What should U.S. businesses be doing right now concerning the FTC's non-compete rule?

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On May 7, 2024, the Federal Trade Commission ("FTC") published a final regulatory rule that, if it takes effect as planned (which is currently scheduled for September 4, 2024 – more on that below), would invalidate and ban virtually all non-compete agreements in the U.S. Following publication of the rule in the Federal Register, legal challenges were promptly filed in Texas and Pennsylvania federal courts (another challenge was filed in Florida federal court in June). Motions seeking to preliminarily enjoin the final rule from taking effect followed, with the petitioners in each case arguing, among other things, that the FTC lacks authority to issue substantive rules concerning workplace non-compete agreements and, also, that the FTC did not sufficiently tailor the rule to the claimed purpose underlying it (by essentially issuing a blanket non-compete ban).

The first jurist to weigh in was Judge Ada Brown of the U.S. District Court for Northern District of Texas, who issued a decision on July 3, 2024 concluding that "the text and the structure of the FTC Act reveal the FTC lacks substantive rulemaking authority with respect to unfair methods of competition. The court concludes the commission has exceeded its statutory authority in promulgating the noncompete rule, and thus plaintiffs are likely to succeed on the merits." On this basis, the court issued a preliminary injunction staying enforcement of the final rule (though, notably, the court limited its decision to cover just the petitioning parties in the case, rather than issuing a nationwide injunction as had been requested). The court also noted that it intends to issue a decision regarding the ultimate merits of the case – i.e., the plaintiff's request for a permanent, nationwide injunction of the final rule – by August 30, 2024. Given the strong language in the court's decision, however, it appears a virtual lock that the forthcoming ruling from Judge Brown, which could still potentially have nationwide application, will similarly conclude that the FTC exceeded its authority in issuing the rule.

Twenty days later, however, Judge Kelley Brisbon Hodge of the U.S. District Court for the Eastern District of Pennsylvania reached the opposite conclusion. In a 39-page decision issued on July 23, 2024, Judge Hodge found that the petitioning business had failed to demonstrate that it was likely to eventually succeed on the merits of its argument that the FTC lacks the authority to issue "procedural and substantive rules as is necessary to prevent unfair methods of competition." According to Judge Hodge, the FTC Act does not limit the commission's rulemaking power to issuing "exclusively procedural rules." On the contrary, Judge Hodge concluded, the FTC has the power to issue substantive rules concerning the use of non-competes by U.S. businesses.

Accordingly, there presently exists a judicial divide over the constitutionality of the FTC's final rule – though the Texas and Pennsylvania rulings are almost assuredly just the first step in the legal process. Appeals to the Fifth and Third Circuit Courts of Appeals, respectively, are likely to follow in short order, with the rule's ultimate fate likely destined to be decided by the U.S. Supreme Court.

That said, with the rule's effective date rapidly approaching and in the absence of a nationwide injunction of the rule having yet been issued or the FTC voluntarily agreeing to delay said effective date while the legal process plays out, we have detailed below some next steps U.S. businesses may want to consider taking between now and September 4, 2024.

Recommended next steps for U.S. employers

A. Assess what non-compete agreements the company currently has with its workers

To start, employers should evaluate which "workers" have existing non-compete agreements and within which documents those non-competes exist. Documents to review in this regard could include:

- Restrictive covenant agreements
- Executive employment agreements
- Offer letters
- Equity-related agreements
- Separation agreements
- Employee handbooks

When conducting this assessment, bear in mind that, under the final rule, a non-compete agreement means "[a] term or condition of employment 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."[1] The FTC's commentary on the final rule specifies, for instance, that forfeiture-for-competition clauses are to be considered non-compete agreements covered by the final rule, whereas most garden leave agreements likely fall outside the rule's scope.

Also bear in mind that the FTC's final rule applies to any non-compete agreements with a "worker," a term that does not just include employees. Indeed, the final rule defines "worker" as any "natural person who works or who previously worked, whether paid or unpaid, without regard to the worker's title or the worker's status under any other State or Federal laws, including, but not limited to, whether the worker is an employee, independent contractor, extern, intern, volunteer, apprentice, or a sole proprietor who provides a service to a person."

As part of this assessment, it may be helpful to prepare a chart identifying each worker subject to a non-compete agreement, the scope of their non-compete (e.g., duration, geographic scope), in what document the non-compete is housed, and, for the reasons below, the state in which the worker performs services.

