Simpson Thacher

Memorandum

FTC Finalizes Rule Barring Non-Compete Clauses Between Employers and Workers, Court to Issue Merits Decision Before Rule's Effective Date

April 29, 2024

Introduction

On April 23, 2024, the Federal Trade Commission ("FTC" or "Commission") voted to finalize and promulgate a rule barring companies from entering into or attempting to enter into non-compete clauses (the "Rule"). This memorandum supplements our earlier memorandum regarding the Rule.

- The Rule largely mirrors the FTC's proposed rule announced on January 5, 2023 and "generally prevent[s] most employers from using non-compete clauses."[1]
- Specifically, the Rule bans all new non-competes with all workers, whether or not with a senior executive, by designating them as an unfair method of competition—and therefore a violation of Section 5 of the FTC Act.
- For existing non-competes, the Rule adopts a different approach, distinguishing between senior executives and other workers. Senior executives are those individuals in a "policy-making position" with annual compensation above $151,164 (see full definition below). For senior executives, existing non-competes can remain in force. However, existing non-competes with other workers are unlawful after the effective date.
- The Rule requires that employers provide written notice to all workers subject to unlawful non-competes by or before the effective date, and makes it unlawful for employers to maintain a non-compete with a worker or, in some cases, represent to a worker that the worker is subject to a non-compete.
- On its face, the Rule would bar all terms or conditions that prohibit a worker from "seeking or accepting work" with *any* different person, regardless of whether that other person is a competitor or not. Read literally, the Rule prohibits any term or condition that would prohibit, penalize, or functions to prevent a worker's ability to look for or accept new employment. If finalized and applied that expansively, this would have broad ramifications on common employment practices including retention bonuses, garden leave pay, signing bonuses, severance and the vesting of equity incentives. However, in its commentary the FTC said it does not consider to be a non-compete any agreement that is in effect only while the person remains

[1] Fed. Trade Comm'n, Open Commission Meeting, (Apr. 23, 2024), available here.

employed and receiving their same annual compensation and benefits (such as a common garden leave arrangement), or which does not create a restriction on where the worker may work following the termination of employment.

- The Rule also purports to preempt state laws other than those that are more restrictive than the Rule.
- Absent a court order enjoining enforcement of the Rule, it is expected to take effect 120 days after publication in the Federal Register. Multiple lawsuits challenging the Rule have been filed at the time of this alert, including by the Chamber of Commerce (the "Chamber").
- The Court overseeing the Chamber's lawsuit has set a schedule that would permit the Court to issue an order on the merits of the Chamber's legal challenge before the Rule's effective date.[2] Assuming no changes to the schedule, the Court could therefore declare the Rule unlawful before the rule comes into effect.[3]

The Commission may enforce the Rule through agency adjudication or an injunction. The Commission cannot obtain civil penalties unless a party is first ordered to cease and desist from a Section 5 violation but that party fails to comply with the court's order. Private plaintiffs are not authorized to bring lawsuits challenging a non-compete as unlawful under Section 5. However, as further discussed below, aggrieved employees may still find redress in declaratory judgment or other actions.

The vote to adopt the Rule was 3-2 along party lines, held during a special Open Commission Meeting. The dissenting Commissioners used the Open Commission Meeting as a forum to express their concerns about the substance and legality of the Rule. The dissenting Commissioners foreshadowed what is expected to be significant legal challenges to the Rule. We discuss those potential legal challenges further below.

Background

Economists have long recognized that non-compete clauses can help protect against the misuse or misappropriation of trade secrets and proprietary information, incentivize investments (particularly in employee training), innovation and new competitive strategies, and protect investors and their investments against free-riding.[4] Policy-makers have also theorized, however, that such non-competes can decrease worker mobility. Accordingly, historically, federal antitrust and state antitrust and unfair competition laws have taken a nuanced approach to the enforceability of non-compete provisions, implicitly recognizing that non-competes provide social benefits and should be evaluated on a case-by-case basis.

---

[2] Scheduling Order, *Chamber of Commerce of the United States v. FTC*, No. 6:24-cv-00148 (E.D. Tex. Apr. 26, 2024), ECF No. 20.

