

FTC's final rule banning worker noncompete clauses: what it means for employers

By Shay Dvoretzky, Esq., Page W. Griffin, Esq., Joseph M. Rancour, Esq., and David E. Schwartz, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

MAY 6, 2024

On April 23, 2024, the Federal Trade Commission (FTC), in a 3-2 vote, issued a final rule that bans noncompete clauses between workers and employers¹ as “unfair method[s] of competition” under Section 5 of the FTC Act, subject to only a few exceptions.

This highly anticipated final rule follows on the FTC’s substantially similar proposed rule released well over a year ago on January 5, 2023. See our January 9, 2023, client alert “FTC Proposes Broad Ban on Worker Noncompete Clauses.”²

Challengers argue that the final rule exceeds the FTC’s statutory authority, is arbitrary and capricious in violation of the Administrative Procedure Act, violates constitutional law, and ignores potential pro-competitive benefits of noncompetes.

The final rule defines “noncompete clause” broadly to include any term or condition of employment that “prohibits,” “penalizes” or “functions to prevent” a worker from seeking or accepting work or operating a business in the U.S. after the conclusion of employment that included the term or condition.

Key features of the final rule include:

- Prohibition of new noncompete clauses between employers and workers on a go-forward basis.³
- Rendering unenforceable existing employer noncompete clauses with workers other than *pre-existing* noncompetes for workers qualifying as “senior executives.”
- Requiring employers to provide notice to employees subject to prohibited noncompetes that the clauses will not be enforced.
- Establishing narrow exceptions for worker noncompete clauses entered into in as part of a bona fide “sale of business,” as well as for existing causes of action under worker noncompetes that accrued prior to the issuance of the final rule.

The final rule is slated to take effect 120 days after its publication in the Federal Register. While this means that employers should prepare to comply with this new rule within a few months, the rule already faces legal challenges that could impact or delay its implementation or result in its invalidation.

Another key area of ambiguity and likely challenge is the applicability of the rule to entities that claim nonprofit status.

In particular, the challengers argue that the final rule exceeds the FTC’s statutory authority, is arbitrary and capricious in violation of the Administrative Procedure Act, violates constitutional law, and ignores potential pro-competitive benefits of noncompetes.

Key changes from the proposed rule

The final rule largely reflects the sweeping provisions of the proposed rule, but the FTC adopted certain changes based upon comments it received during the rulemaking, including:

- **Significantly expanded “sale of business” exception.** The proposed rule included a narrow exception involving the sale of a business with a seller/worker owning at least 25% of business entity. The final rule adopts a broader exception for noncompete clauses that are entered into “by a person pursuant to [1] a bona fide sale of a business entity, [2] of a person’s ownership interest in a business entity, or [3] of all or substantially all of a business entity’s operating assets.” While this exception has been broadened, the FTC made clear that such noncompetes are still subject to relevant state laws as well as federal antitrust law.
- **Inclusion of “senior executive” limitation for existing noncompetes.** The notice of proposed rulemaking questioned whether noncompete clauses between employers and senior executives should be subject to a different standard than employers and other workers because noncompete for senior employees reflect negotiated value. The final rule partially recognized this distinction — it does not invalidate *existing*

noncompete clauses with senior executives — but does prohibit them on a forward-looking basis.

- **Notice requirement instead of rescission.** The proposed rule would have required employers to actively rescind existing noncompete clauses. However, the final rule instead merely requires that employers provide notice to workers bound to an existing noncompete that the noncompete will not be enforced.

Key questions of interpretation and enforcement

Although the final rule was published with 570 pages of background, findings and explanation, it raises a number of questions around enforcement and interpretation.

Less than 24 hours after the final rule was issued, the U.S. Chamber of Commerce and other interested parties filed suit ... seeking a declaratory judgment and injunction that would prevent the implementation of the final rule.

Clauses encompassed by rule. For example, the rule extends to clauses that “penalize[]” or “function[] to prevent” a worker from seeking or accepting employment from another firm, which empowers the FTC to take action against employers for clauses that it believes are functionally noncompetes.

The FTC indicated that, while most worker NDAs and nonsolicitation clauses are not necessarily within the scope of the rule, very broad or abusive versions of these kinds of devices could still be considered functional noncompetes if they prevent workers from accepting employment or operating a business.

“Senior executive.” The final rule also defines the term “senior executive” to refer to workers earning more than \$151,164 in the preceding year who are in a “policy-making position.”⁴

The final rule defines “policy-making position” as a business entity’s president, chief executive officer or the equivalent, and any other officer of a business entity who has policy-making authority. It defines “policy-making authority” as final authority to make policy decisions that control significant aspects of a business entity or a common enterprise.⁵

Public issuers should note that the FTC’s definition of “senior executive” is more limited than the Securities and Exchange Commission’s definition of “executive officer” under Rule 3b-7 of the Securities Exchange Act of 1934.

