

FTC Adopts Rule “Banning” Non-Compete Clauses with Workers

On April 23, 2024, the Federal Trade Commission (“FTC”) voted 3-2 to adopt a final rule (the “Final Rule”)¹ broadly deeming non-compete clauses with “workers” to be an “unfair method of competition” under Section 5 of the Federal Trade Commission Act (“FTC Act”, and Section 5”). The Final Rule generally implements the proposed rule published by the FTC on January 5, 2023 (the “Proposed Rule”),² although some key changes have been made.

Contrary to popular reporting, the Final Rule does not necessarily constitute a ban on non-compete clauses. Only the FTC has authority to enforce Section 5; so, while the Final Rule states that it preempts certain state laws, it would not amend either Federal or state antitrust statutes such as the Sherman Act or state contract or employment law, which traditionally governs non-compete clauses.³ While the Final Rule, if upheld by the courts (see below), would enable the FTC much more easily to condemn such clauses as part of its enforcement program, the Final Rule does not have any separate legal effect. While it is possible that courts view the FTC’s judgment as persuasive in their application of other Federal or state law (and so, for example, may more readily refuse to uphold a non-compete clause in litigation), we have seen no indication that courts will agree that the Final Rule renders unenforceable non-compete clauses that today are valid under all state laws. We are aware of no historical analog in which the FTC has successfully preempted so much otherwise legal conduct. In other words, if the Final Rule is upheld, we would likely find ourselves in a world where non-compete clauses could still be enforced under state law, but employers could find themselves the potential target of FTC enforcement actions for doing so.

Highlights of the Final Rule are:

- On the effective date of the Final Rule (the “Effective Date”),⁴ all existing non-compete clauses with a “worker” are deemed “unfair method[s] of competition” under Section 5
 - “Worker” is defined broadly and includes, among others, employees, executives, officers, directors and independent contractors⁵
 - There is an exception for existing non-compete clauses binding a “senior executive”, which is generally defined as an individual in a “policy-making position”⁶ and who earned annualized compensation of at least \$151,164 in the prior year
 - Employers will be required to provide affected workers with a notice that existing non-compete clauses will not be, and cannot legally be, enforced
- Beginning on the Effective Date, it will be an “unfair method of competition” under Section 5 for an employer to enter into a new non-compete with a worker, including a senior executive
- The definition of non-compete is broad and includes agreements that would result in the forfeiture of compensation if other employment is obtained (including severance under certain circumstances) and, depending on the facts and circumstances, can also include NDAs and non-solicitation covenants
- The Final Rule does not generally restrict the following:⁷
 - Non-competes entered into pursuant to the sale of a person’s interests in a business entity;
 - Non-competes between businesses; and
 - Enforcement of violations of a non-compete clause that occurred prior to the Effective Date

LEGAL CHALLENGES TO THE FINAL RULE

As we anticipated in our prior memo, the Final Rule is already facing significant legal challenges, and therefore its implementation may be delayed beyond the Effective Date.⁸ The challenges include that: (1) the FTC lacks the authority to engage in “unfair methods of competition” (“UMC”) rulemaking; including under the major questions doctrine; (2) if the FTC Act does confer such rulemaking authority, it constitutes an impermissible delegation of legislative power to an agency, in violation of the Constitution; (3) a ban on virtually all non-compete agreements exceeds the FTC’s substantive authority under Section 5; (4) the rulemaking is arbitrary and capricious under the Administrative Procedure Act; and (5) the rule is impermissibly retroactive. During the FTC’s Open Meeting on the Final Rule, the two dissenting commissioners raised some of these legal issues in their public statements.

The FTC asserts authority to fashion UMC rules based on Section 6(g) of the FTC Act, relying on the D.C. Circuit’s 1973 opinion in *National Petroleum Refiner’s Ass’n v. FTC*. Section 6(g) states that “the commission shall also have power . . . from time to time to classify corporations and to make rules and regulations for the purpose of carrying out the provisions of the Act.” Critics, notably including the two dissenting commissioners, argue against the FTC’s reading of the statute (and the Constitution) and the D.C. Circuit’s decision in that case recognizing 6(g) legislative rulemaking power. We expect some of these issues will be resolved through litigation should the FTC continue to defend the rule.

It will take time for challengers to litigate these legal issues. The U.S. Chamber of Commerce is seeking an order permanently enjoining the enforcement of the rule and we expect they will move for a preliminary injunction. If granted and not appealed successfully, the Final Rule would not go into effect until the litigation resolves.