[3] Courts in the Fifth Circuit are no stranger to issuing, on an expedited basis, decisions that prevent the FTC from seeking to extend its statutory powers. For example, last year a court in the Eastern District of Louisiana held that the FTC could not subject a hospital merger to the notification and waiting period requirements of the HSR Act where the merger had already received a Certificate of Public Advantage ("COPA") from the State of Louisiana, reflecting the State's determination that the merger was in the public interest. See *Louisiana Children's Med. Ctr. V. Att'y Gen. of the United States*, No. 23-cv-1305, 2023 WL 6293887 (E.D. La. Sept. 27, 2023). From the time the first complaint was filed to the time the district court issued a decision rejecting the FTC's position was 161 days.

[4] *See, e.g.*, Kate Foreman & Gabriella Monahova, *A Review of the Economic Evidence on Noncompete Agreements*, Competition Pol'y Int'l, (May 31, 2023).

In a dramatic policy shift, the Rule implicitly adopts the view that all non-compete clauses are harmful because they not only suppress mobility in labor markets, contributing in some circumstances to lower wages and reduced innovation, but allow larger firms to gain concentrated market shares and ultimately result in higher prices for consumers.[5]

The Rule has attracted widespread attention. After the FTC proposed the initial version of the non-compete rule on January 5, 2023, over 26,000 public comments were submitted. The FTC extended the standard 60-day public comment period by an additional 30 days on a unanimous vote to accommodate the extensive range of interested parties seeking time to prepare and submit comments, and has taken the last year to evaluate those comments and draft the final Rule.

Final Rule

SUMMARY OF THE RULE

- ***The Rule purports to ban all terms or conditions that prohibit, penalize or function to prevent workers from "seeking or accepting work … with a different person where such work would begin after the conclusion of the employment that includes the term or condition."*** The Rule, on its face, is not limited to terms or conditions that prohibit workers from seeking or accepting work at *competing* firms.
- ***The Rule applies in both a forward-looking and retroactive manner.*** The Rule makes it illegal for an employer to enter into or attempt to enter into a new non-compete clause with any worker. As discussed above, the Rule also applies to existing non-competes, making it illegal for an employer to enforce or attempt to enforce an existing non-compete agreement with any worker, except with respect to senior executives. Additionally, the Rule makes it illegal to represent that a worker is subject to a non-compete clause.
- ***The Rule covers both express non-compete provisions as well as any "term or condition of employment" that functions as a non-compete.*** The Rule prohibits functional non-competes that (a) prohibit, (b) penalize or (c) function to prevent a worker from seeking or accepting employment with a different employer after the conclusion of employment. Examples of functional non-competes that penalize workers might include liquidated damages clauses, deferred compensation forfeiture-for-competition clauses, or severance agreements with payment conditioned on the worker refraining from accepting alternative employment (all of which are common terms of compensation programs). Examples of functional non-competes that function to prevent a worker from competing might include overly broad non-disclosure agreements, training repayment agreement provisions, and non-solicitation agreements. Whether a given restrictive covenant rises to the level of being a functional non-compete will turn on a

[5] Fed. Trade Comm'n, FTC Announces Rule Banning Noncompetes, (Apr. 23, 2024), available here.

case-by-case consideration of the facts and circumstances of the particular covenant and the surrounding market context.

- ***The Rule covers all workers, but permits the "grandfathering of existing non-compete provisions with some high-level executives.*** The Rule applies to any "worker," defined broadly as "a natural person who works or who previously worked, whether paid or unpaid" for a person, and expressly includes employees, independent contractors, externs, interns, volunteers, apprentices, or sole proprietors. The Rule also applies to existing worker non-competes, except for those involving "senior executives," whose non-competes are grandfathered in. A "senior executive" is defined as a worker who is (1) in a "policy-making position", and (2) in the preceding year, received for employment (i) total annual compensation of at least $151,164, (ii) total annualized compensation of at least $151,164 if employed for only part of the preceding year, or (iii) total annualized compensation of at least $151,164 in the preceding year prior to the worker's departure if the worker left employment in the previous year and is subject to a non-compete clause. "Policy-making position" means a business entity's president, CEO, or equivalent, any other person who has policy-making authority.[6] Partners, as a classification, are not explicitly included or excluded from the definition of "worker" under the Rule, but the preamble to the Rule does say non-competes with partners who have policy-making authority for a business presumably would be grandfathered with respect to existing non-compete provisions. The preamble also notes that partners would be eligible to use the sale of business exception if the partner leaves and sells their shares of the partnership. The Rule provides that a "worker" who does not have policymaking authority over a common enterprise may not be deemed to have a policy-making position even if the person has policy-making authority over a subsidiary or affiliate of a business entity that is part of the common enterprise.
- ***The Rule has few, but important, exceptions.*** *First*, employers that are outside the FTC's jurisdiction under the FTC Act are not subject to the Rule. The FTC Act exempts certain entities from the Commission's enforcement jurisdiction, including banks (but not necessarily affiliates of banks), non-retail segments of the meat industry, and certain non-profit organizations. *Second*, State and local government entities may not be subject to the Rule when engaging in activity protected by the State action doctrine. *Third*, the Rule does not apply to franchisees in the context of a franchisor-franchisee relationship. *Fourth*, the Rule does not apply to causes of action related to a non-compete provision that accrued prior to the Rule's effective date. *Fifth*, persons that have a good-faith basis to believe the Rule does not apply to them will not be penalized for enforcing or attempting to enforce non-competes (the "good faith basis exception"). *Finally*, the Rule exempts non-competes made pursuant to a bona fide sale of a business (the "sale-of-business exception"), with no required ownership threshold. The FTC's proposed rule had included a 25% ownership threshold for the sale-of-business exception to apply, which was excluded from the final version. In addition, the FTC's original proposed rule stated that for the sale-of-business exception to apply

