Private Equity Law Report pelawreport.com

Jun. 13, 2024

Employment

Answers to Key Questions Raised by the FTC's Final Rule Banning Non-Compete Provisions

By Lance J. Gotko, *Friedman Kaplan Seiler Adelman & Robbins LLP*

In January 2023, the Federal Trade Commission (FTC) circulated a draft rule proposing to broadly ban non-compete provisions (Proposed Rule). After weighing a plethora of public comments, the FTC issued a final rule (Rule) to officially forbid employers – subject to a limited exception – from imposing or enforcing "non-compete clauses" on April 23, 2024.

Barring a court order in an ongoing legal challenge staying the Rule from going into effect, the Rule will become effective on September 4, 2024. The effective date is important because the Rule is retroactive and requires employers to inform employees in writing on or before the effective date that any non-competes previously imposed on them are unenforceable and will not be enforced. Failure to comply with those requirements can result in significant fines for employers.

This article offers answers to questions raised by private fund managers following the issuance of the Rule, including about its scope, timing, and potential impact on existing and future employment arrangements. The article also provides an update on the status of the bill passed in New York (New York Bill) – and ultimately vetoed by its governor – proposing to ban virtually all new non-compete provisions.

See "What Fund Managers Should Know About the FTC's Proposed Ban on Non-Compete Provisions" (Jun. 1, 2023).

FTC's Final Rule

With a handful of exceptions discussed below, Section 910.2(a)(1) of the Rule broadly declares it an unfair method of competition for a person:

1. to enter into or attempt to enter into a non-compete clause;
2. to enforce or attempt to enforce a non-compete clause; or

3. to represent that a worker is subject to a non-compete clause.

Notably, Section 910.1 of the Rule defines a "non-compete clause" as (emphasis added):

> A term or condition of employment [by contract or policy, written or oral] that *prohibits* a worker from, *penalizes* a worker for, or *functions to prevent* a worker from: (i) 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 (ii) operating a business in the United States after the conclusion of the employment that includes the term or condition.

As discussed below, the phrases "prohibits," "penalizes" and "functions to prevent" cause the Rule's prohibitions to have a wide scope. By the FTC's own estimate (which it says is conservative), the Rule will invalidate up to 30 million non-compete agreements that are currently in place.

If the FTC Cannot Regulate Financial Services Firms, Does the Rule Apply to Them?

Yes. With very few exceptions, the Rule protects all workers wherever they may work. And it is an overstatement to say that the FTC cannot regulate "financial services firms." Although it is true that the FTC lacks regulatory authority over banks, not all financial services firms are banks outside the FTC's purview. For clarity, the following are the only types of banking authorities that are exempt from the FTC's jurisdiction:

- national banks;
- federal branches and federal agencies of foreign banks;
- member banks of the Federal Reserve System;
- branches and agencies of foreign banks;
- commercial lending companies owned or controlled by foreign banks;
- organizations operating under Section 25 or 25A of the Federal Reserve Act;
- banks insured by the Federal Deposit Insurance Corporation; and
- insured state branches of foreign banks.

Does the Rule Protect Only Employees?

No. The Rule invalidates non-competes imposed on all "workers," irrespective of title. That categorie of individuals includes, but is not limited to:

- employees;
- independent contractors;
- externs;
- interns;
- volunteers;

- apprentices; and
- sole proprietors who provide services to a person.

Does the Rule Apply to Highly Compensated Individuals?

Yes. The Rule makes no exception for non-competes imposed on highly compensated individuals. The FTC determined that compensation is not a reliable indicator of whether workers have been exploited and forced to accept a non-compete. The FTC fundamentally found that all non-competes are a drag on the economy – again, no matter how much workers are paid.

Does the Rule Apply to Senior Executives?

Yes and no.

Yes, in that on a going-forward basis the Rule applies to all new non-competes sought to be imposed on senior executives (and anyone else) entered into on or after the Rule's effective date. No matter how high in rank employees may be, new non-competes may not be imposed upon them.

No, in that the Rule does not invalidate non-competes imposed on senior executives before the Rule's effective date. "Senior executive" is defined to mean a worker (1) serving as a business entity's president, CEO or equivalent officer with policy-making authority; and (2) earning a total annual compensation of at least $151,164. For those purposes, "policy-making authority" means "final authority to make policy decisions that control significant aspects of a business entity or common enterprise" which, to be clear, does not include policy-making authority over a subsidiary or affiliate of a common enterprise.

Those narrow definitions are important as employers cannot assume that many individuals who generally are considered "senior executives" qualify for the Rule's carveout.

Does the Rule Apply Retroactively?

Yes. All non-competes – past, present and future – are prohibited by the Rule other than the exception noted above for non-competes imposed on certain senior executives before the Rule's effective date.

Does the Rule Prohibit Post-Employment Non-Competes When the Former Employee Is Paid During the Non-Compete Period?

Yes, the Rule prohibits non-competes even when the former employee will be compensated during or for the non-compete.