EXPECTED FUTURE ENFORCEMENT

Just hours prior to issuing the Proposed Rule last year, the FTC brought enforcement actions against two companies for their non-compete practices, entering into consent orders with each.⁹ We expect future non-compete enforcement, in particular if the courts uphold the Final Rule.

Clients should note, however, that the FTC Act does not provide for penalties for violations of UMC rules, including the Final Rule. Should the Final Rule be upheld, the FTC would still have to investigate and bring enforcement actions, culminating if litigated with orders to rescind or not enforce the contractual provisions. Only if a party violates *that* order would penalties be on the table.¹⁰

CONCLUSION

At this stage, given the challenges, we would not recommend that companies change fundamentally their current approach to entering into or enforcing non-competes. We do, however, recommend that they take stock of non-competes they have with their employees (and other “workers”), and ensure all have a business justification and comport with applicable state law. Given the fast-paced developments in this area, which also include attempts by the Department of Labor and various states to restrict the use of non-competes, we also recommend that companies engage with counsel to ensure that they stay abreast of such developments and are in a position to anticipate and adapt to the changing landscape

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- 1 The text of the Final Rule and the FTC’s related adopting release can be found on the FTC’s website at https://www.ftc.gov/system/files/ftc_gov/pdf/noncompete-rule.pdf.
 - 2 For Cravath’s summary of the Proposed Rule, please see <https://www.cravath.com/a/web/vPuDWYmdovTVyxa9TaLeuU/4PxQYf/ftc-proposes-rule-banning-noncompete-clauses-with-workers.pdf>.
 - 3 The Final Rule states that when it is in direct conflict with state law, the Final Rule would pre-empt the state law (“This part 910 will not be construed to annul, or exempt any person from complying with any State statute, regulation, order, or interpretation applicable to a non-compete clause, including, but not limited to, State antitrust and consumer protection laws and State common law, except that this part 910 supersedes such laws to the extent, and only to the extent, that such laws would otherwise permit or authorize a person to engage in conduct that is an unfair method of competition under §910.2(a) or conflict with the notice requirement in §910.2(b)”).
 - 4 To be 120 days after the Final Rule is published in the Federal Registrar.
 - 5 Although not explicitly mentioned in the Final Rule, it would also appear to apply to non-compete clauses between a partnership and its partners. However, the FTC has noted that partners who sell their interests in the partnership would generally be covered by the sale of a business exemption, noted below.
 - 6 The Final Rule defined those in a “policy-making position” to be a business entity’s president, Chief Executive Officer or equivalent and other officers or natural persons who have “final authority to make policy decisions that control significant aspects of a business entity or common enterprise”. Excluded from those in “policy-making positions” are those that only exert influence over policy or have final authority to make policy decisions for only a subsidiary or affiliate. The FTC noted that it sought to broadly align with the SEC’s definition of “executive officer”, but that the test would need to apply to a wider variety of entities than just public companies. Given this commentary, although the “policy-making position” language differs in several respects from the SEC’s definition of “executive officer”, it appears that the FTC intends for the coverage to be the same at public companies, and for a similar group of individuals to be covered at other business entities subject to the Final Rule. The FTC also noted that it expected that 0.75% of workers would be senior executives.
 - 7 In addition, FTC jurisdiction generally does not extend to certain types of businesses, including certain financial institutions and not-for-profits.
 - 8 On the date the Final Rule was adopted, the U.S. Chamber of Commerce issued a statement that it will “sue the FTC to block this unnecessary and unlawful rule”. *U.S. Chamber of Commerce to Sue Over Unlawful Power Grab on Noncompete Agreements Ban*, U.S. Chambers of Commerce (Apr. 23, 2024), <https://www.uschamber.com/finance/antitrust/u-s-chamber-to-sue-ftc-over-unlawful-power-grab-on-noncompete-agreements-ban>. The following day, the U.S. Chamber of Commerce filed a suit in the Eastern District of Texas. A Texas employer has also filed a suit in the Northern District.
 - 9 See our prior memo on the Proposed Rule for a discussion of the non-compete actions. *FTC Proposes Rule Banning Noncompete Clauses with Workers*, Cravath Swaine & Moore (Jan. 11, 2023), <https://www.cravath.com/a/web/vPuDWYmdovTVyxa9TaLeuU/4PxQYf/ftc-proposes-rule-banning-noncompete-clauses-with-workers.pdf>.
 - 10 In order to seek civil penalties, a party would need to violate an order of the FTC and then the government would need to commence a civil action for civil penalties. 15 U.S.C. § 45(l).

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