The FTC’s final rule does not categorically include in the definition of “policy-making position” the Rule 3b-7 category of “any vice president ... in charge of a principal business unit, division or function (such as sales, administration or finance)” and it also adopts a definition of policy-making authority that is more limited than “policy-making function” under Rule 3b-7.

These definitions leave significant room for interpretation, which in turn, will likely lead to practical and legal challenges to the rule’s applicability and enforcement.

Nonprofits. Another key area of ambiguity and likely challenge is the applicability of the rule to entities that claim nonprofit status. The FTC recognized that the final rule does not apply to entities that are not subject to the FTC Act, including certain financial institutions, common carriers and nonprofit entities.

This lack of jurisdiction has implications for industries where nonprofit models are common, such as certain health care institutions.

However, the FTC has taken the position that, even if an entity is a registered nonprofit for tax purposes, it may still be subject to the rule if it is a profit-making enterprise or organized for the profit of its members. In drawing this line, the FTC specifically referenced health care, but is likely to argue the scope of the rule extends to other similarly organized entities in other industries as well.

State law preemption. The final rule also carries over the regulatory floor on noncompetes from the notice of proposed rulemaking. It purports to preempt all state laws “inconsistent with” the final rule, but would not preempt those state laws that offer greater protection than the final rule. Considering that noncompete laws have been the domain of state legislatures for over 100 years, this is likely to create uncertainty regarding which state laws are and are not preempted.

The final rule faces immediate legal challenges

Since the notice of proposed rulemaking last year, it has been clear that the final rule would be challenged. In promulgating the rule, the FTC relied upon its claimed authority in Sections 5 and 6(g) of the FTC Act, which declare unfair methods of competition unlawful and authorize the commission to make rules, respectively.

In voting against the final rule, Republican Commissioners Melissa Holyoak and Andrew Ferguson — echoing the lengthy opposition of former Commissioner Christine Wilson and other critics — claimed that (1) the FTC lacks authority to engage in rulemaking of *substantive* competition rules (as opposed to *procedural* rules); (2) the rule is barred by the “major questions doctrine”; and (3), it is an impermissible delegation of legislative authority under the nondelegation doctrine.

Commissioners Rebecca Slaughter and Alvaro Bedoya and Chair Lina Khan have taken the position that the plain text of Section 5 and Section 6(g) expressly gives the FTC authority to promulgate rules addressing unfair methods of competition and have cited case law from the 1970s in support.

But critics have emphasized that superseding legislation and modern agency interpretations call into question whether the FTC has this expansive authority and also argue the final rule violates constitutional law and principles of statutory interpretation.

In fact, less than 24 hours after the final rule was issued, the U.S. Chamber of Commerce and other interested parties filed suit in the U.S. District Court for the Eastern District of Texas seeking

a declaratory judgment and injunction that would prevent the implementation of the final rule.⁶

The suit has been assigned to Judge J. Campbell Barker, who recently sided with the Chamber of Commerce in striking down a National Labor Relations Board rule,⁷ although the FTC will likely seek transfer to a more favorable forum.

Assuming no injunction prevents the rule from taking effect, employers should be mindful of the retroactive effects of the final rule.

The challengers allege that the FTC lacks authority to enact the rule (an argument bolstered by the “major-questions doctrine”), that the final rule is inconsistent with the FTC Act because noncompete agreements are not “categorically unlawful,” that the retroactive invalidation of noncompetes exceeds the FTC’s authority and raises Fifth Amendment concerns, and that the final rule is arbitrary and capricious.

They also preserve an argument, foreclosed by current Fifth Circuit precedent, for potential Supreme Court review: that the structure of the FTC violates Article II of the Constitution because FTC Commissioners are improperly insulated from presidential removal.

A separate suit brought by Ryan, a tax services firm, in the U.S. District Court for the Northern District of Texas also seeks to vacate the FTC’s rule on similar grounds.⁸

Key points for employers

Although the final rule will not take effect for 120 days from publication in the Federal Register and will be subject to challenges that may delay or impact its effect, in the meantime, employers should take stock of their current policies and employment contracts.

Retroactive effects. From the FTC’s perspective, noncompetes include both affirmative obligations to refrain from competition as well as forfeiture-for-competition provisions that penalize workers. Assuming no injunction prevents the rule from taking effect, employers should be mindful of the retroactive effects of the final rule.

While noncompetes entered into after the effective date would be unenforceable for all workers, existing noncompetes are only unenforceable for workers who are not senior executives. This provides a short window of opportunity for employers to enter into enforceable noncompetes with their senior executives, and the FTC’s rule may actually result in the introduction of new senior executive noncompetes in that window.

There are no penalties attached to employers for entering into noncompetes before the effective date.

Notices. Employers should also begin to prepare notices for non-executives, which should be delivered prior to the effective date.

These notifications should signal to workers that the employer no longer plans to enforce their noncompete against the worker in the future.

The FTC, in the final rule, provides model language for employers to use as notice to workers that their noncompetes are no longer enforceable. Under the final rule, the use of the FTC’s model language fulfills the notice requirement.

