Frequently Asked Questions About the FTC's Rule Banning Non-Compete Agreements

Insights
5.16.24

Most recently updated July 15

Employers likely have lots of questions as you try to understand the FTC's new non-compete ban. After all, non-competes have become a tool for businesses of all types and sizes, and if the rule survives legal challenges, it will ban these provisions between almost all employers and all employees. The new rule not only prevents employers from entering into new non-competes after the effective date, but also will require you to send notice to most workers who previously signed such agreements. Notably, you'll need to explain that the worker's non-compete clause will not be — and cannot legally be — enforced against them. The good news: we're here to help. This Insight presents a series of frequently asked questions about all aspects of the rule as developed by key members of our Employee Defection and Trade Secrets Practice Group.

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Big-Picture Overview

What happened?

After reviewing empirical research on non-competes and over 26,000 public comments, the FTC adopted a final rule that will prohibit employers from entering into most new non-competes and also prevents you from enforcing existing non-competes in all but a few circumstances, such as against a limited class of senior executives.

You can read more about the final rule and our five-step action plan for employers here.

The rule is slated to take effect on September 4, though legal challenges could cause delays, or a court could invalidate the rule altogether. We will be closely following developments in this area.

What does the rule do?

Assuming the rule is not permanently blocked, it will require employers to:

- Provide clear and conspicuous notice prior to the effective date to current and former workers who do not qualify as a senior executive. The notice should explain that the workers' existing non-compete clauses will not and cannot legally be enforced against them. The final rule provides model language, which can be used to satisfy this notice obligation and provides a safe harbor. (NOTE: The notice may be delivered by hand, by mail to the worker's last known personal street address, by email at an email address belonging to the worker (work or personal), or by text message to a mobile telephone number belonging to the worker. An exemption to the notice requirement exists if no contact information is known.)
- Stop enforcing existing non-compete clauses with all workers other than senior executives (NOTE: it is not necessary to rescind the agreements).
- Refrain from entering into new non-compete clauses with workers.

For workers other than "senior executives" (as defined by the rule), attempting to enforce an existing non-compete clause, entering into a new non-compete clause, or claiming that the worker is subject to a non-compete clause constitutes unfair competition.

For "senior executives," attempting to enter a new non-compete clause or claiming that the senior executive is subject to a non-compete clause (if the agreement is entered into after the rule's effective date) constitutes unfair competition.

How does the Commission define "non-compete" clauses?

The rule defines "non-compete clause" to mean a contractual term (written or oral) that prohibits, penalizes for, or functions to prevent a worker from: seeking or accepting work from a different person or business, or starting a business, within the U.S., after the worker's employment ends.

Why did the FTC do this?

In July 2021, President Biden issued an Executive Order titled "Promoting Competition in the American Economy." It directed the FTC to exercise its "statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

In January 2023, the Commission followed through on the President's request. With the release of the proposed rule, FTC Chair Lina Khan opined that non-compete clauses "block workers from freely switching jobs, depriving them of higher wages and better working conditions, and depriving businesses of a talent pool that they need to build and expand." The Commission reiterated its belief that non-compete clauses negatively affect competition in labor markets by suppressing wages and

labor mobility, and by preventing new businesses from forming, stifling entrepreneurship, and preventing novel innovation that might otherwise occur if workers were not restricted from sharing their ideas.

The FTC estimates that 101 million workers are subject to non-competes, and that the rule will increase workers' annual earnings in the U.S. by $524 per worker, totaling $53 billion nationally.

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Specific Ins and Outs of the Rule

Does the rule prohibit non-solicitation, non-recruit, or confidentiality clauses?

Generally speaking, no. The FTC said those provisions are not generally non-compete clauses under the final rule, so long as they do not 'function to' prevent someone from seeking work or operating a business. However, the determination will be made on a case-by-case basis.

The FTC used a few cases as examples of non-disclosure agreements that were so overbroad they would effectively prevent someone from working for another employer in the same industry or field. However, those cases involved agreements that broadly barred the use of any information that is 'usable in' or 'relates to' the industry in which the employee works, or even publicly available information.