In its commentary, the FTC said it would be too hard to determine whether the compensation is fair (*i.e.*, "commensurate with earnings that would be received in a competitive labor market"). In addition, the FTC said that "significant administrability concerns" would be raised by a carveout for non-competes exchanged for "substantial consideration" or "meaningful consideration." On that

The FTC's solution was to strike down all non-competes, regardless of whether employees are paid for them, and no matter the amount paid.

Does the Rule Affect Separation Agreements?

As a threshold matter, the Rule defines a "non-compete clause" as a "term or condition *of employment*" (emphasis added).Therefore, a good argument seemingly could be made that the Rule does not ban non-competes contained in separation agreements because those provisions are not imposed as a "term or condition of employment" – *i.e.*, those are provisions being imposed after employment ends in return for money to which the employee is not otherwise entitled.

But on that point, the FTC's commentary suggests that non-compete provisions in separation agreements are also banned, along with provisions making the payment of severance benefits contingent on the employee not competing. The FTC assures, however, that "a severance agreement that imposes no restrictions on where the worker may work following the employment associated with the severance agreement is not a non-compete clause [as defined under the Rule], because it does not impose a post-employment restriction."

See "Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Fund Manager Employment Agreements" (Nov. 23, 2011).

Does the Rule Affect Non-Disclosure Agreements (NDAs)?

No, unless the NDA is so broad that it has the "effect" of imposing a non-compete. The FTC's commentary cited a case that found an NDA to be unenforceable when it defined "confidential information" "so broadly as to prevent [the plaintiff] in perpetuity from doing any work in the securities field." Significantly, certain commentators objected to the Proposed Rule on the basis that non-competes are an important tool used to protect confidential information and trade secrets. The FTC brushed that objection aside, noting that employers can use NDAs to protect confidential information and trade secrets.

Unfortunately, it may not be as easy as the FTC apparently assumes for employers to use NDAs to protect their legitimate interests. The National Labor Relations Board (NLRB) recently held that broad NDAs are impermissible because they chill the rights of certain employees – *i.e.*, all employees, unionized or not, other than supervisors – under the National Labor Relations Act of 1935 to engage in "concerted activities." Accordingly, an NDA that forbids a non-supervisory employee from using or disclosing any nonpublic information about the employer's business (a not uncommon formulation) likely would run afoul of the NLRB's ruling because, by its terms, it would prevent employees from discussing working conditions that are not publicly known.

In a memo to field offices sent in response to inquiries about the NLRB's ruling, the NLRB's GC wrote (emphasis added): "Confidentiality clauses that are *narrowly-tailored* to restrict the dissemination of proprietary or trade secret information *for a period of time* based on legitimate business justifications may be considered lawful." That clarification is more alarming than reassuring, however, as it has never been the law that trade secrets or truly proprietary and confidential informa-

tion can only be protected "for a period of time."

See "Procedures for Fund Managers to Safeguard Trade Secrets From Rogue Employees" (Jul. 21, 2016).

Does the Rule Make an Exception for Non-Competes Imposed in Connection With the Sale of a Business?

Yes. Unlike the Proposed Rule, Section 190(3)(a) of the Rule makes an exception for "a non-compete clause that is 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." Thus, a purchaser of a business – including its goodwill – can still use a non-compete provision to protect itself from sellers taking their money and then opening up a competing business.

Does the Rule Prohibit Forfeiture-for-Competition Provisions?

According to the FTC's commentary, yes. Focusing on the Rule's prohibition against clauses that "penalize" an employee who competes, the FTC has opined that the Rule forbids forfeiture-for-competition clauses that "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."

The FTC's stance runs contrary to judicial precedent, however, as courts frequently do not deem forfeiture-for-competition provisions to be non-competes because they do not prohibit competition; it's a matter of the employee's choice. If the employee chooses to go work for a competitor, the employee does so aware that they will forfeit compensation that has not yet been delivered to the employee free of conditions. Thus, courts frequently do not even consider forfeiture-for-competition provisions to be restrictive covenants warranting scrutiny for reasonableness.

See "Restrictive Covenant Laws at the Federal and State Level Increase Challenges of Enforcing Non-Compete Agreements (Part Two of Two)" (Oct. 19, 2021).

Does the Rule Prohibit the Non-Payment of Bonuses When the Employee Is Not Employed (or Has Given Notice) As of the Date Bonuses Are Paid?

No. Companies can have policies that make the payment of bonuses dependent on the employee still being employed (or not having given notice of resignation) as of the date that bonuses are paid. The Rule would be violated, however, if the payment of bonuses was dependent on the employee not going to work for a competitor. Such a result would "penalize" the employee for competing.

Does the Rule Prohibit Garden Leave Provisions?

The FTC declined to opine on how the definition of "non-compete clause" would "apply in every potential factual scenario." In its commentary, however, the FTC indicated that it would not consider a garden leave provision to be a non-compete where "the worker is still employed and receiving the same total annual compensation and benefits on a pro rata basis" during the garden leave period, "because such an agreement is not a post-employment restriction. Instead, the worker continues to be employed, even though the worker's job duties or access to colleagues or the workplace may be significantly or entirely curtailed."