[6] "Policy-making authority" is defined as "final authority to make policy decisions that control significant aspects of a business entity or common enterprise and does not include authority limited to advising or exerting influence overs such policy decisions or having final authority to make policy decisions for only a subsidiary of or affiliate of a common enterprise."

a seller would need to dispose of his or her entire interest in a business entity. That language was also excluded from the final Rule, so it appears that the FTC may be permitting the sale of business exception to apply in connection with partial sales (subject to applicable state law). However, there is nothing in the text of the Rule or the FTC's commentary that directly resolves that issue.

- ***The Rule does not provide a private right of action, but aggrieved employees could likely seek declaratory and other relief under state law.*** Section 5 of the FTC Act does not authorize employees to bring a private action to declare a non-compete unlawful under Section 5. Employees should still be able to seek judicial relief. For example, once the Rule becomes effective, an employee should be able to seek a declaratory judgment that a contractual non-compete is unenforceable since contractual provisions that violate federal laws, regulations, and the public policies derived therefrom are generally unenforceable.[7] These claims would likely be litigated in state court, although in some cases a suit could potentially be lodged in federal court (*e.g.*, where the employee can establish jurisdiction or state a separate, federal claim that invokes federal jurisdiction). In any event, the FTC will presumably be receptive to outreach from and be willing to bring suits on behalf of employees that wish to challenge an employer's non-compete.

IMPLEMENTATION

Absent a court order, the Rule will become effective 120 days after publication in the Federal Register. The Rule is expected to be published in the coming days.

SIGNIFICANT OPEN QUESTIONS

The Rule leaves many unanswered questions which will be left to resolution by interpretation and enforcement, including:

- how broadly the FTC intends to apply the phrase "functions to prevent" with respect to seeking or accepting employment, and whether such interpretation will impact common terms of employment that generally are not been viewed in the same vein as traditional non-competes, such as retention bonuses, garden leave periods, contingent or recoupable signing bonuses, and even the vesting of restricted stock or other equity incentive programs;
- whether and the extent to which application of the Rule might be triggered by a non-solicitation or non-disclosure agreement;

[7] *See, e.g.,* Rest. (Second) of Contracts § 178 cmt. a (1981) ("Occasionally, on grounds of public policy, legislation provides that specified kinds of promises or other terms are unenforceable. . . . Assuming that it is, the court is bound to carry out the legislative mandate with respect to the enforceability of the term."); *Vazquez v. Glassboro Service Ass'n*, 83 N.J. 86, 99 (1980) ("Contracts have been declared invalid because they violate statutes[.]"); *Kaiser-Frazer Corp. v. Otis & Co.,* 195 F.2d 838, 843 (2d Cir. 1952) ("[I]t is clear that a contract which violates the laws of the United States and contravenes the public policy as expressed in those laws is unenforceable."); *UMW of Am. Health & Ret. Funds v. Robinson*, 455 U.S. 562, 575 (1982) (holding that contract terms "are entitled to . . . respect" only "as long as such [terms] do not violate federal law").

- whether courts will hold grandfathered non-compete agreements to a higher standard of scrutiny under existing state law in light of this new regulatory pronouncement of federal antitrust policy;
- how to interpret and define a "common enterprise" and "policy-making authority" for purposes of application of the senior executive exception;
- whether modifications to, or extensions of the terms of a pre-negotiated non-compete in connection with a separation (even narrowing an existing lawful non-compete in that scenario) would result in loss of grandfathered status for senior executives;
- whether and the extent to which other federal agencies will seek to enforce the rule (or take action that has the same effect) with respect to entities subject to their jurisdiction[8];
- whether the sale-of-business exception is applicable to partial sellers.

