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The FTC non-compete rule

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On April 23, 2024, the Federal Trade Commission finalized its rule banning almost all non-competes in employment agreements. The final rule includes limited exceptions for existing non-competes with "senior executives" and non-competes entered into when a business is sold.

The Federal Trade Commission (FTC) has voted 3-2 along party lines to finalize its rule banning almost all non-compete arrangements with only narrow exceptions.[1] The final rule largely tracks the proposed rule but is narrower in a few respects, including a limited exception that will permit enforcement of **existing** (but not new) non-competes against "senior executives" and removes the requirement that employers formally rescind existing non-competes. The Chamber of Commerce and other business groups have already filed suits challenging the final rule and there is a good chance that enforcement of the final rule will be stayed while those challenges are pending.

Summary of the final rule

The final rule bans employers from offering or entering into new non-compete arrangements with all "workers," regardless of position or compensation.[2] Below, we address some key questions about the new rule.

1. What is the scope of the ban on non-competes?

The final rule prohibits any term or condition that "prohibits a worker from, **penalizes** a worker for, or functions to prevent a worker from" working after his or her current employment ends.[3] The use of the term "penalizes" potentially expands the scope of the prohibition beyond literal non-compete clauses to include other common-place compensation arrangements which create significant disincentives to work for a competitor (e.g., compensation clawbacks). The Commission clarified that garden leave arrangements (e.g., agreements where the worker is still employed and receiving the same compensation and benefits on a pro rata basis) are not non-competes under the rule.

2. Who is covered by the ban on non-competes?

The final rule defines "worker" broadly to include any natural person who works or worked in paid or unpaid positions, without regard to job title or job classification under state or federal law.[4] The term expressly encompasses employees, independent contractors, and sole proprietors who provide a service. The term excludes franchisees in franchisor-franchisee relationships, but not employees of the franchisor or franchisee.

3. When does the final rule go into effect?

By its terms, the final rule will go into effect 120 days after publication in the Federal Register.[5] We anticipate that the implementation of the final rule is likely to be stayed pending the outcome of the various legal challenges to it.

4. Is there an exemption for existing non-competes with "senior executives?"

Yes, in a change from the proposed rule, for **existing** (but not new) non-compete agreements, the final rule distinguishes between "senior executives" and other workers. The final rule contains a grandfather clause, which permits existing non-competes to remain in effect for "senior executives," while such clauses are immediately unenforceable for other workers once the final rule becomes effective. The definition of "senior executive" is discussed in the response to question 6 below.

An issue may arise if an employer enters into an **amendment** to an existing employment agreement containing a non-compete (but unrelated to that non-compete), perhaps relating to compensation or other terms of employment. We would expect businesses to take the position that such amendments are not new non-compete arrangements, and so the existing non-compete provision should remain valid and enforceable.

5. What about workers who do not qualify as "senior executives?"

For all other workers, existing non-compete arrangements will become unenforceable when the rule becomes legally effective. In a departure from the proposed rule, employers are not required to rescind existing non-competes. Instead, the Rule requires employers to provide notice to workers that their non-competes will not and cannot be enforced, which may be delivered by hand, mail, email, or text message.[6] The notice must be provided by the rule's effective date.[7]

6. Who qualifies as a "senior executive" under the final rule?

Senior executives are defined as persons who (1) were "in a policy-making position and (2) received a total annual compensation of at least $151,164 in the preceding year."[8] For these individuals, existing non-compete agreements may remain in effect.[9] Employers may not, however, enter into new non-competes with senior executives "on or after the effective date."[10]

A "policy-making position" is defined as "a business entity's president, chief executive officer or the equivalent, any other officer of a business entity who has policy-making authority, or any other natural person who has policy-making authority for the business entity similar to an officer with policy-making authority."[11]

The FTC explains that its definition of "senior executive" was informed by SEC Rule 3b-7's definition of "executive officer."[12] Additionally, the FTC notes that within this definition for the term "officer" it adopts the SEC's definition from 17 C.F.R. § 240.3b-2[13] to maintain consistency.[14] The rule indicates that it is possible for a "senior executive" to be an officer of an affiliate or subsidiary of a business entity that is part of a common enterprise, if the employee has policy-making authority for the common enterprise.

