

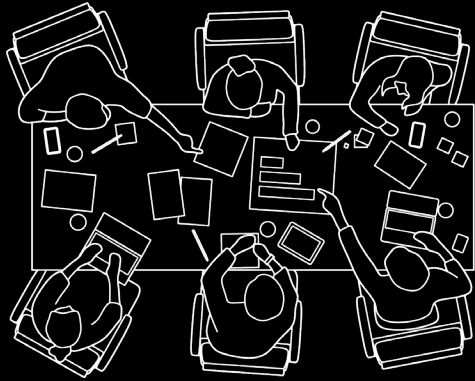
Davis Polk

# The FTC Non-Compete Rule

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# Overview

On April 23, 2024, the Federal Trade Commission finalized its rule banning almost all post-employment\* non-competes with workers, regardless of the worker's job title or level of compensation.

The final rule includes limited exceptions for existing non-competes with "senior executives" and non-competes entered into pursuant to a sale of business. In additions, the rule is limited to those entities over which the FTC has jurisdiction.

*\*The FTC rule applies broadly to all "workers," whether employees or independent contractors. Use of "employee," "employer," and "employment" throughout the FTC rule and these materials is shorthand for any type service recipient/service provider relationship.*

# Definition of a “non- compete clause”

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 U.S. with a different person where such work would begin after the conclusion of employment that includes the term or condition; or
  - (ii) operating a business in the U.S. after the conclusion of the employment that includes the term or condition.

# Non-compete clause (cont.)

## Prohibits

- Expressly prohibits a worker from seeking or accepting other work or starting a business after their employment ends
- Standard plain vanilla non-compete (*example*: worker cannot work for another sandwich shop within 3 miles of any of chain's locations for two years after termination)
- FTC states that the vast majority of existing agreements covered by the FTC rule will call into this category

## Penalizes

- Requires a worker to pay a penalty for seeking or accepting other work or starting a business after their employment ends (*example*: liquidated damages to compete)
- Extinguishes a person's obligation to provide promised compensation or to pay benefits as a result of a worker seeking or accepting other work or starting a business after they leave their job

## Functions to Prevent

- Restrains such a large scope of activity that it functions to prevent a worker from seeking or accepting other work or starting a new business after their employment ends
- So broad or onerous that it has the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work or starting a business after their employment ends

# Non-compete clauses (cont.)

The FTC acknowledged a wide range of comments that it received, and expressly declined to rule on every factual situation.

## ✓ Not “non-competes”

- **Repayment of a bonus** where worker leaves their job before a certain period of time and the repayment amount is no more than the bonus received and the agreement is not tied to who the worker can work for
- **Traditional garden leave:** worker is still employed and receiving the same total annual compensation and benefits, because according to the FTC, such an agreement is not a post-employment restriction
- **Severance agreement** that imposes no restrictions on where the worker may work following the employment, because according to the FTC, it does not impose a post-employment restriction

## X “Non-competes” under FTC rule

- **Forfeiture-for-competition clauses:** as with the liquidated damages clauses, they impose adverse financial consequences on a former employee as a result of the termination of an employment relationship, expressly conditioned on the employee seeking or accepting other work or starting a business after their employment ends.
  - *Note, unlike almost every other hypothetical, the FTC offered no citations to previous court cases or specific reference back to comment letters cited*
- **Severance arrangement** in which the worker is paid only if they refrain from competing

## ? Grey Area

- “Forfeiture-for-competition” versus “continued employment requirement” or “forfeiture on termination”
  - “The common thread that makes each of these types of agreements non-compete clauses ... is that on their face, they are triggered where a worker seeks to work for another person or start a business after they leave their job.”
- Can an employer cease to pay traditional garden leave if employee quits?

# Non-compete clauses (cont.)

NDA and non-solicits

## ✓ Not “non-competes”

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- Garden-variety NDA, where the NDA’s prohibitions on disclosure in a future job do not apply to information that (1) arises from the worker’s general training, knowledge, skill or experience, gained on the job or otherwise; or (2) is readily ascertainable to other employers or the general public
- Non-abusive training repayment agreements (TRAPs)
- Non-solicitation agreements, if not overly broad
- IP assignment provisions

## X “Non-competes” under FTC rule

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- An NDA that bars a worker from disclosing, in a future job, any information that is “usable in” or “relates to” the industry in which they work, or that bars a worker from disclosing any information or knowledge the worker may obtain during their employment whatsoever, including publicly available information
- Certain overly broad or onerous TRAPs, non-solicits or IP agreements that would “function to prevent”

# Covered individuals

“Worker” is defined as any natural person who works or who previously worked, whether paid or unpaid, without regard to job title or job classification under state or federal law.

- Encompasses employees, independent contractors, interns, volunteers and sole proprietors or owners who provide services to or for the benefit of the business
- Remains silent as to directors
- The term excludes franchisees in franchisor-franchisee relationships, but not employees of the franchisor or franchisee

# Exemptions

- Existing non-competes with “senior executives”
- Non-competes entered into in connection with a sale of business
- Entities not subject to FTC jurisdiction