Legal Challenges

We expect that the Rule will face multiple legal challenges. Global tax services company Ryan LLC and the Chamber sued to block the Rule shortly after the vote.[9] The Chamber, and others (including the dissenting Commissioners), have indicated that the Rule is subject to legal challenge on a variety of grounds.

LACK OF AUTHORITY

- ***Some opponents of the Rule, including the Chamber, have argued that the FTC lacks the authority to issue substantive rules regulating UMC.***[10] To enact the Rule, the FTC relies on its putative authority to issue rules regulating unfair methods of competition ("UMC") under Sections 5 and 6(g) of the FTC Act. The FTC's authority to issue substantive UMC rules is not well established. The FTC has promulgated only a single substantive rule—more than 50 years ago—in reliance solely on its UMC rulemaking authority, more than fifty years ago. That rule was never enforced and later repealed. The FTC's authority to conduct rulemaking under Section 6(g) has been tested in court only once. In 1973, the D.C. Circuit held in *National Petroleum Refiners Association v. FTC* that Section 6(g) does authorize the FTC to promulgate substantive Section 5 rules.[11] However, it is unclear (1) whether a court would uphold that ruling today, and (2) whether a ban on non-competes is within the FTC's Section 5 authority, even if the FTC is empowered to promulgate some substantive UMC rules.

[8] In a footnote, the FTC purported that while "[t]he FTC Act is the Commission's organic statute, and interpretive authority of the FTC Act rests with the Commission[,] [w]hether other agencies enforce section 5 or apply the rule to entities under their own jurisdiction is a question for those agencies."

[9] Compl., *Ryan LLC v. FTC*, No. 3:24-cv-986 (N.D. Tex. Apr. 23, 2024), ECF No. 1; Compl., *Chamber of Commerce of the United States v. FTC*, No. 6:24-cv-00148 (E.D. Tex. Apr. 24, 2024), ECF No. 1.

[10] *See, e.g.*, Christine S. Wilson, Comm'r, Fed. Trade Comm'n, Dissenting Statement Regarding the Notice of Proposed Rulemaking for the NonCompete Clause Rule, 1 (Jan. 5, 2023), available here.

[11] *Nat'l Petroleum Refiners Asso. v. FTC*, 157 U.S. App. D.C. 83, 482 F.2d 672, 698 (1973) ("We hold that under the terms of its governing statute, 15 U.S.C. § 41 et seq., and under Section 6(g), 15 U.S.C. § 46(g), in particular, the Federal Trade Commission is authorized to promulgate rules defining the meaning of the statutory standards of the illegality the Commission is empowered to prevent.").

VIOLATION OF THE ADMINISTRATIVE PROCEDURES ACT

- ***Others have argued, again including the Chamber, that the Rule violates the Administrative Procedures Act ("APA").*** Detractors raising an APA challenge may argue that the Rule is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[12]

CONSTITUTIONAL CHALLENGES

- ***The Rule is also likely to be challenged under, and the Chamber's complaint includes, the nondelegation doctrine.*** Where the major questions doctrine asks whether Congress has clearly delegated the authority to an agency to address a particular issue, the nondelegation doctrine asks whether Congress has impermissibly delegated its core legislative authority to an executive branch administrative agency without laying out an "intelligible principle" to guide the agency's use of its discretionary authority. In other words, Congress can only delegate legislative authority to administrative agencies to the extent it "clearly delineates the general policy . . . and the boundaries of this delegated authority" to guide the agency in the exercise of its granted authority.[13]
- ***Opponents may also challenge the Rule's constitutionality under the major questions doctrine.*** This doctrine evaluates federal administrative agency actions by asking "whether Congress in fact meant to confer the power the agency has asserted"[14] by looking to whether the "history and the breadth of the authority that the agency has asserted, and the economic and political significance of that assertion, provide a reason to hesitate before concluding that Congress meant to confer such authority."[15] In effect, where the underlying authority asserted by a federal administrative agency implicates an issue with vast economic or political implications, the major questions doctrine calls for courts to strike down the administrative action unless Congress has clearly granted the agency power to address the issue.
- ***Finally, the Rule is likely to face federalism concerns.*** Assuming Congress could delegate authority to the FTC to ban non-competes, a court may nonetheless find that delegation unlawful "not because Congress lacked legislative authority over the subject matter, but because those statutes violated the principles of federalism."[16] In essence, the federal government cannot "commandeer" state governments by requiring these states to adopt federal policies. Currently, 47 states permit non-competes to be enforced in at least some form. The Rule preempts these 47 state laws to the extent those laws are "inconsistent with [the Rule]," but allows state law to supersede the Rule if the state provision provides "greater [] protection" than the Rule. In other words, the Rule provides a floor, not a ceiling, for regulation of non-competes. However, several State Attorneys General have cautioned against a final rule to the extent it "preempt[s]

[12] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[13] *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 105 (1946).

