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WHITE PAPER

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FAQs About the FTC Final Rule Banning Worker Noncompete Agreements

This week, the Federal Trade Commission ("FTC") voted 3-2 along party lines to finalize a rule that bans noncompete clauses in employment agreements as a per se illegal "unfair method of competition" ("UMC") under Section 5 of the FTC Act. The Chamber of Commerce and others already have filed lawsuits seeking to invalidate the rule, and those lawsuits could result in a stay of the rule as the cases proceed. In this *White Paper*, we summarize the ban and provide guidance for businesses about how to react to the uncertainty that the FTC's recent actions have created.

WHAT DOES THE FTC'S FINAL NONCOMPETE RULE SAY?

- The final rule creates a comprehensive ban on new post-employment noncompetes with virtually all workers (defined broadly), including senior executives, regardless of wage or skill level.
- For existing noncompetes, the final rule creates a narrow exception for "senior executives," who are defined to include only workers earning more than $151,164 who have "final authority to make policy decisions that control significant aspects of a business entity or common enterprise." Workers with final authority for "only a subsidiary or affiliate of a common enterprise" are not subject to the exception. The FTC estimates that approximately 0.75% of workers are likely to fall within this exception.
- On its face, the rule does not prohibit non-solicit agreements (of customers or employees) or non-disclosure agreements. However, the rule broadly defines noncompetes to include any contractual term between employers and workers that would "function to prevent" or penalize a worker from competing with a prior employer.
- The rule does not apply to entities that are exempt from the FTC's jurisdiction, such as certain nonprofit organizations, financial institutions (banks, credit unions, savings and loans), air carriers, other common carriers, and corporations subject to the Packers and Stockyards Act, 1921, as amended. Although the FTC acknowledges it lacks authority to enforce the ban against non-profit entities, it reserved the right to investigate whether non-profits qualify for that exemption.
- The rule will become effective 120 days after its publication in the *Federal Register*, which is expected soon.
- By the effective date, the rule requires employers to notify workers (other than "senior executives") that their noncompetes are no longer in effect and will not be enforced. The FTC included a model notice, which is available here.
- The FTC is facing serious challenges in court that it lacks authority to engage in rulemaking with respect to unfair methods of competition, among other arguments. Those courts are likely to address whether to issue a stay within several weeks or a few months, before the 120-day effective date.
- The final rule expands the M&A exception from the draft rule, permitting noncompete clauses entered into 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."

WHAT SHOULD I DO NOW IF MY COMPANY HAS NONCOMPETES?

The ban will not take effect until 120 days after the FTC publishes the rule in the *Federal Register*, which is likely to happen in the coming days. Therefore, even if courts decline to stay the rule, there is time to develop a plan for compliance. However, until we know if a stay will be issued, companies should begin outlining a plan for compliance in case it becomes necessary. They should understand the universe of existing noncompete agreements; develop a plan for recission notices; and consider alternative provisions, such as installment payments, non-solicitation agreements, and garden leave while ensuring that such alternatives do not constitute "de facto" noncompetes. Similarly, companies should review agreements offered to new hires and consider whether to include alternative protections until we know if the rule will be stayed.

WHAT ARE THE EXCEPTIONS TO THE FTC RULE?

Subject to the exceptions below, the final rule bans most employer/worker noncompete clauses nationwide, superseding state laws that are less restrictive than the FTC rule. The broad definition of "worker" covers both employees and independent contractors, and other workers whether or not classified as employees, including externs, interns, volunteers, apprentices, or sole proprietors who provide a service to a client or customer.

"Senior Executive" Exception

The "senior executive" exception (allowing only ***existing*** noncompetes to remain in effect) is narrow, applying only to workers earning more than $151,164 who have "final authority to make policy decisions that control significant aspects of a business entity or common enterprise." Only CEOs and presidents are presumed to be in a policy-making position, but others might qualify too. For example, the FTC states that "many executives in what is often called the 'C-suite' will likely be senior executives if they are making decisions that have a significant impact on the business, such as important policies that affect most or all of the business."

