New FTC Rule Imposes Sweeping Ban on Non-Compete Agreements with Workers

BY CARLY KROLAK AND STEVEN L. MANCHEL • APRIL 24, 2024

In January of 2023, Bowditch alerted clients that the Federal Trade Commission ("FTC") was proposing a sweeping new rule that would ban the use of virtually all non-compete agreements and have a seismic effect on employment relationships throughout the United States. On Tuesday, April 23, 2024, after receiving over 26,000 comments, the FTC voted (3-2) to finalize "The Non-Compete Clause Rule" (the "Rule"), which contains only a few modifications to the proposed rule.

As anticipated, the final Rule bans most employers from using post-employment non-compete agreements in nearly all contexts. Additionally, as the FTC's accompanying commentary acknowledges, the Rule will invalidate nearly 30 million existing agreements, impacting roughly one fifth of the entire United States workforce. The impact on United States employers' business operations will, indeed, be quite significant.

ALL NEW NON-COMPETES ARE PROHIBITED

The Rule provides that it is an unfair method of competition, in violation of section 5 of the Federal Trade Commission Act, to enter a new non-compete agreement with any worker, including senior executives, on or after the effective date of the Rule.

The prohibition applies, with almost no exceptions (see the limits below), to new non-compete agreements with any person who performs work, whether paid or unpaid, regardless of classification as an employee, volunteer, independent contractor, or other designation.

RETROACTIVE APPLICATION TO MOST EXISTING NON-COMPETES

The Rule also applies to prohibit all previously entered non-compete agreements with two narrow exceptions.

First, the Rule permits continued enforcement of previously entered non-compete agreements against workers who

qualify as "senior executives." Under the Rule, workers must meet both an income test and be in a "policy-making position" to qualify as a senior executive.

Second, the Rule also permits causes of action related to non-compete agreements that accrued before the effective date.

BAN APPLIES TO A BROAD RANGE OF AGREEMENTS RESTRICTING POST-EMPLOYMENT WORK

The Rule defines the term "non-compete clause" to apply not only to agreements that overtly prohibit a worker from engaging in work or starting a business after their employment has ended, but also to those that "function to prevent" a worker from, or "penalize" a worker for, engaging in work or starting a business after the end of their employment.

The Rule's definition does not appear to cover most reasonably tailored non-solicitation agreements and non-disclosure agreements. In response to comments, the FTC declined to explicitly include such agreements within the definition of prohibited agreements and stated that "restrictive employment agreements other than non-competes—such as NDAs, non-solicitation agreements, and TRAPs—do not by their terms or necessarily in their effect prevent a worker from seeking or accepting work with a person or operating a business after the worker leaves their job." However, the FTC acknowledged decisions regarding whether such agreements fall within the "functions to prevent" category must be made on "case-by-case basis" and will depend on "the facts and circumstances of particular covenants and the surrounding market context." As a result, any such alternative post-employment restrictions will need be drafted carefully to avoid falling into the prohibited "functions to prevent" category.

NOTICE OF UNENFORCEABILITY REQUIRED FOR EXISTING NON-COMPETE AGREEMENTS

The Rule mandates that any person with an existing non-compete agreement with a worker, other than a "senior executive," provide written notice informing the worker that the non-compete provision is unenforceable. The notice must be sent to all current and former workers, other than "senior executives," who are subject to existing non-compete provisions. The Rule provides "safe harbor" model language for the notice and a limited exception for former workers for whom no contact information is available.

All required notices must be provided to workers *before* the effective date of the Rule.

FEW LIMITS ON APPLICABILITY

The Rule does not apply to non-competition restrictions *during the term of employment*. The Rule also does not apply to franchisees in a franchisee/franchiser relationship. As discussed above, the Rule also does not apply to previously entered agreements with "senior executives."

There is also an exception in the Rule for agreements entered into by a person in connection with the sale of a business, the person's interest in a business, or the operating assets of a business.

As noted above, there is also an exception in the Rule for causes of action based on non-compete agreements that accrue prior to the effective date.

Additionally, the FTC itself is subject to the jurisdictional limits established by the Federal Trade Commission Act. As a result, the Rule does not apply to any employers that are outside the FTC's jurisdiction, such as certain banks and nonprofit entities meeting the FTC's test [which is not coextensive with the test to qualify for tax-exempt status under section 501(c)(3) of the Internal Revenue Code].

EFFECTIVE DATE

The Rule is set to go into effect 120 days after its publication in the Federal Register.

Prior to the effective date, however, there are expected to be numerous legal actions seeking to block implementation of the Rule. The U.S. Chamber of Commerce President and CEO Suzanne P. Clark immediately vowed that "[t]he Chamber will sue the FTC to block this unnecessary and unlawful rule[.]" Within 24 hours, the Chamber and at least one business had filed actions challenging the FTC's authority to issue the Rule in federal courts in Texas. We will continue to monitor for future developments.

In the meantime, businesses that rely on non-compete provisions and other types of post-employment restrictive covenants should consult with their Bowditch attorney to prepare for compliance with the Rule.