[14] *West Virginia v. EPA*, 142 S. Ct. 2587, 2608 (2022).

[15] *Id.* at 2595 (cleaned up).

[16] *Reno v. Condon*, 528 U.S. 141, 149 (2000).

other state laws, such as antitrust, consumer protection, and other laws . . . [that] confer distinct enforcement rights to state agencies and residents not afforded by the [then-] proposed rule."[17] As such, the Rule risks scrutiny from claims that the FTC unlawfully "legislate[d] in areas traditionally regulated by the States."[18]

Next Steps

The Rule introduces sweeping changes to the use of non-compete agreements in the United States. As such, employers would be well-advised to evaluate the potential impact of the Rule on their past and future usage of non-competes for when (or if) the Rule formally goes into effect. As described above, multiple challenges to the Rule are expected—and indeed already occurring—on a variety of grounds, which may delay implementation of the Rule. While exact timing for resolution of the challenges is difficult to predict, the Chamber's lawsuit also involves a request to stay the implementation of the Rule pending the outcome of the challenge, which should be decided in the near term.

Simpson Thacher will continue to monitor developments including any challenges to the Rule and the timing for its implementation. In the meantime, please reach out to a member of the team if you have questions about how this Rule may impact your business.

[17] *See* Public Comments of 18 Attorneys General in Support of Notice of Proposed Rulemaking, Non-Compete Clause Rule, 88 Fed. Reg. 3482 (Jan. 19, 2023), (Apr. 19, 2023), available here. (cautioning that the final Rule clarify the scope of the Rule's preemption of state laws).

[18] *West Virginia v. EPA*, 142 S. Ct. at 2621 (2022) (Gorsuch, J., concurring) (citation omitted) ("[T]his Court has said that the major questions doctrine may apply when an agency seeks to 'intrud[e] into an area that is the particular domain of state law.'").

For further information regarding this memorandum, please contact one of the following authors:

ANTITRUST AND TRADE REGULATION

Lindsey C. Bohl
+1-202-636-5908
lindsey.bohl@stblaw.com

Abram J. Ellis
+1-202-636-5579
aellis@stblaw.com

Peter Guryan
+1-212-455-2750
peter.guryan@stblaw.com

Karen Kazmerzak
+1-202-636-5996
karen.kazmerzak@stblaw.com

Preston Miller
+1-202-636-5822
preston.miller@stblaw.com

Sara Y. Razi
+1-202-636-5582
sara.razi@stblaw.com

John Terzaken
+1-202-636-5858
john.terzaken@stblaw.com

Richard J. Jamgochian
+1-212-455-3019
richard.jamgochian@stblaw.com

EXECUTIVE COMPENSATION AND EMPLOYEE BENEFITS

Andrew Blau
+1-212-455-2380
andrew.blau@stblaw.com

Tristan Brown
+1-650-251-5140
tbrown@stblaw.com

Gregory T. Grogan
+1-212-455-2477
ggrogan@stblaw.com

Harry N. Hudesman
+1-650-251-5264
harry.hudesman@stblaw.com

Jamin R. Koslowe
+1-212-455-3514
jkoslowe@stblaw.com

Caitlin A. Lucey
+1-212-455-2775
caitlin.lucey@stblaw.com

Jeannine McSweeney
+1-212-455-3349
jeannine.mcsweeney@stblaw.com

Laurence M. Moss
+1-212-455-2280
larry.moss@stblaw.com

Brian D. Robbins
+1-212-455-3090
brobbins@stblaw.com

Erica Rozow
+1-202-636-5961
erica.rozow@stblaw.com

David E. Rubinsky
+1-212-455-2493
drubinsky@stblaw.com

LABOR AND EMPLOYMENT

Andrew M. Kofsky
+1-212-455-7437
andrew.kofsky@stblaw.com

Daniel J. Venditti
+1-212-455-7387
daniel.venditti@stblaw.com