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The Era of the Non-Compete Agreement Is Ending – Or Is It?

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The wait is over, but the fight is just beginning. Will U.S. employers need to break up with non-compete agreements forever? The Federal Trade Commission (FTC) voted "yes" earlier this week in pushing through a Final Rule that broadly bans nearly all forms of non-compete agreements. But while the move represents the culmination of the Biden administration's years-long effort to prohibit such agreements, this victory may be short-lived – or at least delayed – as legal challenges are already mounting.

The Broad Reach of the Final Rule

In January of 2023, we reported that the original proposed rule had an "extraordinarily broad reach" in its definitions of "non-compete clause" and "worker." These definitions remain largely unchanged in the Final Rule.

Specifically, the Final Rule defines a "non-compete clause" as "[a] term or condition of employment 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."

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The term "worker" is also defined extremely broadly; it includes employees, independent contractors, externs, interns, volunteers, apprentices, and sole proprietors. It also includes persons who "work for a franchisee or franchisor," but not a "franchisee in the context of a franchisee-franchisor relationship." Non-competes used in franchisor-franchisee relationships remain subject to state common law and federal and state antitrust laws.

While the Final Rule is vast in its reach, non-solicitation, non-disclosure, or training-repayment agreements (requiring workers to reimburse an employer or third-party for training costs if their employment terminates within a certain period), unless they function as non-compete agreements, remain viable options for protecting an employer's business interests, despite the Final Rule. The FTC distinguished such agreements from non-competes, noting that they do not necessarily prevent workers from finding work elsewhere or operating their own business.

The Final Rule Bans All New Non-Competes

The Final Rule prohibits employers from entering into non-compete clauses with workers on or after the Final Rule's effective date – i.e., 120 days after the date the Final Rule is published in the Federal Register, which will likely take place imminently. Likewise, employers cannot enforce or attempt to enforce a non-compete, or represent that the worker is subject to a non-compete clause.

The Final Rule Renders Nearly All Existing Non-Competes Unenforceable, With a Carve Out for "Senior Executives"

Although existing non-competes that were entered into before the Final Rule's effective date are also generally banned under the Final Rule, the FTC has carved out an exception for "senior executives."

The FTC defines a "senior executive" as a worker who: (1) earns at least $151,164 annually (representing the 85th percentile of earnings of full-time salaried workers on a national level); and (2) is in a "policy-making position," meaning a president, CEO, or the equivalent, or any other officer or similar person who possesses final authority to "make decisions that control significant aspects of a business entity or common enterprise." Individuals do not possess policy-making authority if they merely advise or exert influence over policy decisions, or if they have final authority to make such decisions, but only for a subsidiary or affiliate of a common enterprise. Thus, how many pre-existing "senior executive" non-compete agreements will actually be "grandfathered in" remains to be seen.

Employers' Notification Requirements

Employers need not formally rescind existing non-competes. Instead, by the effective date of the Final Rule, employers must provide "clear and conspicuous notice" to all affected workers with existing non-competes that such provisions will not be, and cannot legally be, enforced. Employers may choose to deliver this notice by hand, email, text message, or to the worker's last known street address. If an employer has no record of a street address, email address, or mobile telephone number, it is exempted from the notice requirement.

As a safe harbor for employers, the Final Rule includes model language that satisfies the notice requirement. However, employers may use different language as long as it clearly communicates that the non-compete is no longer in effect and cannot be enforced.

The Retroactivity Problem: No Easy Solutions for Employers Who Have Already Provided Benefits to Workers With Now Unenforceable Agreements

The FTC also addressed comments expressing concern that retroactively "rescinding or invalidating agreements would lead to increased litigation against workers who received the benefit of the bargain but were no longer bound by a non-compete in exchange, and that such litigation would seek to nullify severance agreements, employment agreements, clawback agreements, and others."

