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April 2024

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FTC Announces Expansive and Unprecedented Non-compete Ban

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On April 23, 2024, the Federal Trade Commission (FTC) adopted a Non-Compete Clause Rule (the "Rule") prohibiting most employee non-compete agreements as unfair methods of competition by a vote of 3 to 2. The Rule is a somewhat narrowed version of the regulation proposed in January 2023. In voting for the passage of the Rule, FTC Chair Lina Khan took the position that non-compete agreements have a net negative impact on working conditions, labor markets, and product-and-service markets, and that "robbing people of their economic liberty also robs them of all sorts of other freedoms" and stifles innovation. Chair Kahn also took the position that the FTC has the authority to issue the Rule, a statement that was disputed by the dissenting commissioners.

The FTC regulation stems from a notice of proposed rulemaking issued in January 2023, which was subject to a 90-day public comment period. This marks the FTC's most notable attempt to date to use its authority under Section 5 of the FTC Act to expand enforcement efforts into new areas of the economy. Members of the public submitted more than 26,000 comments during the proposed rule's notice-and-comment period.

While legal challenges are anticipated, employers should take steps to minimize exposure and protect their interests.

To Whom Does the Rule Apply?

The Rule covers most workers—paid and unpaid—in most industries. A "worker" is broadly defined to include not just employees but independent contractors, interns, volunteers, apprentices, and sole proprietors who provide services to a client. It also includes former workers that may be covered by an employer's non-compete agreement, even though no longer employed by the employer.

The Rule deliberately leaves "Employer" undefined, but most employers are covered. However, some exceptions apply. For example, non-profit entities as well as certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers and foreign air carriers, and persons subject to the Packers and Stockyards Act of 1921, sit outside the scope of the FTC Act. These entities need not alter their approach to non-compete agreements in response to the new rule (though other regulations may apply).

The FTC estimates the Rule covers 99% of non-senior executive workers. Notably, the Rule does not govern non-competes between franchisors and franchisees, though commissioners in the majority indicated they would be interested in seeing an applicable policy in the future.

What Does the Rule Cover?

The Rule defines a "non-compete clause" as "a term or condition of employment that either 'prohibits' a worker from, 'penalizes' a worker for, or "functions to prevent" a worker from (A) 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 (B) operating a business in the United States after the conclusion of the employment that includes the term or condition." The Rule abandons the *de facto* test found in the prior rule.

In addition to restricting non-compete agreements going forward, the Rule generally invalidates prior agreements between workers and employers—with the exception of existing agreements for senior executives as described below—and prohibits employers from enforcing them. Additionally, employers must provide notice to workers with existing non-competes by the effective date; the Rule offers model language in section 910.2(b)(4), but employers are free to prepare their own language if they prefer. The notice must identify the person who entered into the non-compete with the worker and be delivered through at least one of the following methods: by hand to the worker, by mail to the worker's last known personal street address, at an email address belonging to the worker, or by text message. Employers are exempted from providing notice to workers when they have no record of that contact information.

The retroactive effect of the Rule does not apply to existing non-compete agreements with "senior executives." A senior executive is defined as an officer with final authority to make policy decisions that control significant aspects of a business, with annualized total compensation of $151,164 in the preceding year. This includes a business entity's president, chief executive officer or the equivalent, or any other worker of a business entity who has policy-making authority for the business entity. The Rule notes that this does not include workers with policy-making authority over only a subsidiary or affiliate of a common enterprise who do not have policy-making authority over the common enterprise. While the Rule forbids such non-compete agreements going forward, employers need not rescind or decline to enforce agreements made with senior executives. Prior to the vote, the FTC noted that agreements with senior executives are more likely to be negotiated than agreements with rank-and-file employees, so the non-compete may represent an important part of the overall deal reached by the parties; it would be unfair to invalidate one part of that deal and leave the balance intact.

Exceptions to the Rule

Notably, the Rule does not apply to non-competes entered into by a person pursuant to the bona fide sale of a business entity. It also does not apply where a cause of action relates to a non-compete cause of action that accrued prior to the effective date of the Rule. Finally, the Rule does not limit or affect enforcement of state laws restricting non-competes where the state laws do not conflict with the Rule, but where state laws do conflict, the Rule preempts such state laws.

What Will Enforcement Look Like?

For employers who sit under the FTC's regulatory authority, violations of the Rule may draw a range of enforcement actions from the FTC. Penalties include injunctions, reporting and other notice requirements, forced compliance with notice obligations to impacted employees and forced nullification of existing non-compete agreements, inspection of employer's premises by the FTC, and monetary fines.

Are Legal Challenges Expected?

Legal challenges to the Rule are expected. For example, the U.S. Chamber of Commerce announced it will file suit requesting an injunction barring enforcement of the Rule.

Given the scope of the Rule, we can expect challenges under several legal theories, including whether it falls outside the FTC's authority. The dissenting commissioners stated that the Rule is "likely" to be struck down and that the FTC Act is "nowhere close" to giving the FTC the authority to promulgate the regulation. (While the dissenting commissioners disagreed with the majority's interpretation of the FTC's authority, they neither expressly opposed limits to non-compete agreements as a matter of policy).

Another expected challenge to the Rule is under the "major questions" doctrine, which looks at whether Congress delegated issues of major political or economic significance to executive agencies. *See West Virginia v. EPA,* 597 U.S. 697 (2022) (rejecting claim of regulatory authority when (1) the underlying claim of authority concerns an issue of "vast 'economic and political significance,'" and (2) Congress has not clearly empowered the agency with authority over the issue). Indeed, in emphasizing the transformative effect of the Rule, challengers may rely on the FTC's own statements to support the notion that the Rule presents a "major question." The agency estimates it will have a $400 billion economic impact and affect the work of 30 million Americans.

As a former FTC commissioner suggested, we may see a similar challenge arguing that the FTC's regulation of non-compete agreements exceeds the agency's authority to regulate "unfair methods of competition" under Section 5 of the FTC Act. Traditionally, the FTC's mandate has focused on markets that impact consumer prices, and arguably the banning of non-competes goes beyond that mandate.

Commissioner Andrew N. Ferguson, one of the two commissioners who voted against the Rule, argued that even if the Rule falls within the FTC Act's assignment of authority, that assignment lacks an "intelligible principle" and therefore violates the non-delegation doctrine. *See Gundy v. United States*, 139 S. Ct. 2116 (2019) (reiterating that a congressional delegation of legislative power to an executive agency must articulate an "intelligible principle" to be lawful under separation of powers).

Challenges may also address the rulemaking process under the Administrative Procedure Act or the Rule's retroactivity via its application to pre-existing non-compete agreements.

Notably, over the last several months, the FTC has made numerous attempts to persuade states to leverage state law to ban non-compete agreements. The agency sent letters to New York, Oregon, and likely other states encouraging them to enact restrictive legislation promoting employment mobility. Potential litigators may argue that if a federal regulation were valid, there would be no need for states to enact their own.

What Are The Next Steps?

Despite the ongoing legal challenges, the Rule cannot be ignored. Unless it is modified by a legal challenge, the Rule's effective date (and the date on which compliance is required) will be 120 days after publication. We expect this to be as early as August 22, 2024.

Many employers have already begun to scrutinize the use and enforceability of non-competes. Many states, including California, Colorado, Minnesota, North Dakota, and Oklahoma, already have restrictions analogous to the new regulation. Other states, particularly in light of the FTC's recent advocacy, may tighten restrictions in the near future. Regardless of the outcome of the legal challenges to the Rule,

employers should be prepared to use other tools beyond non-compete provisions to protect their legitimate business interests and intellectual property.

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