The FTC clarified that "where a worker does not meet a condition to earn a particular aspect of their expected compensation, like a prerequisite for a bonus, the Commission would still consider the arrangement 'garden leave' that is not a non-compete clause under [the Rule] even if the employer did not pay the bonus or other expected compensation." Accordingly, if a prerequisite to getting a bonus is that the employee be "in good standing" – *i.e.*, not having resigned or given notice of resignation – the employee still could be held off the market via garden leave even though no bonus will be paid.

As a Practical Matter, What Does the Rule Require Employers to Do Right Now?

Right now, nothing. If the Rule goes into effect, however, (which may not happen due to the litigation discussed below) employers are forbidden from imposing or enforcing non-competes, as broadly defined by the Rule. Further, on or before the Rule's effective date, employers must reach out to all applicable workers who have non-competes to inform them in writing that their non-compete is unenforceable and will not be enforced. The Rule provides sample language, blessed by the FTC, that can be used for this purpose.

What About State Law?

Developed painstakingly over centuries, the common law and statutes of 47 states generally provide for the enforcement of reasonable non-competes to protect legitimate business interests. All of that would be swept away by Section 910.4(a) of the Rule, however, which expressly states that it preempts any state laws that would allow anything the Rule bans or detracts from the Rule's notice requirement.

Are There Potential Penalties for Failing to Comply With the Rule?

Yes. For knowing violations of the Rule, the FTC can commence an action in federal court seeking a penalty of up to $51,744 for "each violation." For continuing violations, each day equals a separate violation. When determining the amount of a civil penalty, a court will take various factors into account, such as:

- the degree of culpability;

- any history of prior such conduct;
- ability to pay;
- effect on the employer's ability to continue to do business; and
- "such other matters as justice may require."

Will the Rule Go Into Effect on September 4, 2024?

Possibly not. Litigation has commenced in federal court in the Northern District of Texas, which is pending before a conservative judge appointed by President Trump. The plaintiffs are challenging the Rule on multiple fronts, including that the Rule exceeds the FTC's authority as a matter of constitutional and administrative law.

Lately, multiple wide-ranging regulations have been struck down by courts, including the U.S. Supreme Court, where the regulation in question would cause a sea change in the nation's economy and/or existing law. The regulations have been invalidated under the theory that major questions need to be addressed by Congress through specific legislation, not through agency rules promulgated pursuant to vague statutory grants.

In the case of the Rule, the substantive statute pursuant to which it was promulgated by the FTC states only that: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." Time will tell whether the Rule will go into effect, is stayed pending the litigation or will ultimately be struck down as invalid.

New York Non-Compete Bill

Passed in 2023, the New York Bill would have banned virtually all new (*i.e.*, not on a retroactive basis) employment-based non-competes. The New York Bill did not contain an exception for highly compensated individuals, nor did it exempt non-competes imposed in connection with the sale of a business. The New York Bill did not expressly address whether forfeiture-for-competition provisions – historically given deference by New York courts – were exempt from its prohibitions. Finally, the New York Bill would have created a private cause of action for violations, allowing courts to grant employees:

- injunctive relief;
- lost compensation;
- other damages;
- attorneys' fees and costs; and
- mandatory liquidated damages (not to exceed $10,000).

See "Changes Brewing for Enforceability of Non-Compete Provisions" (Sep. 7, 2023).

Somewhat unexpectedly, Governor Kathleen Hochul vetoed the bill on December 22, 2023. In her veto memorandum, the governor made clear she does not oppose reigning in non-competes, but

thought the bill was too broad. While acknowledging the need for "limits on non-compete agreements for middle-class and low-wage workers, to protect[] them from unfair practices that would limit their ability to earn a living," the governor also recognized the need to allow "New York's businesses to retain highly compensated talent." She went on to note that "New York has a highly competitive economic climate and is home to many different industries. These companies have legitimate interests that cannot be met with the [New York Bill's] one-size-fits-all approach."

The New York Bill's original sponsor has said he intends to reintroduce some form of the bill, which may exempt non-competes for employees earning over $250,000 (an amount mentioned by the governor) and address other problematic issues with the original bill as written.

Notably, the promulgation of the FTC's sweeping Rule does not render irrelevant the idea of a narrower New York statute. As noted, if the Rule goes into effect and is upheld, it will preempt any narrower laws that would allow anything the Rule broadly forbids. If the Rule is struck down, however, a revised New York statute – that generally bans non-competes but also protects the legitimate business interests of employers – could be applicable to New York-based employers.

Lance J. Gotko heads Friedman Kaplan's employment practice group and represents companies and individuals in the financial services and other industries in connection with a wide variety of employment-related matters. He provides advice and representation in disputes related to employment-related issues; separation agreements; group moves; compensation; misappropriation of trade secrets; breaches of non-compete agreements and fiduciary duties; and employment discrimination.