In response to such comments, the FTC pointed to its exclusion of senior executives with existing non-competes from the Final Rule. As for other workers, the FTC acknowledged the "practical concerns" that could arise where an agreement has been invalidated after the worker has already received benefits thereunder, but dismissed this as a "very rare" situation. Reading between the lines, it appears that the FTC is willing to leave such workers exposed to potential litigation. Employers finding themselves in this situation are well-advised to consider whether the remainder of such agreements are severable and contain other sufficient consideration, such as an appropriately tailored non-solicit or non-disclosure agreement.

Exceptions to the Final Rule

Though the Final Rule is nearly all-encompassing in its reach, limited exceptions remain. Specifically, the Final Rule does not apply to non-competes that are 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. Notably absent from this definition is the 25% ownership threshold initially set forth in the Proposed Rule. The FTC removed this threshold to protect against the possibility that employers would "structure their businesses as several smaller legal entities in order to fall within the sale-of-a-business exception." Instead, the FTC now favors a "functional test" that makes it "more difficult for workers and employers to know whether a given non-compete is enforceable in the context of the sale of a business." In general, a "bona fide sale" is "one that is made

between two independent parties at arm's length, and in which the seller has a reasonable opportunity to negotiate the terms of the sale."

Additionally, the Final Rule does not apply where a cause of action accrued prior to the effective date, or where an employer has a good faith basis to believe that the Final Rule is not applicable and seeks to enforce a non-compete or otherwise makes representations about the worker's non-compete.

Preemption

The Final Rule is not intended to annul or exempt compliance with state law applicable to non-competes. Rather, the FTC makes clear that the Final Rule supersedes such laws "only to the extent" that they would otherwise permit the now-unlawful enforcement of non-compete clauses.

Litigation Aiming to Block the Final Rule Has Already Begun

In a widely expected move just one day after the FTC vote, the U.S. Chamber of Commerce fulfilled its promise to sue to block the Final Rule. The suit, which was filed in the Eastern District of Texas, decries the FTC's "astounding assertion of power" and its "novel claim of authority" to "issue substantive, binding regulations prohibiting 'unfair methods of competition' under Section 6(g) of the FTC Act." Specifically, the Chamber of Commerce makes four main arguments. First, it claims the FTC "lacks the authority to issue regulations proscribing 'unfair methods of competition.'" Second, it asserts that even if the FTC had such authority, the Final Rule "would still be unlawful because non-compete agreements are not categorically unlawful under Section 5 of the FTC Act [prohibiting unfair or deceptive acts or practices in or affecting commerce]." Third, the Chamber claims that the Final Rule is "impermissibly retroactive," because "parties that bargained for the protection afforded by a non-compete agreement will no longer be able to enforce those contracts going forward, even if they

already upheld their obligations under the contract." This, the Chamber claims, also implicates Fifth Amendment rights barring the federal government from "retroactively disrupting settled legal rights." Fourth and finally, the Chamber argues that the Final Rule is an "arbitrary and capricious exercise of the [FTC's] powers," given the "categorical ban on virtually all non-competes." While the Chamber of Commerce was among the first to reach the courthouse steps, we anticipate a crowded race to stop or delay enforcement of the Final Rule.

The text accompanying the Final Rule provides insight into the FTC's anticipated defense against such claims. It lists dozens of legislative rules promulgated by the FTC, and cites precedent upholding this practice as a "proper exercise of the Commission's power." The FTC cited examples where it used the rulemaking process in the past, including to "require warnings on cigarette packages" following the Surgeon General's "landmark report" determining that "smoking is a health hazard." The FTC notes that the rule was "front-page news" at the time, and while Congress ultimately supplanted the regulation with legislation, it did not disturb the FTC's rule or its rulemaking authority more generally.

Takeaway for Employers

With litigation pending, it remains unclear when – or if – the Final Rule will ultimately take effect. In the interim, employers should review their existing non-competes and determine which workers would be classified as "senior executives" under the Final Rule. Also, for those individuals who seemingly fit the definition of "senior executive," now may be an opportune time to consider entering into non-compete agreements, if otherwise permissible under state or local law, before the effective date of the Final Rule.

For guidance on the developing legal landscape for non-competes and other workplace issues, consult

your Akerman attorney.