B. Assess where any workers subject to a non-compete physically work

As part of identifying the non-compete agreements maintained by the employer, we recommend that the company also assess the state in which each worker subject to a non-compete agreement physically performs their services.[2]

This is a recommend step because, in addition to the FTC's rule, state-level non-compete laws have rapidly evolved and grown increasingly restrictive over the past several years. For example, on January 1, 2024, California strengthened its longstanding law banning non-compete agreements to include contracts signed *outside* the state by employees who subsequently move to the Golden State. And just a few months earlier, in July 2023, Minnesota enacted a California-style full-scale ban on non-compete agreements.

Assessing where workers subject to a non-compete physically work is thus an important step in this process because, while the FTC rule preempts any inconsistent or conflicting state law, the rule also makes clear that, where state law imposes different, additional, or greater – but not conflicting – obligations, then such law likely would not be preempted by the rule. For instance, although the final rule permits preexisting non-compete agreements entered into with "senior executives" to remain in force (more on that below), if such agreement does not also comply with applicable state law (e.g., in California, whose law generally bars post-employment restrictive covenants), then the agreement at issue would still be unenforceable (even if it might be enforceable under the final rule).

C. Assess whether any workers subject to a non-compete agreement are or might be considered "senior executives"

If the final rule takes effect, virtually all preexisting and future U.S. non-compete agreements would be banned and unenforceable. There are several exceptions to this, however, with perhaps the most notable being for non-compete agreements with "senior executives" that were entered into prior to the rule's effective date (which, again, is currently September 4).[3]

It is therefore important for businesses to evaluate whether any current workers do or might fall within the rule's definition of a "senior executive" and, if so, whether they (i) previously signed a non-compete agreement or (ii) have not yet signed a non-compete agreement but are someone the company might like to have do so (and thereby the company could

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[1] The final rule clarifies that "term or condition of employment" includes but is not limited to a contractual term or workplace policy, whether written or oral.

[2] If the state identified in the choice-of-law provision governing the worker's non-compete agreement differs from the state in which the worker physically performs services for the employer, you should consult with a Reed Smith attorney about the potential implications of, and any potential enforceability issues with, said choice-of-law provision.

[3] The final rule also contains other, limited exceptions, including for non-compete agreements 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."

consider taking advantage of this short window of time preceding the potential effective date of the FTC rule to negotiate and execute any agreements with such individuals).

To conduct this assessment, note that the FTC rule's definition of "senior executive" largely mirror's the SEC's existing definition for "executive officers," however, the FTC's definition includes a required income threshold for the previous year. The final rule defines "senior executive" as a worker who:

1. Was in a policy-making position; and
2. Received from a person for the employment:
   i. Total annual compensation of at least $151,164 in the preceding year; or
   ii. Total compensation of at least $151,164 when annualized if the worker was employed during only part of the preceding year; or
   iii. Total compensation of at least $151,164 when annualized in the preceding year prior to the worker's departure if the worker departed from employment prior to the preceding year and the worker is subject to a non-compete clause.

The final rule defines a "policy-making position" 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. An officer of a subsidiary or affiliate of a business entity that is part of a common enterprise who has policy-making authority for the common enterprise may be deemed to have a policy-making position for purposes of this paragraph. A natural person who does not have policy-making 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.

"Officer" means a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any natural person routinely performing corresponding functions with respect to any business entity whether incorporated or unincorporated.

"Policy-making authority" means 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 over such policy decisions or having final authority to make policy decisions for only a subsidiary of or affiliate of a common enterprise. In the FTC's commentary on the final rule, it explains that "policy-making authority" is "assessed based on the business as a whole, not a particular office, department, or other sublevel. It considers the authority a worker has to make policy decisions that control a significant aspect of a business entity without needing a higher-level worker's approval."

For purposes of this definition, "total annual compensation" is based on the worker's earnings over the preceding year. Total annual compensation may include salary, commissions, nondiscretionary bonuses, and other nondiscretionary compensation earned during that 52-week period. Total annual compensation does not include board, lodging and other facilities as defined in *29 CFR 541.606*, and does not include payments for medical insurance, payments for life insurance, contributions to retirement plans and the cost of other similar fringe benefits.

In the FTC's commentary on the final rule, it refers to "senior executives" as "highly paid workers with the highest levels of authority in an organization." It also underscores that senior executives are likely to "negotiate the terms of their employment and may often do so with the assistance of counsel" and "have bargained for a higher wage or more generous severance package in exchange for agreeing to the non-compete," which makes their non-competes unlikely to be exploitative. The FTC also cautions in its commentary that "mere job title alone is insufficient to confer bargaining power on a worker, and lower-wage senior executives can be subject to the same exploitation and coercion that other workers face." To that end, it also takes the position that "[s]enior executives are relatively few in number" and "have highly specialized knowledge and skills."