The FTC clarifies, however, that it modified certain aspects of SEC Rule 3b-7 to define senior executive, including (1) removing the phrase "any vice president of the registrant in charge of a principal business unit, division or function" because the rule applies to nonpublic companies, and (2) choosing to define "policy-making authority" as "final authority to make policy decisions that control significant aspects of a business entity and does not include authority limited to advising or exerting influence over such policy decisions," which it adopted from case law interpreting Rule 3b-7.[15] The FTC stated that its goal with this change was to prevent overbroad application of the definition to lower-level workers.[16]

7. Is there an exemption for non-competes executed as part of the sale of a business?

Yes, the final rule also exempts non-competes entered into by a person pursuant to a "bona fide sale of a business entity, of the person's ownership interest in a business entity, or of all or substantially all of a business entity's operating assets" without regard to such person's percentage ownership interest in said business entity or assets.[17] This exception reflects 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.[18] In the final rule, there is no percentage cut-off (nor any minimum sales proceeds) for this exemption to apply. Businesses active in states that limit non-competes under state law (e.g., California) should note that the exception in the final rule permitting non-compete provisions incidental to the sale of a business may differ in some respects from similar exceptions under state statute or common law.[19] If a state law has a narrower exception to its prohibition on non-compete provisions, that will survive the final rule per section 910.4; however, a broader exception to the prohibition would be preempted.[20]

8. Are there any other significant exemptions from the final rule?

The final rule clarifies that it does not apply to entities over which the FTC traditionally lacks jurisdiction,[21] nor does it apply to franchisee/franchisor contracts—although, as noted above, the definition of "worker" extends to employees working for a franchisee or franchisor.[22]

9. What should companies do now, when there is uncertainty about the legality of the rule and its scope?

By its terms, the final rule will not come into effect until 120 days after publication in the Federal Register. The final rule's effectiveness may be delayed further due to litigation. In the intervening period, the general prohibition on non-competes will not be in effect, either for "senior executives" or other workers. During this period, we believe companies should still be able to enter into non-compete agreements with employees if permitted under state law, but may want to consider adding additional language to any agreements making clear that they are enforceable only to the extent permitted by law. These non-competes could still be subject to antitrust challenge on a case-by-case basis under current law.

This approach may be particularly relevant in dealing with employees who may qualify as "senior executives," as existing non-competes with these individuals can remain in place even after the final rule takes effect. Companies should look to finalize arrangements, such as employment agreements, with such employees now, before the final rule comes into effect. In addition, given potential disputes over whether an employee qualifies as a "senior executive," employers may want to seek provisions in employment agreements where the parties expressly acknowledge that an employee qualifies as a "senior executive" under the final rule.

Companies may also want to identify their "senior executives" and inventory the different employment arrangements that may contain non-competes, especially given the breadth of the prohibition. Non-competes and provisions that have similar effect may be included not only in employment agreements, but also in offer letters, bonus and equity plans, commission plans, severance plans and polices, deferred compensation plans, pension plans, and carry plans. Additionally, companies may wish to consider whether any restrictive covenants with employees (e.g., confidentiality provisions, non-solicit, and IP assignment provisions) need to be enhanced in light of the rule, but companies should be mindful that the final rule prohibits arrangements that are functionally equivalent to non-competes.

10. Is the final rule subject to legal challenge?

As predicted when the rule was first proposed, the final rule will face legal challenges before it becomes effective. At least two lawsuits have already been filed challenging the FTC's authority in creating the rule and the constitutionality of the FTC itself,[23] and more will surely follow.

The legal challenges to the final rule fall into the following categories:

Challenges to the FTC's unfair methods of competition rulemaking authority:

The final rule states that the Commission proposes the rule pursuant to Sections 5 and 6(g) of the FTC Act.[24] Section 6(g) gives the FTC authority to "from time to time classify corporations and … to make rules and regulations for the purpose of carrying out the provisions of this subchapter."[25] Opponents of the rule have argued that this provision only permits the FTC to promulgate procedural or internal rules necessary to carry out the other provisions of the subchapter of the Act and does not provide authority for legislative unfair methods of competition rulemaking. This view of Section 6(g) is supported by the fact that the FTC has disclaimed that it has competition rulemaking authority for most of its history.[26] On the other hand, proponents of the rule point to *National Petroleum Refiners Association v. FTC*[27] as binding precedent authorizing the FTC under its governing statute and Section 6(g) to "promulgate rules defining the meaning of the statutory standards of the illegality the Commission is powered to prevent."[28] These proponents also point to Congress's decision in passing the Magnuson-Moss Act in 1975 to introduce additional procedures for rulemaking for unfair or deceptive acts or practices—but not for unfair methods of competition[29]—despite Congress's awareness of the FTC's power to do so.[30]

