Cahill

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FTC Approves Final Rule Prohibiting Worker Non-Competes…and is Immediately Challenged in Court

On April 23, 2024, the Federal Trade Commission ("FTC") voted 3 – 2 in favor of issuing a final rule (the "Rule") prohibiting employers from entering into or enforcing essentially all non-competition agreements covering employees and individual service providers, other than non-competes entered into pursuant to a sale of a business. While the Rule permits enforcement of non-competes that are entered into before the effective date covering a limited group of senior executives, the Rule establishes a complete ban on new non-competes with all workers, regardless of position or compensation. The Rule was published in the Federal Register on May 7, 2024 and is scheduled to become effective on September 4, 2024.

The Rule preempts well-established law governing the enforcement of non-competes in the vast majority of states and renders obsolete several state statutes aimed at prohibiting non-competes with lower-wage workers in recent years. Multiple lawsuits have already been filed challenging the validity of the Rule, and there is potential for a court to issue a nationwide injunction putting the effective date on hold pending further proceedings. Although the outcome of such challenges and the timing of any preliminary relief remains uncertain, employers should review their existing restrictive covenants and related practices to assess the potential impact should the Rule go into effect.

The FTC Non-Compete Ban

Pursuant to the Rule, it is an unfair method of competition under federal law to enter into, attempt to enter into, enforce, attempt to enforce, or represent that a worker is subject to a non-compete clause. The Rule defines "worker" broadly as a natural person who works or previously worked for another person or entity, whether paid or unpaid, and expressly applies to employees and independent contractors. The FTC may seek equitable or monetary remedies against an employer found to have engaged in an unfair method of competition, including, but not limited to, injunctive relief and civil penalties.

A "non-compete clause" is generally defined under the Rule as a term or condition that "prohibits," "penalizes," or "functions to prevent" a worker from seeking or accepting work in the United States that would begin after (or from operating a business after) the conclusion of the employment or service relationship. The language of the definition is very expansive, potentially capturing a wide range of common compensation and benefits arrangements, as well as restrictive covenants other than traditional non-compete covenants. FTC commentary specifically noted forfeiture-for-competition clauses and liquidated damages provisions as examples of terms or conditions that penalize workers, given that they are triggered by post-employment competition. Similarly, the FTC also noted that non-disclosure agreements, training repayment agreements and non-solicitation agreements which do not by their terms prohibit or penalize post-employment work could nevertheless be so broad or onerous as to function as a non-compete.

The Rule contains a narrow exception preserving the enforceability of non-competes entered into with "senior executives" before the effective date, as further discussed below. The Rule also provides an exception preserving the enforceability of non-competes for which a cause of action has accrued before the effective date and an exception where an employer had a "good faith" basis to believe the Rule was inapplicable.

Sale-of-Business Exception

The Rule does not apply to a non-compete clause entered into pursuant to a *bona fide* sale of a business entity, a person's ownership interest in a business entity, or all or substantially all of the operating assets of a business entity, without regard to the ownership level (in contrast to the 25% threshold in the proposed rule) or the position of the person covered by the non-compete. As discussed in its commentary accompanying the Rule, the FTC considers that, for a sale to be "*bona fide*," it must be both made in good faith and an arm's-length sale between two independent parties in which the seller is given a reasonable opportunity to negotiate the terms of the sale.

Senior Executive Exception

While the Rule generally prohibits entering into new non-competes covering senior executives after the effective date, it does not prohibit enforcement of existing non-competes (or new non-competes entered into on or before the effective date) covering senior executives. The definition of "senior executives" who may qualify for the exception, however, is quite limited in scope, requiring that they both meet a minimum annual compensation threshold (at least $151,164, generally consisting of salary and other nondiscretionary compensation, but excluding fringe benefits) and have had policy-making authority either for the employer or, if the employer entity is part of a "common enterprise," for the common enterprise as a whole. That is, an individual who has policy-making authority over a subsidiary or affiliate within a common enterprise must also have policy-making authority over the common enterprise or the senior executive exception will not apply. The term "policy-making authority" is defined based on case law interpreting the federal securities laws and requires that the executive have final authority to make policy decisions that control significant aspects of the business entity or common enterprise.

Notice Requirement

Regarding workers for whom non-competes entered into before the effective date of the Rule will no longer be enforceable (e.g., for workers other than senior executives), the Rule provides that the person or entity that entered into the non-compete with the worker must provide "clear and conspicuous notice" to the worker that the worker's non-compete clause will not and cannot legally be enforced. The Rule provides that the notice must be provided to the worker by the effective date and is deemed to comply with this requirement if in the form of a model notice included in the Rule.

Legal Challenges to the Rule

Three lawsuits have already been filed challenging the validity of the Rule.[1] The U.S. Chamber of Commerce's lawsuit, which was filed the day after the Rule was issued, has been stayed due to another plaintiff,

[1] See *Ryan, LLC v. Federal Trade Commission*, Case No. 3:24-cv-00986, in the United States District Court for the Northern District of Texas; *Chamber of Commerce of the United States of America, et al. v. Federal Trade Commission*, Case No. 6:24-cv-00148, in the United States District Court for the Eastern District of Texas (Tyler Division); *ATS Tree Services, LLC v. Federal Trade Commission, et al.*, Case No. 2:24-cv-01743, in the United States District Court for the Eastern District of Pennsylvania.

Ryan, LLC, having filed a similar challenge a day earlier. As of this writing, the third case, brought by ATS Tree Services, LLC, has not been stayed. These actions generally assert that (1) the FTC lacked the statutory authority to issue the Rule, (2) the Rule is based on an unconstitutional delegation of Congressional authority, and/or (3) the Rule is arbitrary and capricious. Considering that these actions are in the early stages and the Rule is scheduled to become effective on September 4, 2024, there is the potential for a court to put the Rule on hold beyond its effective date during the pendency of the proceedings. The court in the *Ryan, LLC* case issued an order on May 7, 2024 denying the plaintiff's motion for expedited briefing but stated that it will decide the merits of the plaintiff's motion for a stay of the Rule's effective date and preliminary injunction by July 3, 2024.

Next Steps

Although the recently filed legal challenges create uncertainty as to when (or whether) the Rule will in fact go into effect, employers may want to review their approach to restrictive covenants going forward, while holding off on making any changes to their existing practices pending further judicial developments. Employers should also keep in mind that the Rule does not apply to causes of action related to non-competes accrued before the Rule's effective date. For workers and non-competes directly impacted by the Rule, employers should examine whether such workers are already subject to sufficient confidentiality and customer and employee non-solicitation restrictions and enter into appropriate amendments enhancing those provisions as needed. This should also serve as an opportunity for employers to examine other restrictive covenants in place with workers and assess whether any such arrangements could potentially be challenged as penalties or functional non-competes under the Rule. In the meantime, employers should keep apprised of ongoing judicial, regulatory, and state legislative developments affecting restrictive covenants and should continue to tailor non-competes based on a worker's role, responsibility and authority to avoid a one-size-fits-all approach.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Joel Kurtzberg (partner) at 212.701.3120 or jkurtzberg@cahill.com; Geoffrey E. Liebmann (senior counsel) at 212.701.3313 or gliebmann@cahill.com; Mark Gelman (counsel) at 212.701.3061 or mgelman@cahill.com; or Eric Scher (senior attorney) at 212.701.3984 or escher@cahill.com; or email publicationscommittee@cahill.com.