# Limited exemptions for senior executives

- For **existing** (but not new) non-compete agreements, the final rule distinguishes between “senior executives” and other workers
  - It permits existing non-competes to remain in effect for “senior executives”
  - For all other workers, non-competes are immediately unenforceable once the rule becomes effective
- Senior executives are defined as workers who (1) were in a policy-making position and (2) received a total annual compensation of at least \$151,164 in the preceding year (annualized if partial year)
  - A “policy-making position” means president, chief executive officer or equivalent, any other officer of who has policy-making authority, or any other natural person who has policy-making authority similar to an officer with policy-making authority
    - “Officer” means president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any natural person routinely performing corresponding functions
    - “Policy-making authority” means final authority to make policy decisions that control significant aspects of a business entity or common enterprise (does not include authority limited to such decisions for only a subsidiary or affiliate of a common enterprise)
  - “Total annual compensation” is based on worker’s earnings, and may include salary, commission, nondiscretionary bonuses and other nondiscretionary compensation earned during the applicable period; does not include board/lodging, payments for medical insurance, life insurance, contributions to retirement plans and other similar fringe benefits
  - “Preceding year” means a person’s choice of most recent 52-week period, most recent calendar year, most recent fiscal year, or most recent anniversary of hear year

# Limited exemptions for senior executives (cont.)

## Areas of uncertainty

- Relevant time of determination of “senior executive” status: at time of entry into existing non-compete, on effective date of FTC rule, or at time of termination of employment? Can one shift in and out of senior executive status (and if so, does non-compete immediately end, or immediately come back to life)?
- Impact of future amendments of existing agreements with senior executives that contain non-competes
- There is not a neat line between the FTC’s concept of “senior executives” and workers who have agreements with compensation – whether paid or promised to be paid – contingent on a non-compete
- Uncertainty should diminish over time, however, as existing non-competes run their course

# Exemption under a business sale and other exemptions

- The rule exempts non-competes entered into by a person pursuant to a
  - bona fide sale of a business entity
  - sale of the person's ownership interest in a business entity
  - sale of all or substantially all of a business entity's operating assets
- This is a material change from the proposed rule, under which the sale-of-a-business exception required at least a 25% ownership interest in the business entity being sold
  - In the final rule, there is no minimum ownership percentage (nor minimum sales proceeds or minimum holding period) for this exemption to apply

# Entities exempt from FTC Act

- Certain industries exempt from FTC Act, including banks, savings and loan institutions, federal credit unions, common carriers, air carriers and foreign air carriers, and persons and businesses subject to the Packers and Stockyards Act
  - **Note:** While banks are exempt from FTC Act, bank holding companies are not exempt
- Nonprofit organizations (including certain nonprofit health care providers)
  - **Note:** While nonprofits are exempt from FTC Act, certain nonprofits use management or administrative corporations that may be for-profit entities (e.g., health care organizations using for-profit medical groups to employ physicians and hospitals contracting with for-profit staffing companies to provide coverage), which would be covered by the FTC Act

# International application of the rule

- Definition of non-compete clause is expressly limited to terms or condition that prevent workers from seeking or accepting work in the U.S. or operating a business in the U.S.
- Does not apply to non-competes that restrict work or starting a business outside the U.S.
- Could apply to overseas employers if the non-compete purports to restrict work in the U.S. or starting a business in the U.S. and the reviewing court applies U.S. law

# Legal challenges

At least three lawsuits have already been filed challenging the FTC's authority in creating the rule and the constitutionality of the FTC itself, and more will almost certainly follow. The legal challenges to the final rule fall into the following categories:

- FTC's unfair methods of competition rulemaking authority
- Major Questions doctrine
- FTC's rulemaking process
- FTC's interpretation of Section 5 of the FTC Act:
- Delegation of authority to the FTC
- Retroactivity of the rule
- Constitutionality of the FTC's structure

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## What happens next?

- The rule will not come into effect until 120 days after publication in the Federal Register
- This may be further delayed if it is enjoined by the courts or voluntarily stayed as litigation proceeds
- In the intervening period, the general prohibition on entering into or enforcing non-competes will not be in effect, either for “senior executives” or other workers
- Once the rule comes into effect, companies are required to give notice to current and former workers who are subject to a non-compete (other than senior executives) that their non-compete is no longer enforceable

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## What should companies do now?

Many more states are passing non-compete bans and restrictions, and Congress could do the same, and courts have become more dubious of enforcing non-competes. In light of this, **regardless of the outcome of the FTC rule, companies that rely on non-compete covenants should consider:**

- reviewing other restrictive covenants, like confidentiality, IP covenants and non-solicitation covenants
- utilizing and/or formalizing notice provisions and garden leave provisions in employment agreements (in lieu of more traditional severance arrangements)
- in M&A transactions, consider seeking non-competes from key management equity holders
- reviewing overall compensation and incentive plan structure to ensure there are other incentives for employees to stay with the company, e.g., longer retention and/or vesting periods



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## What should companies do now?

In order to prepare for the possibility that the FTC rule may survive, companies should consider:

- following whether the rule is enjoined, and the deadline for compliance if not
- adding additional language to any agreements making clear that they are enforceable only to the extent permitted by law, and confirm relevant severability/blue pencil provisions are in place
- finalize arrangements with “senior executives” before the rule comes into effect and (where appropriate) seek express acknowledgement from senior executives that they qualifies as a “senior executive” under the final rule
- taking inventory of their current arrangements that may contain non-competes, such as employment agreements, severance agreements, operating agreements and equity plans, and prepare list of affected current and former employees for notice
- in considering whether to bolster its other restrictive covenants, remain mindful that the final rule prohibits arrangements that are functionally equivalent to non-competes

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## Key takeaways

- The final rule reflects an ambitious undertaking by the FTC to expand its regulatory power and reinforces its heightened focus on labor markets
- Pending outcome of litigation challenging the final rule, the FTC may continue to bring enforcement actions challenging non-competes on a case-by-case basis and to investigate suspected limits to competition in labor markets
- Additionally, state legislatures may continue to enact new state laws limiting non-competes or, as was true in a new California law passed earlier this year, to strengthen existing limitations

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