Challenges under the Major Questions doctrine:

Even if the FTC has rulemaking authority in this area, litigants have challenged the final rule on the basis that Congress did not provide the FTC a "clear statement" of authority, which is required to undertake broad rulemaking on what recent

Supreme Court decisions have described as so-called "major questions."[31] The major questions doctrine developed by the Supreme Court in *West Virginia v. EPA* applies heightened scrutiny to rulemaking authority undertaken if it: (1) involves a matter of "great 'political significance'" or is to end a "debate across the country"; (2) if the agency seeks to regulate a significant portion of the economy; and (3) if the agency seeks to intrude in an area that is traditionally the province of state law.[32] During the FTC open meeting, Commissioner Ferguson indicated that he believes all three of these indicia are met by the final rule due to the political interest in non-competes, the millions of contracts potentially invalidated, the billions of dollars at issue in those contracts, and the police power of the states to regulate employment contracts. Indeed, the fact that the FTC is touting hundreds of billions of dollars in savings it claims will result from the final rule arguably highlights the final rule's sweeping impact on wide swathes of the U.S. economy.

Challenges to the FTC's rulemaking process:

Under the Administrative Procedure Act, the final rule's rulemaking has been challenged to examine whether the FTC properly considered evidence and comments regarding the benefits or harms of non-competes and alternative proposals. If not, the final rule may be arbitrary and capricious.[33] It is apparent that the FTC has attempted to shield the final rule from this form of attack given the very lengthy discussion (570 pages worth) of competing comments and evidence considered.

Challenges to the FTC's interpretation of Section 5 of the FTC Act:

Opponents of the rule have argued that the FTC's interpretation of Section 5 is unlawful because it exceeds the Commission's authority to designate almost all non-compete agreements as unfair competition.[34] Opponents of the rule have argued that the FTC's recent broad interpretation of Section 5 is an unlawful departure from history and precedent.

Challenges to the delegation of authority to the FTC:

Opponents have argued that **if** the FTC Act is interpreted to permit the FTC to categorically prohibit non-competes, that is an impermissible delegation because a delegation by Congress of legislative power to an agency requires an "intelligible principle."[35] Opponents under this theory state that the statutory phrase "unfair methods of competition" fails to set forth such a limiting principle—particularly in light of the agency's broad interpretation of that clause.

Challenges to the retroactivity of the rule:

The final rule has also been challenged on the basis that the FTC lacks the power to issue retroactive regulations.[36] If the rule goes into effect, it will void almost every existing non-compete contract, which critics argue will deprive those who have bargained for such agreements of their consideration. Challenges under this theory argue that the FTC Act lacks the necessary explicit statutory authority to issue retroactive rules, and that the Fifth Amendment of the Constitution prevents the government from imposing retroactive burdens that "deprive citizens of legitimate expectations and upset settled transactions."[37]

Challenges to the constitutionality of the FTC's structure:

Finally, the rule has been challenged on grounds that the FTC is unconstitutionally structured in violation of Article II of the Constitution because the agency is exercising executive power but the FTC Commissioners are improperly insulated from presidential removal.[38]

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 (as they have done in the past) and to investigate suspected limits to competition in labor markets. Another recent example of the FTC's focus on labor markets are the allegations concerning unionized labor in its challenge to Kroger's proposed acquisition of Albertsons. 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.