One final point on this issue: employers may want to consider how broadly they construe the term "senior executive." Employers should of course review and apply the above-detailed definitions in good faith to ensure

compliance with the final rule. That being said, if an employer construes the term "senior executive" as applied to its workforce too narrowly or too conservatively, it may then be difficult, if not impossible, for the employer to later argue down the road that a particular worker or position that may have been a borderline determination is, in fact, a senior executive whose preexisting non-compete agreement was unaffected by the final rule.

D. Prepare a template notice regarding preexisting non-compete agreements (except for those with senior executives)

The FTC rule requires that, for all preexisting non-compete agreements – except for preexisting non-competes with senior executives – the employer must provide "clear and conspicuous notice to the worker," by the final rule's effective date, that said agreement will not, and cannot legally, be enforced against the worker after the effective date. Conveniently, the FTC has provided template notices in multiple languages that comply with the rule's requirements for employers to use. The template notice is attached as *Exhibit A*.

That said, with the current pending legal challenges to the rule, U.S. employers could face a significant predicament – namely, that

- the rule could technically take effect on September 4 (again, if no nationwide injunction of the FTC's rule has been issued and the FTC has not voluntarily agreed to delay the rule's effective date while the legal process plays out),
- the employer could correspondingly send out the above-referenced notices informing workers that their non-compete agreements will no longer be enforceable,
- and then a court could thereafter conclude that the rule is unconstitutional (meaning it arguably should never have taken effect in the first place).

In an attempt to account for this unenviable position, employers may wish to include a clause at the end of the notice indicating that, should the final rule be invalidated by a court in the future, the notice would be null and void and the non-compete agreement would remain in effect. A notice containing an example of such an additional clause is attached as *Exhibit B*.[4]

E. Understand the penalties for failing to send the required notices by the final rule's effective date

As noted above, if we get close to September 4 and no nationwide injunction of the FTC's final rule has been issued and the FTC has not voluntarily agreed to delay the final rule's effective date while the legal process plays out, employers may be caught with choosing between the proverbial lesser of two evils, which will likely involve a balancing of several risks and an assessment of the company's risk tolerance and threshold.

On the one hand, if we get to September 4 and the rule takes effect, some employers may opt to send the above-referenced notices to workers subject to a non-compete agreement – and thereby comply with the rule's notice requirement. However, this runs the risk that, if the final rule is later found by a court to be unconstitutional, any worker who received the notice could argue that, regardless of the court's decision, their non-compete became null, void, and unenforceable as of the date the notice was sent by the employer. As noted above, we have tried to account for this with the template notice attached as *Exhibit B*, but we cannot be certain that a court would agree that the reservation of rights in said template is sufficient or enforceable.

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[4] As noted in section (c) above, when determining which workers must be provided the required notice, a careful analysis of the worker's duties is critical to determining if they fall within the senior executive exception. If they do, the exception to the final rule applies and no notice need be provided. However, if a notice is sent to a worker that may have been a borderline case for meeting the "senior executive" definition, the employer would likely then lose the right to later argue that the worker was indeed a senior executive and, thus, would likely lose the right to enforce that worker's non-compete agreement. Alternatively in borderline cases, the employer could consider not sending the worker a notice, however this could expose the employer to the penalties discussed below.

On the other hand, some employers may opt to not send the requisite notices or to delay sending them in hopes that the U.S. Supreme Court will eventually strike down the rule. Under this scenario, the employer would avoid the predicament described above but, at the same time, would be in technical non-compliance with the rule.

In assessing this latter option in particular, it is important to understand the penalties for non-compliance. To that end, for employers who fail to comply with the final rule (including failing to send the required notices by the effective date), the FTC Act permits the FTC to obtain both equitable remedies (such as consent and judicial orders), as well as seek monetary remedies, such as civil fines for failure to comply with orders or statutory requirements. That said, the final rule *does not provide for a private right of action* by workers and, therefore, any aggrieved worker would have to ask the FTC to intervene and seek relief on their behalf.

In short, if we reach September 4, 2024 and the FTC's non-compete rule does indeed take effect (even if only for a short while), employers may want to consider balancing (i) the risk of complying with the rule's notice requirements and potentially invalidating their existing non-compete agreements despite there being at least a reasonable likelihood that the U.S. Supreme Court will strike down the rule, against (ii) the risk of technically not complying with the rule's notice requirements and being potentially subject to corresponding penalties but preserving a stronger argument – if the rule ends up ultimately being deemed unconstitutional – that the company's non-compete agreements remain in full force and effect.

