] The Commission received more than 26,000 comments on the proposed rule.[9]

THE FINAL RULE

On April 23, 2024, in an Open Commission Meeting, the Commissioners voted 3-2 to approve the issuance of the final rule, with Commissioners Melissa Holyoak and Andrew N. Ferguson dissenting on the ground that the Commission lacks authority to promulgate the rule under Sections 5 or 6(g) of the FTC Act. In issuing the final rule, the Commission reaffirmed many of its findings regarding the effects of non-compete clauses on competition in labor markets.[10] The final rule implements many of the provisions of the proposed rulemaking, though it allows existing non-compete clauses with senior executives to remain in force and adopts other changes intended to "streamline compliance."[11] The final rule also clarifies the categories of provisions that are subject to the ban on non-compete clauses.

New Non-Compete Clauses. The final rule adopts a "comprehensive ban on new non-competes with all workers"[12] by making it an "unfair method of competition"—and therefore a violation of Section 5 of the FTC Act[13]—to "enter into or attempt to enter into a non-compete clause."[14] The final rule modifies the definition of "non-compete clause" that the FTC offered in its proposed rulemaking. The final rule encompasses any "term or condition of employment"—whether memorialized as a contractual term or a workplace policy, and whether written or oral—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."[15] This portion of the rule applies to any "worker," a term defined to mean "a natural person who works or who previously worked, whether paid or unpaid," and including both employees and independent contractors.[16]

Pre-Existing Non-Compete Clauses. In response to some commenters' concerns about "the practical impacts of extinguishing existing non-competes for senior executives," the Commission adopted a different approach for existing non-compete agreements involving senior executives as compared with other workers.[17] The final rule defines the term "senior executive" as workers who are in a "policy-making position" and who earned at least $151,164 in the preceding year.[18] With respect to workers who are not senior executives, the final rule prohibits both "enforc[ing] or attempt[ing] to enforce a non-compete clause" and "represent[ing] that the worker is subject to a non-compete clause."[19] But for senior executives, non-compete clauses entered into before the effective date are permitted to remain in force.[20]

Exceptions. The final rule preserves and expands the proposed rulemaking's exception for non-compete agreements 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."[21] The final rule removes the requirement in the proposed rulemaking that to qualify for the exception an ownership interest must meet a 25% threshold, on the basis that the 25% threshold "failed to reflect the relatively low ownership interest held by many owners, members, and partners with significant goodwill in their business."[22] The final rule also creates a new exception allowing enforcement of a non-compete clause where a cause of action for its breach accrued prior to the effective date.[23] And finally, the final rule provides that it is not an unfair method of competition to enforce, attempt to enforce, or make representations about a non-compete clause "where a person has a good-faith basis to believe that this [rule] is inapplicable."[24]

Excluded Employers. The final rule further clarifies that employers who "are outside the Commission's jurisdiction under the FTC Act are not subject to the final rule."[25] For example, the FTC Act applies to "persons, partnerships, or corporations," but exempts from the Commission's enforcement jurisdiction certain "banks," "savings and loan institutions," "Federal credit unions," "common carriers," "air carriers," and "persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act."[26] The FTC Act also excludes from its definition of "corporation" any entity that is not "organized to carry on business for its own profit or that of its members."[27] While the final rule states that "not all entities claiming tax-exempt status as nonprofits fall outside the Commission's jurisdiction,"[28] the Commission's statement implicitly acknowledges that at least some entities claiming nonprofit tax-exempt status may not be subject to the final rule.[29]

Provisions Subject to the Final Rule. The Commission noted that "non-compete clause[s]" covered by the final rule include "de facto" or "functional" non-competes, which the Commission argued is consistent with current state law defining what agreements constitute non-compete provisions.[30] The definition does not categorically prohibit other restrictive employment agreements, such as non-disclosure agreements, training-repayment agreements (which the FTC calls "TRAPs"), and non-solicitation agreements. But the Commission noted that any such agreement that is "so broad or onerous that it has the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work or starting a business after their employment ends," considering the facts and circumstances of the agreement

and the surrounding market context, would be subject to the final rule's prohibition on non-competes.[31] For example, NDAs that prohibit a worker from disclosing information that is "'usable in' or 'relates to' the industry in which they work," or "any information or knowledge the worker may obtain during their employment whatsoever," are so broadly written as to functionally prevent a worked from obtaining employment in the same field and will be considered non-competes.[32] Similarly, the Commission noted that non-solicitation agreements can qualify as non-competes if they "function to prevent a worker from seeking or accepting other work or starting a business after their employment ends."[33]