We will continue to monitor these developments and provide updates, including updates on specific sectors, such as banking.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Arthur J. Burke
+1 212 450 4352
+1 650 752 2005
arthur.burke@davispolk.com

Jennifer S. Conway
+1 212 450 3055
jennifer.conway@davispolk.com

Ronan P. Harty
+1 212 450 4870
ronan.harty@davispolk.com

Anna M. Kozlowski
+1 212 450 3327
anna.kozlowski@davispolk.com

Kyoko Takahashi Lin
+1 212 450 4706
kyoko.lin@davispolk.com

Christopher Lynch
+1 212 450 4034
christopher.lynch@davispolk.com

Howard Shelanski
+1 202 962 7060
howard.shelanski@davispolk.com

Margaret E. Tahyar
+1 212 450 4379
margaret.tahyar@davispolk.com

Caroline Ziser Smith
+1 650 752 2009
caroline.zisersmith@davispolk.com

1 Fed. Trade Comm'n, 16 C.F.R. Part 910, Non-Compete Clause Rule (Apr. 23, 2024), https://www.ftc.gov/system/files/ftc_gov/pdf/noncompete-rule.pdf (hereinafter Final Rule).

2 Final Rule at 3.

3 Final Rule at 65-68 (emphasis added).

4 Final Rule § 910.1.

5 Final Rule § 910.6.

6 Final Rule § 910.2(b). This is a change from the proposed rule, which required employers to formally rescind existing non-competes. Final Rule at 212.

7 Final Rule § 910.2(b).

[8] Final Rule at 328. The rule clarifies that this threshold should be annualized if the worker was employed during only part of the preceding year. Final Rule at 255-56. Preceding year is defined by the FTC as an employer's choice among the following time periods: the most recent 52-week year, the most recent calendar year, the most recent fiscal year, or the most recent anniversary of hire year." Final Rule at 264.

[9] Note: The final rule does not specify the specific time at which "senior executive" status is relevant (e.g., at the date the existing non-compete bound the senior executive, the effective date of Final Rule, or date of the senior executive's termination). Issues may arise, for example, if an individual was a senior executive when he or she entered into the existing non-compete, but at the time of his or her termination of employment no longer met the test for senior executive.

[10] Final Rule at 243.

[11] Final Rule § 910.1.

[12] *See* Final Rule at 268; 17 C.F.R. § 240.3b-7 ("The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.").

[13] 17 C.F.R. § 240.3b-2 ("The term officer means a president, vice president, secretary, treasury or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated.").

[14] Final Rule at 268.

[15] Final Rule at 271-72 (discussing adoption of standard in *SEC v. Prince*, 942 F. Supp. 2d 108, 133-36 (D.D.C. 2013)).

[16] *Id.*

[17] Final Rule § 910.3(a); *see also* Final Rule at 340-342.

[18] *See* Fed. Trade Comm'n, 16 C.F.R. Part 910, Non-Compete Clause Rule Notice of Proposed Rulemaking, at 106, 113-14. https://www.ftc.gov/system/files/ftc_gov/pdf/p201000noncompetenprm.pdf; Final Rule at 62, 335-36.

[19] For example, California Business and Professions Code Section 16601.

[20] Final Rule § 910.4(a).

[21] Final Rule at 52.

[22] Final Rule at 4, 385-88.

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

[24] Final Rule at 1.

[25] 15 U.S.C. § 46(g).

[26] *See Nat'l Petroleum Ref'rs Ass'n v. FTC*, 482 F.2d 672, 696 nn. 38, 39 (D.C. Cir. 1973).

[27] *Id.*

[28] *Id.* at 674, 698.

[29] *See* Magnuson-Moss Act, 88 Stat. 2183; 15 U.S.C. 57a.

[30] *See* S. Rep. No. 93-151, at 32 (1973); H.R. Conf. Rep. No. 93-1606, at 30 (1974) (rejecting amendment to FTC Act, which would have prohibited prescribing rules related to unfair competitive practices).

[31] *See West Virginia v. Env't Prot. Agency*, 597 U.S. 697, 717 (2022). For a discussion of the origins and implications of the major questions doctrine, please see our previous client update.

[32] *Id.* at 743-745 (Gorsuch, J., concurring).

[33] 5 U.S. Code § 706.

[34] *Id.*

[35] *SeeMistretta v. United States*, 488 U.S. 361, 372 (1989).

[36] 5 U.S.C. § 706.

[37] *See Eastern Enters. v. Apfel*, 524 U.S. 498, 533 (1998).

[38] *See* U.S. Const. art. II, § 1, cl. 1.1.