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ALERT

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FTC Bans Non-Competes

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On April 23, 2024, the Federal Trade Commission ("FTC") adopted a Non-Compete Clause Rule (the "Rule") that bans non-compete clauses between workers and employers as unfair methods of competition under Section 5 of the FTC Act, subject to limited exceptions. The Rule is presently scheduled to go into effect on September 4, 2024, which is 120 days from the date of its publication in the Federal Register (the "Effective Date"). However, the Effective Date may be delayed or enjoined in light of pending litigation challenging the Rule.

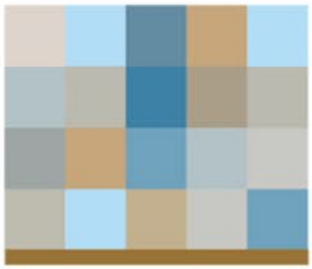
The Rule prohibits any employer from entering into or attempting to enter into any post-employment non-compete clause with its workers, with limited exceptions, and renders existing non-competes unenforceable, except for those with senior executives. Any non-compete entered into after the Rule's Effective Date will be considered a method of unfair competition in violation of the FTC Act.

To Whom Does the Rule Apply?

Most workers in most industries will be subject to the Rule. The Rule defines "worker" broadly, including employees, independent contractors, interns, volunteers, apprentices and sole proprietors, regardless of whether paid or unpaid. It also covers former workers who may be subject to an employer's non-compete agreement, even though such former workers are no longer employed by the employer.

Although the Rule deliberately leaves the term "employer" undefined, most employers who otherwise fall within the FTC's jurisdiction will be subject to the Rule. The FTC acknowledges that the Rule applies to only those entities that are subject to the FTC Act. Thus, entities that sit outside the scope of the FTC's jurisdiction will be exempt from the Rule.[1]

[1] The FTC declined to clarify the scope of its jurisdiction. However, commentators have opined that certain non-profits (as discussed in this alert), certain common carriers, certain domestic and foreign air carriers, and businesses subject to the Packers and Stockyards Act of 1921 are among the entities that will be exempt from the Rule. There have also been discussions among commentators that while certain banks and savings and loan institutions, federal credit unions, FDIC insured state-chartered banks and other commercial lenders are outside of the FTC's jurisdiction, the FTC did not exclude bank holding companies, investment advisors or securities brokerages from the Rule.



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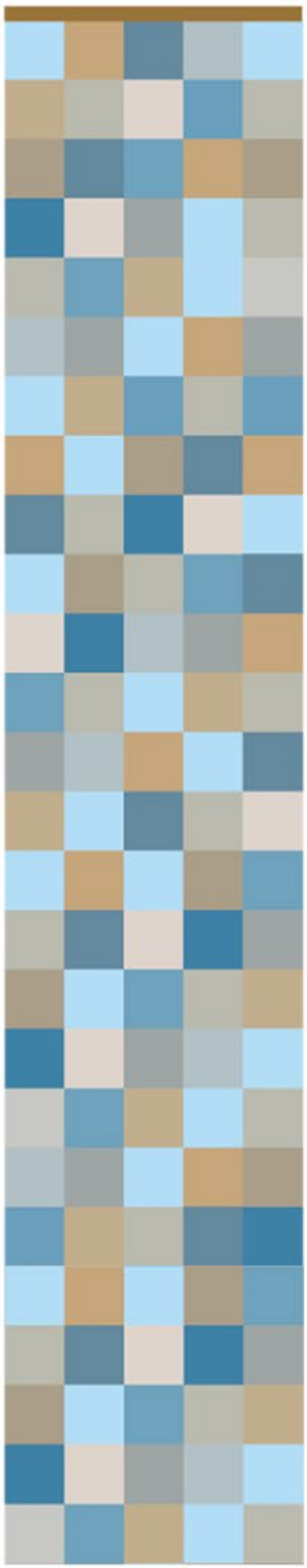

While non-profit entities have historically fallen outside the scope of the FTC's jurisdiction, the FTC takes the position that certain non-profit entities could be subject to the Rule despite their tax-exempt status. Under the Rule, a "corporation" is defined, in part, as an entity that is "organized to carry on business for its own profit or that of its members." The FTC will apply a two-part test to determine whether a corporation is organized for profit and thus within the FTC's jurisdiction. The two-part test is (1) whether the corporation is organized for and actually engaged in business solely for charitable purposes, and (2) whether either the corporation or its members derive a profit. The FTC provides examples of when non-profit corporations have fallen under its jurisdiction, which include a Section 5 enforcement action brought over a tax-exempt physician-hospital organization because the hospital "engaged in business on behalf of for-profit physician members." Thus, non-profit entities need to be aware that even if they have 501(c)(3) tax-exempt status, the presence of private benefit or private inurement or any other indication that the entity is organized for its own profit or that of its members could cause the entity to be subject to the Rule.