The "senior executive" definition excludes workers with final authority for "only a subsidiary or affiliate of a common enterprise." "Common enterprise" is not defined. Rather, the FTC states that it will look "beyond legal corporate entities to whether there is a common enterprise of "'integrated business entities.'" The example provided is having "one or more of the following characteristics: maintain officers, directors, and workers in common; operate under common control; share offices; commingle funds; and share advertising and marketing."

The supplemental information to the rule provides the following examples:

- If the head of a marketing division in a manufacturing company makes policy decisions only for the marketing division, and those decisions do not control "significant aspects of the business (which would likely be decisions that impact the business outside the marketing division)," the FTC would not consider that worker to be a senior executive.
- In a hospital system, neither the head of a hospital's surgery practice nor a physician who runs an internal medical practice that is part of a hospital system would be "senior executives," assuming they are decision-makers only for their particular division.
- Partners in a business, such as physician partners of an independent physician practice, would qualify as senior executives under the duties prong, assuming the partners have authority to make policy decisions about the business. In contrast, a physician who works within a hospital system but does not have policymaking authority over the organization as a whole would not qualify.

The stated intention of the narrow definition is "to isolate the workers who are least likely to have experienced exploitation and coercion and most likely to have bargained for meaningful compensation for their noncompete." The FTC concluded that "the only group of workers that is likely to have bargained for meaningful compensation in exchange for their noncompete is senior executives who are both highly paid and, as a functional matter, exercise the highest levels of authority in an organization." The FTC estimates that approximately 0.75% of workers qualify under the "senior executive" exception.

Additional Limited Exceptions

- **Bona fide sale of a business**. The rule does not apply "to a noncompete clause that is 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."
- **Existing causes of action**. The rule "does not apply where a cause of action related to a noncompete clause accrued prior to the effective date."
- **Good faith**. "It is not an unfair method of competition to enforce or attempt to enforce a noncompete clause or to make representations about a noncompete clause where a person has a good-faith basis to believe that [the rule is] inapplicable."

Notably, unlike the various state laws prohibiting or restricting noncompetes, the FTC's rule is a competition-based rule prescribing novel per se illegal treatment for UMC. Although the approach is consistent with the Biden administration's desire to return to pre-1970s antitrust law, the U.S. Supreme Court has long since held that per se illegal treatment is reserved for conduct that is "so plainly anticompetitive" that "the economic impact" is "immediately obvious."

DOES THE BAN APPLY TO OTHER RESTRICTIVE COVENANTS, SUCH AS NON-SOLICIT AGREEMENTS OR NON-DISCLOSURE AGREEMENTS ("NDA")?

The FTC's ban on noncompetes does not extend to non-solicit agreements of employees or customers unless a non-solicit would "function to prevent" a worker from competing with a prior employer.

The FTC's comments on the rule acknowledge that non-solicits "do not by their terms or necessarily" prevent an employee from seeking or accepting alternative employment. However, the rule defines noncompete clauses to include any term that "prohibits a worker from, penalizes a worker for, or functions to prevent a worker from" seeking or accepting work with a different person or operating a business after the conclusion of that worker's employment. According to the FTC, a contractual

term, including, for example, non-solicits, training-repayment agreements, or non-disclosure agreements, could be "so overbroad" as to have the same effect as a prohibited noncompete. The FTC commented that "unlike non-solicitation of client agreements, [coworker non-solicitation agreements] do not frustrate workers' ability to build up a client base after moving to a new employer." The ban's coverage of non-solicits is therefore subject to a "fact-specific inquiry."

According to the FTC, an NDA also can be a de facto noncompete if it defines "confidential information that is "usable in" or "relates to" a particular industry or prevents disclosure of even publicly available information obtained during employment.

Contractual terms that "penalize" a worker for accepting other work or starting a business post-employment also are subject to the ban. Examples from the FTC include liquidated damage clauses, an agreement that extinguishes an "obligation to provide promised compensation or to pay benefits," or severance agreements paid only if the worker "refrain[s] from competing."

WHAT DID THE FTC SAY ABOUT NONCOMPETES AND NONPROFIT ENTITIES?