The Commission also discussed forfeiture-for-competition clauses—*i.e.*, provisions that "impose[] adverse financial consequences on a former employee as a result of the termination of an employment relationship, expressly conditioned on the employee seeking or accepting other work or starting a business"—and noted that such provisions "penalize" a worker for post-employment work for another employer or business and thus fall within the meaning of the final rule.[34] On the other hand, the Commission noted that several types of "garden leave" agreements—such as severance agreements without restrictions on post-employment work, or agreements whereby the worker remains employed and receiving the same compensation and benefits, but with a reduced workload or job responsibilities—are not non-compete clauses because they do not impose post-employment restrictions.[35]

Notice Requirements. The final rule eliminates a provision in the proposed rulemaking that would have required employers to formally rescind existing non-compete agreements, which the Commission found "would have imposed unnecessary burdens on employers."[36] Instead, the final rule requires employers to "provide clear and conspicuous notice" to workers, by the effective date, that any pre-existing non-compete clause "will not be, and cannot legally be, enforced against the worker."[37] The notice must be provided in writing and delivered to the worker by hand, by mail to the worker's personal address, or by email or text message. The final rule provides model language that employers may use that will satisfy the notice requirements; that language is incorporated into the text of the final rule.[38]

LEGAL CHALLENGES TO THE RULE

The Non-Compete Clause Rule represents a significant expansion of the Commission's authority, with implications that could reach beyond the labor markets. This far-reaching exercise of rulemaking authority has already given rise to multiple litigations challenging the final rule.[39] These litigations challenge, among other things, two primary aspects of the Commission's interpretation of the scope of its authority under the FTC Act.

First, in issuing the final rule, the Commission has relied on Section 5 of the FTC Act, which prohibits "unfair methods of competition."[40] In July 2021, President Biden issued an Executive Order that called upon the Commission to increase enforcement under Section 5.[41] In November 2022, the Commission issued a policy statement regarding Section 5, which broke from accepted practice by concluding that Section 5

"reaches beyond the Sherman and Clayton Acts to encompass various types of unfair conduct that tend to negatively affect competitive conditions."[42] Under that policy, "unfair methods of competition" include conduct that "has a tendency to generate negative consequences," even if it is not causing "actual harm in the specific instance at issue."[43] That sweeping interpretation of Section 5 is reflected in the Non-Compete Clause Rule, which states that whether a method of competition is unfair within the meaning of Section 5 "does not turn on whether the conduct directly caused actual harm in the specific instance at issue and therefore does not require a detailed economic analysis or current anticompetitive effects."[44] After the Commission first issued the proposed rulemaking, former Commissioner Wilson issued a written dissent and commented that the proposed rule was a "graphic illustration of [her] concern" that the policy change would "facilitate expansive enforcement, often without requiring evidence of anticompetitive effects."[45] Commissioners Holyoak and Ferguson echoed these sentiments in their public comments on the final rule at the Open Commission Meeting on April 23, 2024, where the final rule was announced.

Second, the Commission found that it has authority to issue the Non-Compete Clause Rule under Section 6(g) of the FTC Act, which empowers the Commission to "make rules and regulations for the purpose of carrying out the provisions of" the Act.[46] The Commission has not attempted to issue binding regulations under Section 6(g) since the 1970s,[47] and many have argued that the Commission lacks the authority to promulgate rules to enforce Section 5.[48] Although the Commission's Policy Statement on Section 5 asserted its authority to issue rules,[49] the Non-Compete Clause Rule is the first test of that approach and will likely offer an opportunity for regulated parties to litigate the Commission's authority in court. Public comments reflected the concern that Section 6(g) does not authorize the Commission to issue the final rule.[50] Public comments also expressed concern that the Commission lacked congressional authorization to undertake the final rule under the major questions doctrine, which presumes that Congress explicitly authorizes regulatory actions with major economic and political significance, and that the final rule runs afoul of the non-delegation doctrine, which prevents Congress from delegating legislative authority to executive branch agencies.[51] Similar comments were expressed by Commissioner Ferguson at the April 23, 2024 Open Commission Meeting.

TAKEAWAYS

The final rule is scheduled to go into effect 120 days after its publication in the Federal Register, and covered employers have until that date to comply with the rule. It is likely that the litigants challenging the rule will seek a stay of the final rule, which, if granted, would delay its implementation while the courts address the validity of the rule.