What Does the Rule Cover?

The Rule defines "non-compete clause" as a term or condition of employment (written or oral) "that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from (1) 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 (2) operating a business in the United States after the conclusion of the employment that includes the term or condition."

Notably, the Rule extends to clauses that "penalize" or "function to prevent" a worker from seeking or accepting employment, which empowers the FTC to take action against employers for clauses that the FTC believes are the functional equivalent of non-competes. The FTC notes that, while other types of restrictive covenants (e.g., non-disclosure and non-solicitation clauses) are not categorically prohibited by the Rule, very broad or abusive versions of such covenants could still be considered a functional non-compete if they prevent workers from accepting employment or operating a business. The FTC explains that whether certain restrictive covenants rise to the level of being functional non-competes requires case-by-case consideration.

Existing Non-Compete Agreements

The Rule provides that existing non-competes can remain in full force and effect with "senior executives," but only until these agreements expire. After the Effective Date, new non-compete agreements with senior executives, including extensions of existing agreements, will be subject to the ban. To qualify as a "senior executive," a worker must (1) earn more than $151,164 annually and (2) be in a "policy-making position," which is defined narrowly to mean a business entity's chief executive officer or president (or the equivalent) or any other officer

or natural person who has final authority to make policy decisions that control significant aspects of the business. Notably, other than the chief executive officers and presidents, no officers are presumed to have policy-making authority. Authority to advise or exert influence over business decisions or to have final authority that is limited to a subsidiary or affiliate of a common enterprise would not satisfy the "policy-making position" definition. Nevertheless, the FTC notes that many c-suite executives and partners in a partnership will likely qualify as senior executives if they are making decisions that have a significant impact on the business.

Notice Requirement for Existing Non-Competes

For all current and former non-senior executive workers who have existing non-competes, employers are required to provide notice to such workers, by the Effective Date, that the worker's non-compete clause is no longer in effect and will not be enforced against the worker. Employers seeking to satisfy the notice requirement may rely on model language in the Rule.

Limited Exception for the Bona Fide Sale of a Business

The bona fide sale of a business exception is the only complete exception to the Rule. Any non-compete clause, whether existing or new, entered into by a person pursuant to the sale of their business, the person's ownership interest in the business or of all or substantially all of the business's operating assets, will be enforceable.

State Law Preemption

The Rule makes clear that it will preempt all conflicting state laws, regulations and orders. However, states will be able to impose requirements and restrictions with respect to non-compete clauses if such requirements and restrictions afford greater protection than that provided by the Rule.

Enforcement

The Rule reflects that engaging in prohibited activities relating to non-compete clauses constitutes an "unfair method of competition" within the meaning of Section 5 of the FTC Act and therefore would deem such activity to be a violation of Section 5. Under the FTC's regulatory authority, violations of the Rule may draw a range of enforcement actions from the FTC. Penalties include injunctive relief, cease and desist orders prohibiting the use of non-competes and monetary fines. Section 5 of the FTC Act does not provide a party saddled with a contractual prohibition against competition with a private right of action against her employer. However, to the extent an employer brings a lawsuit to enforce a non-competition agreement, the employee can assert Section 5's prohibition against such agreements as an affirmative defense. In addition to the assertion of an affirmative defense, the FTC Ban could

be raised and considered by a court applying a traditional "reasonableness/unreasonableness" analysis to the non-compete provision.

What This Means for Employers and Businesses

Due to pending legal challenges, the Effective Date of the Rule is still uncertain. The U.S. Chamber of Commerce (and several private businesses) have already filed lawsuits against the Rule. In a suit filed in the Eastern District of Texas, the U.S. Chamber of Commerce is seeking an injunction preventing enforcement of the Rule pending litigation. The U.S. Chamber of Commerce argues that the FTC lacks the authority to institute a nationwide ban and that it is an issue for Congress to decide. A ruling on the injunction is anticipated before the Effective Date. The pending lawsuits could delay implementation of the Rule or even invalidate the Rule entirely. Nevertheless, employers may be proactive by reviewing their non-compete agreements and considering whether to enter into narrower restrictive employment agreements, including, for example, non-solicitation and/or confidentiality agreements, to protect their legitimate business interests.

If you have any questions regarding the matter raised in this Alert, please feel free to contact **Rachel A. Fernbach** at rfernbach@moritthock.com, **Olivia Garrison** at ogarrison@moritthock.com, or **Benjamin Geizhals** at bgeizhals@moritthock.com.

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