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FTC's Final Rule Prohibits Non-Competes With Employees

On April 23, 2024, the FTC voted to adopt a rule prohibiting employers from entering into non-competes with workers employed by companies over which the FTC has jurisdiction. In accordance with the commentary issued in connection with its proposed rule, issued on January 4, 2023, and as discussed in a prior Client Alert, which addressed the rule as initially proposed, the FTC has held that non-competes with employees are an unfair method of competition, and therefore a violation of Section 5 of the Federal Trade Commission Act.

The final rule provides that existing non-competes with workers will be unenforceable after the effective date of the final rule, which will take effect 120 days from the date the rule is published in the *Federal Register*. This date is expected to occur on or about August 21, 2024. By the rule's effective date, employers are required to notify workers who previously entered into non-competes that such agreements cannot and will not be enforced, unless they fit within the "senior executive" exception, as explained in greater detail below.

A non-compete is broadly defined to go beyond a traditional contract. Instead, the final rule defines a non-compete as any term or condition of employment, whether 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 . . .; or (2) operating a business in the United States" where such actions occur after conclusion of the employment. The final rule's commentary indicates that the rule is still intended to prohibit "de facto" non-competes, including overbroad non-solicitation agreements, non-disclosure restrictions and training repayment agreements, as well as forfeiture for competition agreements. The commentary indicates that garden leave restrictions would be acceptable to the extent the worker remains employed and compensated at the employee's regular rate of pay throughout the leave period.

[1] The Federal Trade Commission Act applies only to entities "organized to carry on business for [their] own profit or that of [their] members." While this would appear to remove any not-for-profit organization from the Act's jurisdiction, the comments to the final rule note that having tax-exempt status under the Internal Revenue Code will not necessarily exempt an organization from coverage. According to the final rule, to determine if the FTC has jurisdiction, the FTC will evaluate (1) whether an organization is engaged in business for a charitable purpose, and (2) whether the organization or its members derive a profit.

Notably, a worker is defined as "a person who works or who previously worked, whether paid or unpaid, without regard to the worker's title or the worker's status" including whether the worker is an employee, independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a person. This means that companies may not enter into non-competes with independent contractors or other non-employee workers.

Exceptions

The final rule provides an exception for non-competes with "senior executives" existing as of the effective date, meaning such non-competes are not invalidated by the final rule if all of the requirements of the exception are met. However, the final rule prohibits companies from entering into new non-competes with senior executives after the effective date of the rule. The rule defines "senior executive" to mean a worker earning $151,164 or more annually who is in a "policy making position." A "policy-making position" means an individual "with the final authority to make policy decisions that control significant aspects of a business entity[.]"

As in the proposed rule, non-competes entered into in connection with the bona fide sale of a business entity are not prohibited by the rule. However, the final rule does not require the individual to hold a specific ownership percentage, unlike the proposed rule, which required ownership of at least 25% of the business.

Non-competes entered into by a franchisee in the context of a franchisee-franchisor relationship are not impacted by the rule.

Preemption of State Law

The final rule specifically preempts state law to the extent such laws would otherwise permit a non-compete made invalid by the rule. State laws that restrict non-competes and do not conflict with the final rule are not preempted. For instance, in states that permit non-competes for workers earning less than $150,000 per year, the FTC's rule will control.

Guidance to the final rule indicates that non-competes outside the FTC's jurisdiction or otherwise outside the scope of the final rule will be covered by state restrictive covenant law.

Legal Challenges and Action Items:

The final rule is likely to face several legal and constitutional challenges in the coming days, and may be enjoined. In fact, one such legal challenge has already been filed by a tax services firm in the Northern

District of Texas. In addition, the U.S. Chamber of Commerce, along with other business associations, filed suit for declaratory and injunctive relief in the Eastern District of Texas.

Despite these legal challenges, employers should nonetheless start preparing to take the following actions until and unless an injunction is issued:

- By the effective date, which is anticipated to be on or about August 21, 2024, plan to notify current and former employees (excluding "senior executives" who meet the compensation requirements of the final rule) who are subject to existing non-competes that the previously executed non-compete provisions are no longer effective. The FTC has provided a sample notification form that employers may use;
- Carefully review and revise agreements to ensure targeted yet effective protection for customer, employee and other business relationships as well as confidential information, trade secrets and other proprietary information. This can be accomplished through the use of narrowly tailored non-solicitation and confidentiality agreements;
- Review and revise internal policies and procedures related to the protection of confidential information, trade secrets and other proprietary information, including limiting access, imposing passwords, and prohibiting the use of personal devices at work or removing or accessing confidential information away from the workplace;
- Consider whether to implement garden leave agreements if, through a business evaluation, it is determined that prohibiting key employees from working for a competitor after they are no longer working for your business would be justified from a risk and economic standpoint; and
- Prepare to litigate trade secret claims under applicable state or federal law.

If you have any questions about the FTC's Rule, or how it may impact your organization, please contact your Kutak Rock attorney or a member of the firm's National Employment Law Group. You may also visit us at www.KutakRock.com.