Alternative protections. For employers concerned about employees leaving for competitors and taking trade secrets along with them, the FTC suggests using nondisclosure agreements. Other forms of restrictive covenants may also be employed to protect an employer’s business, as long as the restrictive covenant does not “penalize[] a worker” or “function[] to prevent a worker” from working for a different employer.

Nonsolicitation agreements that bind employees are one such option for employers that is not categorically prohibited by the final rule, as long as the agreement is drafted to not be so broad as to have the same functional effect as a noncompete. Nonsolicitation agreements are still subject to applicable state laws and other antitrust considerations.

For employers concerned about employees leaving for competitors and taking trade secrets along with them, the FTC suggests using nondisclosure agreements.

“Garden leave,” an arrangement where a worker remains employed and receives the same compensation and benefits, fixed-term employment contracts, or requirements that employees give advance notice of resignation may also continue to be options for employers, as they do not fall squarely under the final rule’s definition of noncompete.

Similarly, the use of contingent or accrued bonuses that require repayment or loss of sick days if an employee ends their employment before a certain period of time would not be deemed noncompetes under the rule so long as those conditions are not tied to who the worker can work for or their ability to start a business after leaving their current job.

Enforcement

To enforce violations of the final rule, the FTC could potentially commence an administrative proceeding under Section 5(b) or seek a district court injunction under Section 13(b) of the FTC Act. Accordingly, the FTC could seek to enjoin a defendant in federal court when the defendant “is violating, or is about to violate” Section 5 and such an injunction is in the public’s interest.

In this case, the FTC could seek an injunction forcing companies to follow the noncompete clause rule, including via rescinding existing

noncompete agreements and informing current and former workers that they have been canceled.

By contrast, the FTC may be unable to seek monetary relief for violations of this competition rule. Section 19 of the FTC Act enables the FTC to seek monetary relief for violations of consumer protection rules on unfair or deceptive practices, but it is silent regarding remedies for unfair methods of competition.

In addition, the Supreme Court held in *AMG Capital Mgmt., LLC v. FTC* that courts may not grant equitable monetary relief such as disgorgement or restitution under Section 13(b) of the FTC Act.

Notes:

¹ <https://bit.ly/44tdzxY>

² <https://bit.ly/3wkkmgG>

³ “Worker” is defined to include employees, interns, externs, independent contractors, volunteers, apprentices and sole proprietors, whether paid or unpaid. Notably, “workers” does not include franchisees in the context of a franchisor-franchisee relationship, but does include employees of franchisees.

⁴ Federal Trade Commission, Non-Compete Clause Rule (April 23, 2024) (pp. 268-69).
⁵ *Id.* at 562.

⁶ Daniel Wiessner, “US Ban on Worker Noncompete Agreements Faces Lawsuit From Major Business Group,” Reuters, (April 24, 2024), <https://reut.rs/3QveoAy>. See *Chamber of Commerce v. FTC*, No. 6:24-CV-148 (JCB) (E.D. Tex. April 23, 2024).

⁷ *Chamber of Commerce v. NLRB*, 2024 WL 1203056 (E.D. Tex. March 18, 2024).

⁸ See *Ryan, LLC v. FTC*, No. 3:24-CV-986-E (AB) (N.D. Tex. April 23, 2024).

About the authors



(L-R) **Shay Dvoretzky** is head of **Skadden, Arps, Slate, Meagher & Flom LLP**'s Supreme Court and appellate litigation group, representing clients in matters before the U.S. Supreme Court, federal courts of appeals and state appellate courts. He is based in Washington, D.C., and can be reached at shay.dvoretzky@skadden.com. **Page W. Griffin** is a partner in the firm's executive compensation and benefits group. He advises companies, executive management teams and individual executives on the design, implementation and termination of compensation and benefit arrangements, including executive employment and severance agreements; retention, severance and change-in-control plans; cash and equity-based incentive programs; and nonqualified deferred compensation plans. He is based in Palo Alto and can be reached at page.griffin@skadden.com. **Joseph M. Rancour** is a partner in the firm's antitrust/competition group and represents clients in mergers and acquisitions, conduct investigations, counseling, and litigation. Rancour has broad antitrust experience across a variety of industries, including semiconductors, technology platforms, telecommunications, medical devices, life sciences, chemicals and financial exchanges. He is based in Washington, D.C., and can be reached at joseph.rancour@skadden.com. **David E. Schwartz** serves as global head of the firm's labor and employment law group. He advises clients on a full spectrum of employment-related issues, and often with respect to noncompetes and other restrictive covenants. He is based in New York and can be reached at david.schwartz@skadden.com. The authors would like to thank law clerk Oliver F. Green, associate Christopher McCooey, and associate Connor A. Riser for their contributions to this article. This article was originally published April 24, 2024, on the firm's website. Republished with permission.

This article was published on Westlaw Today on May 6, 2024.

* © 2024 Shay Dvoretzky, Esq., Page W. Griffin, Esq., Joseph M. Rancour, Esq., and David E. Schwartz, Esq., Skadden, Arps, Slate, Meagher & Flom LLP

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.