Does the rule prohibit other types of clauses, such as forfeiture-for-competition or garden leave clauses?

Many commentators asked the FTC to expressly state in the final rule whether various specific restrictive employment agreements satisfy the definition of a non-compete clause. The Commission specifically declined to do so with one exception—the Commission noted that a garden leave agreement where the worker is still employed and receives the same total annual compensation and benefits on a pro-rata basis is not a non-compete clause under the rule. It observed that the final rule contains a definition of the term "non-compete clause" that reflects the need for case-by-case consideration of whether certain restrictive covenants rise to the level of being functional non-competes.

The FTC goes on to note that certain agreements — including TRAPs, bonus repayment clauses, and garden leave provisions — do not necessarily constitute non-competes. The Commission also states that a forfeiture-for-competition clause is an example of a term that "penalizes" a worker because it "imposes 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 after their employment ends."

The Commission cites additional examples of provisions as potentially "penalizing" a worker, including certain liquidated damages and severance arrangements in which a worker is paid only if they refrain from competing. A common thread that could make these types of agreements non-compete clauses, according to the FTC, is where they appear on the surface to be triggered when the worker is seeking to work for another person or start a business after they leave their job — in other words, if the agreement prohibits or penalizes post-employment work for another employer or business.

What are the potential penalties for violating the rule?

The FTC has the authority to issue a complaint in situations where it believes its rules have been violated. If a respondent contests the charges, the complaint is adjudicated before an administrative law judge (ALJ) in a trial-type proceeding. Upon conclusion of the proceeding, the ALJ issues an "initial decision" setting forth findings of fact and conclusions of law and a recommendation for either a "cease and desist" order or dismissal of the complaint. The FTC and the respondent may appeal the initial decision to the full Commission. After the Commission issues a final decision, the matter may be appealed in court.

After a cease-and-desist order is finalized, and an employer does not comply with the order, the Commission may seek an array of remedies in court including civil penalties, restitution, damages, injunctive relief, orders of rescission or reformation of contracts. The FTC may also make referrals to the U.S. Department of Justice for criminal prosecution.

Will the rule be retroactive?

The final rule removed a provision that would require existing agreements to be rescinded. However, for all workers except "senior executives," non-compete clauses entered into prior to the effective date will be unenforceable. Moreover, the final rule requires notice to all such workers that the clauses are no longer effective.

Will the retroactive provision invalidate an entire existing agreement containing a non-compete clause, or just the non-compete clause itself, leaving other restrictive covenants intact?

Only the non-compete clause will be impacted by the rule. Indeed, the FTC highlighted that point when it described the prior rescission requirement as onerous because of the costs and time spent "modifying" existing employment agreements. Moreover, the model language for notification to workers includes the following: "The FTC's new rule does not affect any other terms or conditions of your employment."

Could we face retroactive liability for existing agreements?

Employers will not face retroactive liability for use of a non-compete clause prior to the effective date of the rule, but such agreements will not be enforceable after the effective date unless subject

to one of the exceptions to the rule.

Does the rule apply to claims that accrue prior to the effective date?

No, the rule expressly states that its requirements do not apply where a cause of action related to a non-compete clause accrued prior the effective date of the rule.

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Scope of Rule

Does the rule preclude all non-competes?

The rule does not apply to a non-compete clause entered into pursuant to a bona fide sale of a business entity, of a person's ownership interest in a business entity, or of all or substantially all of a business entity's operating assets. Unlike the original proposed rule, the Commission elected not to impose a minimum ownership interest threshold for the sale-of-business exception to apply.

The FTC explained that it added the term "bona fide" and made changes to clarify that any excluded non-compete must be made "pursuant to bona fide sale" to address commenters' concerns that employers may attempt to use sham transactions with wholly owned subsidiaries, "springing" non-competes, repurchase rights, mandatory stock redemption programs, or other mechanisms to attempt to evade the rule.

The rule does not apply to franchisees in the context of a franchisee-franchisor relationship. Additionally, employers that are beyond the scope of the FTC's regulatory authority are not covered by the rule, including, for example, non-profits and federally regulated banks and credit unions.