Absent a stay of the final rule, covered employers will need to identify and track existing non-compete agreements for which notification may need to be provided to the extent that the rule becomes effective. In addition, absent a stay, employers should consider reviewing existing employment agreements and

workplace policies to identify potential modification of their terms, including assessing the scope of non-solicitation and non-disclosure agreements to ensure that they do not constitute a "functional" non-compete.

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ENDNOTES

1 Fed. Trade Comm'n, *Non-Compete Clause Rule*, RIN 3084-AB74 (Apr. 23, 2024), *available at* https://www.ftc.gov/system/files/ftc_gov/pdf/noncompete-rule.pdf.

2 15 U.S.C. § 45.

3 15 U.S.C. § 46(g).

4 *See Chamber of Commerce of the United States* v. *FTC*, No. 6:24-cv-148 (E.D. Tex. filed Apr. 24, 2024).

5 See Fed. Trade Comm'n, *Notice of Proposed Rulemaking: Non-Compete Clause Rulemaking*, RIN 3084-AB74 (Jan. 5, 2023).

6 *Id.* at 3.

7 *Id.* at 93–105.

8 *Id.* at 6, 73.

9 *Non-Compete Clause Rule*, *supra* n.1, at 2.

10 Fed. Trade Comm'n, *FTC Announces Rule Banning Noncompetes* (Apr. 23, 2024), *available at* https://www.ftc.gov/news-events/news/press-releases/2024/04/ftc-announces-rule-banning-noncompetes ("The Commission found that noncompetes tend to negatively affect competitive conditions in labor markets by inhibiting efficient matching between workers and employers. The Commission also found that noncompetes tend to negatively affect competitive conditions in product and service markets, inhibiting new business formation and innovation. There is also evidence that noncompetes lead to increased market concentration and higher prices for consumers.").

11 *Id.*

12 *Id.* at 2.

13 15 U.S.C. § 45.

14 *Non-Compete Clause Rule*, *supra* n.1, at 564.

15 *Id.* at 561–62.

16 *Id.* at 563–64.

17 *Id.* at 219.

18 *Id.* at 563.

19 *Id.* at 564.

20 *Id.*

21 *Id.* at 567.

22 *Id.* at 341.

23 *Id.* at 567.

24 *Id.*

25 *Id.* at 47.

26 15 U.S.C. § 45(a)(2).

27 15 U.S.C. § 44.

28 *Non-Compete Clause Rule*, *supra* n.1, at 52.

ENDNOTES (CONTINUED)

29 *Id.* at 50–54.

30 *Id.* at 77–78.

31 *Id.*

32 *Id.* at 80–81.

33 *Id.* at 81.

34 *Id.* at 76–77.

35 *Id.* at 83–84.

36 *Id.* at 326.

37 *Id.* at 564–65.

38 *Id.* at 565–66.

39 *See Chamber of Commerce of the United States* v. *FTC*, No. 6:24-cv-148 (E.D. Tex. filed Apr. 24, 2024); *Ryan, LLC* v. *FTC*, 3:24-cv-986 (N.D. Tex. filed Apr. 23, 2024).

40 15 U.S.C. § 45.

41 Exec. Order 14036, 86 Fed. Reg. 36,987, 36,992 (July 14, 2021).

42 Fed. Trade Comm'n, *Policy Statement Regarding the Scope of Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act*, Comm'n File No. P221202, at 1 (Nov. 10, 2022) (Section 5 Policy Statement).

43 *Id.* at 9–10.

44 *Non-Compete Clause Rule*, *supra* n.1, at 56.

45 Dissenting Statement of Commissioner Christine S. Wilson Concerning the Notice of Proposed Rulemaking for the Non-Compete Clause Rule 4 (Jan. 5, 2023) (Wilson Dissent).

46 15 U.S.C. § 46(g).

47 *See Nat'l Petroleum Refiners Ass'n* v. *Fed. Trade Comm'n*, 482 F.2d 672, 678 (D.C. Cir. 1973).

48 *Compare* Rohit Chopra & Lina Khan, *The Case for "Unfair Method of Competition" Rulemaking*, 87 U. Chi. L. Rev. 367 (2020) (arguing that Section 6(g) authorizes competition rulemaking), *with* Noah Joshua Phillips, *Against Antitrust Regulation*, Am. Enterprise Inst. (Oct. 13, 2022) (arguing that antitrust rulemaking is not supported by the text or structure of the FTC Act).

49 Section 5 Policy Statement at 6 & n.33.

50 *Non-Compete Clause Rule*, *supra* n.1, at 32-33.

51 *Id.* at 36-37, 42.

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