

# U.S. Federal Trade Commission Issues Final Non-Compete Rule



On April 23, the U.S. Federal Trade Commission (FTC) issued its final rule (the Final Rule) prohibiting non-compete agreements with workers, with very limited exceptions. Unless litigation challenges prevail, the Final Rule will become effective on the date (the Effective Date) that is 120 days after publication in the Federal Register. The Effective Date will be on or around September 1, 2024.

## **What you need to know**

- **Scope.** The Final Rule bans all new post-employment non-compete clauses, regardless of a worker's compensation level, seniority or responsibilities.
  - The Final Rule also prohibits the enforcement of all existing post-employment non-compete clauses, except for existing non-compete clauses with "senior executives"—workers who are in a "policy-making position" and received total annual compensation of at least US\$151,164 in the preceding year.
- **Key exception.** The Final Rule permits non-compete clauses entered pursuant to a bona fide sale of business and the pursuit of claims accrued prior to the Effective Date.
- **Notice obligation.** The Final Rule requires employers to provide written notice to current and former workers subject to unenforceable non-compete clauses that the non-compete is illegal and unenforceable.
- **Employer considerations.** Lawsuits challenging the Final Rule may delay its implementation. However, employers should start preparing for the impact of the Final Rule on their businesses and workforce. We highlight some key areas of attention for employers below.

## **Non-compete clauses subject to the Final Rule**

Under the Final Rule, a non-compete clause includes a term or condition of employment that prohibits a worker from seeking or accepting work in the U.S. or operating a business in the U.S. during a post-employment period. A typical example would be a non-compete clause contained in an employment agreement or otherwise required as consideration for an employment offer, promotion or additional compensation.

A non-compete clause under the Final Rule also includes a term or condition of employment that penalizes or prevents a worker from seeking or accepting work in the U.S. or operating a business in the U.S. during a post-employment period. This would

typically include a severance arrangement with a worker where the severance entitlement is contingent upon the worker's continued compliance with the non-compete clause, or a compensatory equity award that is subject to forfeiture if the equity holder breaches a non-compete clause.

The Final Rule does not expressly apply to other restrictive covenants, such as non-solicitation or non-disclosure agreements; however, the FTC has indicated it intends to capture functional non-competes. That is, if a restrictive covenant is so broad or onerous that it effectively prohibits a worker from seeking or accepting other work or starting a business during a post-employment period, then such covenant would constitute a non-compete under the Final Rule.

## **Impact on new non-compete clauses**

The Final Rule prohibits an employer from entering into (or attempting to enter into) new post-employment non-compete agreements with any worker after the Effective Date. This prohibition applies to all types of workers—including independent contractors, volunteers, interns, apprentices, and sole proprietors who provide services—and applies regardless of the worker's compensation level, seniority or responsibilities.

## **Impact on existing non-compete clauses**

Once the Final Rule becomes effective, no employer will be permitted to enforce (or attempt to enforce) an existing non-compete clause against any worker, except that existing non-competes entered into with a "senior executive" before the Effective Date will remain enforceable.

A "senior executive" refers to a worker who is in a "policy-making position" and who received total annualized compensation of at least US\$151,164 in the preceding year (generally disregarding discretionary compensation and fringe benefits). Whether a worker is in a policy-making position is a factual determination based on, among other things, the organizational structure of a particular business. Generally, senior executives refer to C-suite executives with final authority to make policy decisions that control significant aspects of a common enterprise (and not just a subsidiary, division or affiliate of the common enterprise).

## **Notice requirement**

Employers who have entered into non-competes that are no longer enforceable after the Effective Date must provide their workers with written notice that the non-compete clause will not be, and cannot legally be, enforced. Such written notice must be provided by the Effective Date.

The Final Rule provides flexibility as to the method of delivery of the notice, which can be provided by email or text message. The Final Rule also provides model language for the notice. The model notice is phrased in general terms, does not include individualized information regarding the worker or the non-compete, and does not clarify that there may be non-competes that remain enforceable under the Final Rule (such as a non-compete agreed to in connection with a bona fide sale of business).

## **Exceptions under the Final Rule**

The Final Rule provides the following exceptions to the non-compete ban:

- **Bona fide sales of business.** The Final Rule does not apply to non-compete clauses that are entered into by an individual pursuant to a bona fide sale of a business entity, of an individual's ownership interest in a business entity, or

of all or substantially all of a business entity's operating assets. Importantly, and unlike the proposed rule, the Final Rule does not include a minimum required ownership threshold for the seller. In its commentary to the Final Rule, the FTC clarified that this sale of business exception is intended to apply to transactions between independent parties at arm's length in which the seller has a reasonable opportunity to negotiate the terms of the sale. The FTC further clarified that non-competes that arise out of repurchase rights or mandatory stock redemption programs do not qualify for this exception.

- **Existing causes of action.** Employers are permitted to pursue causes of action related to non-compete clauses that accrued prior to the Effective Date. This means that, even if a non-compete clause becomes unenforceable on the Effective Date, an employer may still bring a claim against a worker for a breach that occurred prior to the Effective Date.
- **Good faith.** The Final Rule does not prevent an employer from enforcing a non-compete or making a representation about a non-compete where there is a good-faith basis to believe the Final Rule is not applicable.

## Practical considerations for employers

Pending and forthcoming lawsuits challenging the Final Rule may pose roadblocks to the implementation of the Final Rule.

While the Final Rule may never become effective, or while implementation may be delayed as a result of these challenges, employers should nonetheless prepare for the eventual implementation of the Final Rule in its current form.

Such preparatory steps could include:

- taking stock of who in the employer's workforce is subject to a non-compete clause;
- determining who would be considered "senior executives" of the employer;
- considering any opportunities to enter into new or enhanced restrictive covenants with senior executives before the Final Rule becomes effective; and
- reviewing and, if necessary, enhancing protections around trade secrets, customer lists and other proprietary information.

Employers should also consider whether their overall compensation structure has the desired retentive value for their key employees. Historically in the U.S., a contractual severance provision has not only served as consideration for a non-compete clause, but also as a retention tool (as the employee would not be entitled to severance if he or she resigns). If the Final Rule becomes effective, employers may be inclined to pivot from severance arrangements towards retention bonuses or other types of deferred compensation arrangements. We may also see a rise in the use of reasonable "garden leave" or notice periods, which have the effect of lengthening the period (at least in the short term) during which the employer may enforce a non-compete against the employee before the employment relationship ends.

If implemented, the Final Rule will bring some uniformity to the current patchwork of various state non-compete laws, as the Final Rule purports to pre-empt existing state laws that are less restrictive than the Final Rule. However, applicable state laws will continue to apply to non-compete clauses that survive the Final Rule, such as the existing non-competes entered by senior executives and non-competes entered in the context of a bona fide sale of business.

There are a number of interpretive issues that remain unresolved in the Final Rule. We will continue to monitor further guidance from the FTC on these issues, along with legal challenges to the Final Rule, and any case law that may clarify the scope of

the Final Rule.

*The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.*

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