F. Understand the penalties for failing to send the required notices by the final rule's effective date

Employers should assess, more broadly, what type of agreements they currently have in place with their workers. If workers are subject to non-compete agreements or clauses, but do not have any obligations with respect to customer/client non-solicitation, employers should consider requiring employees to sign new agreements containing customer/client non-solicitation clauses.[5]

Additionally, employers should consider conducting audits of their trade secrets and associated processes and procedures. Identifying its trade secrets, limiting access to only those who need it, and implementing proper training for employees on how to handle them and protect trade secret theft is perhaps more important now that non-competes could be rendered ineffective. Employers need strong internal protections if they can't rely on non-compete agreements.

Lastly, employers should consider reviewing other existing restrictive covenants, such as confidentiality and non-solicitation provisions, to ensure they are not so broad as to trigger the prohibitions of the final rule. The FTC has been clear that other provisions that effectively operate as non-compete agreements, that are not reasonably tailored to protect a company's legitimate interests, will be considered a non-compete and deemed unenforceable. Employers should not ignore these provisions in preparing for the effective date of the final rule.

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[5] If employers do so, they should consult with a Reed Smith attorney as there are certain state law parameters on non-solicitation clauses, as well as rules with respect to what constitutes sufficient consideration for employees agreeing to such clauses.

Exhibit A

A new rule enforced by the Federal Trade Commission makes it unlawful for us to enforce a non-compete clause. As of [DATE EMPLOYER CHOOSES BUT NO LATER THAN EFFECTIVE DATE OF THE FINAL RULE], [EMPLOYER NAME] will not enforce any non-compete clause against you. This means that as of [DATE EMPLOYER CHOOSES BUT NO LATER THAN EFFECTIVE DATE OF THE FINAL RULE]:

- You may seek or accept a job with any company or any person—even if they compete with [EMPLOYER NAME].
- You may run your own business—even if it competes with [EMPLOYER NAME].
- You may compete with [EMPLOYER NAME] following your employment with [EMPLOYER NAME].

The FTC's new rule does not affect any other terms or conditions of your employment. For more information about the rule, visit ftc.gov/noncompetes. Complete and accurate translations of the notice in certain languages other than English, including Spanish, Chinese, Arabic, Vietnamese, Tagalog, and Korean, are available at ftc.gov/noncompetes.

Exhibit B[6]

A new rule enforced by the Federal Trade Commission, but which is currently subject to legal challenge in the federal court system, makes it unlawful for us to enforce a non-compete clause. As of [DATE EMPLOYER CHOOSES BUT NO LATER THAN EFFECTIVE DATE OF THE FINAL RULE], [EMPLOYER NAME] will, subject to the bolded language below, not enforce any non-compete clause against you. This means that, again subject to the bolded language below, as of [DATE EMPLOYER CHOOSES BUT NO LATER THAN EFFECTIVE DATE OF THE FINAL RULE]:

- You may seek or accept a job with any company or any person—even if they compete with [EMPLOYER NAME].
- You may run your own business—even if it competes with [EMPLOYER NAME].
- You may compete with [EMPLOYER NAME] following your employment with [EMPLOYER NAME].

The FTC's new rule does not affect any other terms or conditions of your employment. For more information about the rule, visit ftc.gov/noncompetes. Complete and accurate translations of the notice in certain languages other than English, including Spanish, Chinese, Arabic, Vietnamese, Tagalog, and Korean, are available at ftc.gov/noncompetes.

Notwithstanding anything to the contrary in this notice, in the event that the FTC's new rule is at any time in the future (1) stayed to any extent by a final, non-appealable judicial or other decision or (2) deemed by a final, non-appealable judicial or other decision to be unconstitutional, invalid, impermissible, unlawful, unauthorized, null, void, or otherwise unenforceable on any grounds or for any reason, then in any such case this notice shall be deemed to be retroactively null, void, and unenforceable, and all non-compete clauses or agreements will remain and be deemed to remain and have remained in full force and effect, as if this notice was never issued (including but not limited to in relation to any acts or omissions that may have occurred or transpired between the issuance date of this notice and the date of such judicial or other decision). The company shall consider your decision to continue your employment therewith – which shall at all times remain on an "at will" basis – following receipt of this notice, as your consent to the terms and conditions set forth in this paragraph.

[6] As noted above, we cannot guarantee that a court would agree that the reservation of rights in the last paragraph of this template is sufficient or enforceable.

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