The rule also contains a limited exclusion for "senior executives," permitting the enforcement of non-competes entered into with senior executives prior to the effective date of the rule.

How does the rule define "senior executives"?

To explain the definition of "senior executives," the FTC has defined not only that term, but also the components of the term relating to "policy-making positions" and "policy-making authority." The commentary that accompanies the rule also contains additional guidance on the subject.

The rule defines a "**senior executive**" as a worker who (1) was in a policy-making position; and (2) received total annual compensation of at least $151,164 in the preceding year.

The term "**policy-making position**" is defined to mean a business entity's president, CEO, or the equivalent, any other officer of a business entity who has policy-making authority, or any other

equivalent, any other officer of a business entity who has policy-making authority, or any other natural person who has policy-making authority for the business entity similar to an officer with policy-making authority. The definition states that an "officer of a subsidiary or affiliate of a business entity that is part of a common enterprise who has policy-making authority for the common enterprise may be deemed to have a policy-making position for purposes of this paragraph," but that a "natural person who does not have policy-making authority over a common enterprise may not be deemed to have a policy-making position even if the person has policy-making authority over a subsidiary or affiliate of a business entity that is part of the common enterprise."

"**Policy-making authority**" is defined as having "final authority to make policy decisions that control significant aspects of a business entity or common enterprise and does not include authority limited to advising or exerting influence over such policy decisions or having final authority to make policy decisions for only a subsidiary of or affiliate of a common enterprise."

The Commission's commentary includes a statement that it is seeking to "broadly align with the SEC's definition of 'executive officer' while focusing on *senior* executives in a wider variety of entities." The Commission offers some examples of positions that would not be considered "senior executives," including the head of a marketing division in a manufacturing firm, where that person only makes policy decisions for the marketing division. The Commission observes that if those decisions do not control significant aspects of the business (which would likely be decisions that impact the business outside the marketing division), then the head of the marketing division would not be considered a senior executive.

The Commission also explains that to be a "**common enterprise**," an entity must include "integrated business entities," meaning that the various components of the common enterprise would have, for example, "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."

Does the rule preclude non-competes with independent contractors?

Yes, the rule will apply to independent contractors, as well as anyone who works for a business, whether paid or unpaid.

My state has a statute that allows non-competes. What effect does the rule have on state law?

The proposed rule states that it supersedes any inconsistent state statute, regulation, order, or interpretation. State statutes, regulations, orders, or interpretations that afford greater protection to workers would be allowed.

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Next Steps: Legal Challenges and More

Have there been legal challenges to the rule? (answer most recently updated July 15)

Yes. Three lawsuits have been filed challenging the FTC's authority. The first of these cases, *Ryan LLC v. FTC*, was filed in the Northern District of Texas on the same day that the FTC voted to finalize the rule. The U.S. Chamber of Commerce initiated a lawsuit against the FTC in the Eastern District of Texas on the following day, and ATS Tree Services, LLC filed the third lawsuit the day after that.

- The U.S. Chamber of Commerce lawsuit has been paused and instead the Chamber has successfully joined the *Ryan* suit as an additional plaintiff.
- A judge from the Northern District of Texas ruled on July 3 that the rule should be blocked from taking effect – but only for the five plaintiffs in the *Ryan* case as employers. That limited ruling means that just about every employer in the country was not impacted by her decision. She further declined to extend the ruling nationwide in a separate ruling on July 11. You can read about that decision here.
- The third lawsuit challenging the non-compete ban is pending in Pennsylvania federal court. A hearing on the plaintiff's motion to pause the effective date took place on July 10, and the court said it should issue a ruling by July 23.

When will the rule become effective?

The FTC published the rule in the Federal Register on May 7, and the rule will become effective 120 days later on September 4.

What actions have other federal agencies taken that will impact non-competes?

NLRB Activity

Last year, NLRB General Counsel Jennifer Abruzzo issued a memo urging NLRB regional directors to find that many employer-mandated non-compete agreements infringe on employees' rights under Section 7 of the National Labor Relations Act (NLRA). This memo could apply to at least a segment of your workforce regardless of whether your company is unionized, though independent contractors, managers, most supervisors, public sector employees, and some agricultural workers are not covered by these NLRA protections.

