SMITH O'CALLAGHAN & WHITE

33 NORTH LASALLE STREET
SUITE 3600
CHICAGO, ILLINOIS 60602

WEBSITE
www.socw.com

TELEPHONE
(312) 419-1000

NEW FEDERAL TRADE COMMISSION RULE POTENTIALLY BARS MOST NON-COMPETE AGREEMENTS

On April 23, 2024, the Federal Trade Commission (FTC) in Washington, D.C. voted 3-2 to approve and issue a final rule that purports to ban non-compete agreements for nearly all workers of for-profit employers with limited exceptions. If the final rule survives legal challenge and goes into effect – it is not yet effective and there is serious question whether it survives legal challenges, *existing* non-compete agreements will not be enforceable by employers except for existing non-compete agreements with employees meeting the definition of a "senior executive." The final rule if it goes into effect also will ban *new* non-compete agreements with all workers, including senior executives.

More specifically, the final rule makes it an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause, to enforce or attempt to enforce a non-compete clause, or to represent that the worker is subject to a non-compete clause.

The 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.

When would the new final rule go into effect? The new final rule does not become effective immediately. It would go into effect 120 days after the rule's publication in the Federal Register. That is not 120 days after the FTC's April 23, 2024 public announcement which has been covered by news sources. The final rule is expected to be published in the Federal Register on May 7, 2024, *giving the rule an effective date of approximately September 4, 2024*, subject to the outcome of legal challenges to the rule. When published, the final rule will be codified as 16 C.F.R. Part 910.

Several lawsuits already have been filed challenging the enforceability of the FTC's new final rule. These challenges assert that the FTC lacks authority to engage in rulemaking regarding unfair methods of competition, the FTC lacks congressional authorization to issue this final rule, the FTC's action is an impermissible delegation of legislative authority, and the FTC's enactment of the rule fails to take into consideration the economic impact of the rule on employers and businesses. If a Federal Court enters a temporary restraining order or preliminary injunction the effective date of the new rule may be impacted. Many legal commentators expect that the rule will be invalidated as a result of the legal challenges.

What businesses and workers are covered by the final rule? The rule covers any employer, including a natural person, partnership, corporation, association or other legal entity within the FTC's jurisdiction, including any person acting under color or authority of state law, which effectively includes all persons or businesses operating for profit. It would prohibit non-compete agreements for any type of worker including employees, independent contractors, interns, volunteers, apprentices or sole proprietors who provide a service to a client or customer.

The FTC Act does not apply to non-profit organizations such as 501(c)(3) entities that are not organized to carry on business for their own profit, as well as certain banks and financial institutions and common carriers and air carriers. Accordingly, the final rule does not apply to employees in such organizations. However, if such 501(c)(3) tax-exempt organizations are actually profit-making enterprises they may still be covered by the final rule.

Non-compete agreements between members or individuals in partnerships and LLC's may remain enforceable if the parties to such non-compete agreements are not also employees. Non-compete agreements between businesses and between franchisor and franchisee are not covered by or subject to the new final rule.

Would the new rule impact existing or only new non-competes? The final rule would ban new non-compete agreements with all workers, including senior executives, after the effective date. For existing non-compete agreements, only those agreements with "senior executives" may be enforced after the final rule takes effect. "Senior executive" is defined under the final rule to mean a worker earning more than $151,164 in total compensation who is in a "policy-making position." A policy making position means an entity's president, CEO or the equivalent, or any other officer who has policy making authority which the rule defines as having final authority to make policy decisions that control significant aspects of a business entity. Whether an employee is in a "policy-making position" is likely to be the subject of litigation if the final rule goes into effect.

Would the final rule prohibit confidentiality and non-solicitation agreements? The final rule does not expressly prohibit employers from using confidentiality or customer or employee non-solicitation agreements, and such agreements should remain enforceable so long as they are narrowly tailored and not overly broad or restrictive. We expect this case and fact specific question to be litigated and courts will determine whether such agreements rise to the level of a "non-compete" agreement if they "function to prevent" a worker from accepting a position or starting a business after their employment ends. The broader the scope of such confidentiality and non-solicitation agreements the more likely they are to be interpreted to function as an unlawful non-compete. Whereas, more narrowly drafted non-disclosure agreements that protect an employer's confidential and proprietary information and non-solicitation agreements limited to clients that an employee serviced or for which they were responsible are likely to remain enforceable.

What other exceptions might apply? The final rule does not apply to non-compete agreements in the sale of business context. Specifically, non-compete agreements entered into as part of the sale of a business, as contrasted with the typical employer-employee relationship, will remain enforceable.

Employers with existing non-compete agreements may still bring claims or causes of action against employees who breach their non-competes if the breach occurred prior to the date the new final rule goes into effect. This may be especially important if expected legal challenges to the new final rule delay its effective date. So, the passing of the new final rule is not a license to breach an existing non-compete.

The new rule would not appear to apply to restrictions that prohibit an employee from competing for some period of time after providing notice of resignation in "garden leave" situations. So-called "garden leave" restrictions prohibit an employee from competing for some specific period during which they technically remain employed with the employer and receive their pay. Such agreements do not appear to fall under the rule's definition of "non-compete" agreement.

Importantly, employers should review their information security measures and trade secret protections, including ensuring that employees sign confidentiality and non-disclosure agreements and limit information on a need to know basis. Trade secret laws and non-disclosure agreements both provide employers with well-established means to protect proprietary and other sensitive information.

What should employers do? In the event that the final rule survives all legal challenges and goes into effect on approximately September 4, 2024, notice is required to employees regarding existing non-compete agreements being declared unenforceable under the new rule. Specifically, employers must provide a "clear and conspicuous" notice by the effective date of the new final rule to workers bound by an existing non-compete agreement (other than senior executives) that the non-compete agreement will not be and cannot legally be enforced against them in the future. The notice can be personally delivered or sent by mail or email to the employee. In the event the FTC's new final rule survives legal challenge and is set to go into effect, we will provide an updated alert addressing the required notice in more detail.

Employers should also note that the final rule supersedes all state laws and regulations that are not consistent with the FTC's final rule, meaning states may impose regulations on non-competes that afford greater protections to employees but not with less protections. If the final rule survives legal challenge, employers may be left with multiple different rules governing the use of non-compete agreements in their respective states.

Smith O'Callaghan & White
www.socw.com

Robert R. Duda Jr. robert.duda@socw.com
Terry J. Smith terry.smith@socw.com

May 1, 2024