The FTC's comments on the rule acknowledge that non-profit entities are outside the reach of Section 5 (and the noncompete ban) unless their non-profit status is a sham or the non-profit entity is organized by and operates for the benefit of for-profit members. However, the FTC reserved the right to evaluate an entity's non-profit status and noted that some "entities that claim tax-exempt nonprofit status may in fact fall under the FTC's jurisdiction." Specifically, the FTC stated that "some portion of the 58% of hospitals that claim tax-exempt status as nonprofits and the 19% of hospitals that are identified as State or local government hospitals . . . likely fall under the Commission's jurisdiction and the final rule's purview."

ARE NONCOMPETES ALLOWED IN CONNECTION WITH M&A TRANSACTIONS?

Yes, in certain circumstances. The FTC's ban does not apply to noncompetes between a buyer and 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." Unlike the draft rule, which excepted only "substantial" owners of a business (defined as a 25% ownership interest), there is no minimum threshold in the final rule. The FTC warns that noncompetes subject to the sale of a business are still subject to state laws and federal antitrust law that, in the FTC's view, require "a showing that a noncompete is necessary to protect the value of the business being sold."

The FTC's comments on the rule indicate that a "bona fide sale" is made in good faith, made between independent parties at arm's length, and one in which the seller has a reasonable opportunity to negotiate the sale. According to the FTC, a transaction whose "sole purpose is to evade" the ban is not a bona fide sale. The FTC further stated that "springing" noncompetes and noncompetes arising out of repurchase rights or mandatory stock redemption programs do not qualify for the M&A exception.

Although the expanded M&A exception is a welcome change, there are often non-shareholder employees that may contribute substantially to the value a buyer derives from a deal. Buyers and sellers may want to consider alternative arrangements (e.g., long-term vesting of equity interests) to protect deal value.

ARE THERE WAYS TO CHALLENGE THE FTC'S RULE?

Industry groups already have challenged the rule, and courts are likely to consider the need for a stay while the case proceeds. A decision granting or denying a stay would likely be issued within several weeks to a few months, before the 120-day effective date. Full litigation, however, will include review by the court of appeals and potentially the Supreme Court, and could last more than a year.

The FTC will face serious arguments that the rule is invalid, likely focused on:

- The FTC's lack of substantive rulemaking authority under Section 6(g) of the FTC Act, which is a narrow grant of authority to make procedural rules. This is confirmed by a

1975 amendment to the FTC Act in which Congress added separate rulemaking provisions expressly authorizing the FTC to define unfair or deceptive acts or practices, but not UMC.

- Constitutional challenges such as the nondelegation doctrine and major questions doctrine, which could potentially operate as a brake on the FTC's expansive views of its own power.
- A variety of arguments that the rule is arbitrary and capricious under the Administrative Procedure Act. For example, the rule lacks a record that noncompete agreements result (or are likely to result) in systematic harm, particularly given that the empirical evidence is mixed with respect to effects on low-wage workers, and that the best evidence with respect to higher-paid skilled workers is that noncompetes tend to make both employees and employers better off.
- Court challenges may also seek to reign-in the FTC's recent attempt to significantly expand the scope of its UMC authority.

One of the Biden administration's first actions was to withdraw the Obama administration's bipartisan 2015 UMC Policy Statement, which tethered UMC analysis to the consumer welfare standard and the rule of reason framework applied under traditional antitrust laws. The consumer welfare standard focuses antitrust analysis on whether there is harm to consumers as distinct from competing producers. In late 2022, the FTC issued a new statement, setting forth theories that extend beyond actual or threatened harm to competition. The main alleged support for the new approach is a line of cases decided at the end of the period of extremely aggressive enforcement approaches (1937–1973), which was characterized by per se rules. At "peak per se" in 1972, the Supreme Court openly mocked the use of economic analysis. Since then, the Supreme Court has issued a number of landmark decisions aimed at bringing antitrust law in line with modern economic learnings. While those modern decisions were decided under the antitrust laws and did not explicitly address the FTC Act, appellate court decisions on the reach of UMC, the makeup of the current Supreme Court, and modern economics support a more limited reach for UMC.

The decision regarding a stay should arrive in a matter of weeks to a few months and will provide a key initial look at the landscape. In the meantime, companies should consider a wait-and-see approach while also outlining a plan for compliance if it becomes necessary.

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