A few months later, a regional NLRB office brought charges against a business that required certain low-level employees to sign contracts containing both non-competition and non-solicitation provisions. That case settled in February. The NLRB announced that the settlement included rescission of the policies at issue and over $25,000 to be paid to two affected employees. In addition, the company agreed to post a remedial notice across all its U.S. facilities and to its Slack messaging app.

FDIC Activity

The FDIC recently requested public comments on proposed policy updates involving banks that are forced to sell certain branches or businesses to obtain FDIC approval for a merger. These banks would be prohibited under the proposed revisions from using non-compete clauses with employees of those branches or businesses being sold off.

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Practical Gameplan for Employers

What can I do to protect my trade secrets, confidential information, and customer relationships?

As noted above, the rule does not expressly ban non-disclosure and non-solicitation provisions. However, it will apply a functionality test that could invalidate one of these provisions if it either "prohibits" a worker from, "penalizes" a worker for, or "functions to prevent" a worker from either:

- seeking or accepting work in the U.S. with a different person where such work would begin after the conclusion of the employment that includes the term or condition; or
- operating a business in the U.S. after the conclusion of the employment that includes the term or condition.

Carefully drafted non-solicitation, confidentiality and non-disclosure clauses should withstand such scrutiny, enabling employers to protect confidential information and customer relationships, as well as prevent their employees from being poached by other employees.

Additionally, the rule does not prohibit garden leave agreements where the worker is still employed and receives the same total annual compensation and benefits on a pro-rata basis.

Finally, employers could still protect trade secret information by relying on the federal Defend Trade Secrets Act and state trade secret statutes.

Employers should make sure they roll out appropriate policies, procedures, and training on handling and protecting confidential and trade secret information.

What should we do now?

The rule is scheduled to go into effect on September 4, but it is far from clear whether the effective date of the rule will survive pending legal challenges. Nonetheless, there are some preliminary

steps you can consider taking to put yourself in the best position if the final rule takes effect in the coming months:

- **Develop a personalized strategy plan.** You will want to work with your legal counsel as soon as possible to craft an individualized strategy plan in light of these developments. You'll want to take into consideration the size of your business, the number of non-competes in play, the importance of such agreements to your business, your risk tolerance levels, the resources you have on hand, and a variety of other factors to determine your next steps.
- **Use the next few months to take an inventory of all existing restrictive covenant agreements – including those that bind former workers.** This is often a good use of time and money even without the looming FTC rule. You should also make sure you determine which workers fall under the "senior executive" category to allow for enforcement. At the same time, make sure you are tracking all new non-competes you put into effect from here on out.
- **Revisit your restrictive covenants — including non-solicitation and confidentiality provisions — to ensure they are reasonably tailored to protect your legitimate interests.** The day before it issued notice of the proposed rule, the FTC announced three consent orders forcing three employers to drop their non-competes against thousands of workers. Sounding a lot like the analysis in the notice, the consent orders found that the employers use of non-competes was a method of unfair competition, and it required them to terminate the agreements and notify the employees who signed them. While the final rule's effective date is pending, there is no reason to believe the FTC will relent on its investigative and enforcement efforts.
- **You should ask whether the non-competes your company uses are necessary to protect your legitimate interests.** You should also consider whether you can protect your interests with a less burdensome covenant such as a properly tailored customer non-solicitation or confidentiality provision.
- **Get your trade secrets house in order.** This is perhaps more important now than ever. The FTC cites the availability of trade secret protection as a factor that mitigates the harm of abrogating non-competes. You should identify your trade secrets and put proper policies and procedures in place. Limit trade secret access only to those who need it; train employees how to handle trade secrets and protect against theft; and implement suitable technological controls.

Conclusion

We will continue to monitor the pending legal challenges to the rule and provide updates as warranted, so you should ensure you are subscribed to Fisher Phillips' Insight System to gather the most up-to-date information directly to your inbox. If you have questions, please contact the authors of this Insight, your Fisher Phillips attorney, or any attorney in our Employee Defection and Trade Secrets Practice Group.

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