ALERT MEMORANDUM

Alert Memo: FT*C You Later: U.S. Federal Agency Says Goodbye to Noncompetes*

May 2, 2024

On April 23, 2024, the U.S. Federal Trade Commission ("***FTC***") voted to approve its final rule banning noncompetes in the United States (the "***final rule***").[1] The final rule was largely based on the FTC's proposed rule, which was first introduced in January 2023 (the "***proposed rule***"). For our summary of the FTC's proposed rule, please see our January 2023 alert memo.[2] After being under consideration for more than a year and absent an injunction staying its effectiveness, the final rule will go into effect 120 days after publication in the U.S. Federal Register—publication is scheduled for May 7, 2024, such that the final rule's effective date is likely to be September 4, 2024. The final rule has already begun to face legal challenges, including a lawsuit filed by the U.S. Chamber of Commerce (the "***Chamber***") on April 24, 2024. These challenges involve arguments focused on the FTC's lack of statutory authority under the FTC Act to issue the rule, the FTC's violation of the major questions doctrine, and its contravention of the non-delegation doctrine. The Chamber has since filed a motion for stay of the final rule's effective date and a preliminary injunction. Our overview of the final rule, insights and what we believe comes next follows.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Alan Levine
+1 212 225 2810
alevine@cgsh.com

Michael Albano
+1 212 225 2438
malbano@cgsh.com

Julia Rozenblit
+1 212 225 2814
jrozenblit@cgsh.com

Emily Barry
+1 212 225 2128
ebarry@cgsh.com

Irene Kwon
+1 212 225 2196
ikwon@cgsh.com

WASHINGTON

Daniel Culley
+1 202 974 1593
dculley@cgsh.com

Bruce Hoffman
+1 202 974 1784
bhoffman@cgsh.com

[1] FTC Non-Compete Clause Final Rule (to be codified at 16 C.F.R. Part 910), available here.

[2] *FTC Proposes Rule to Ban Non-Competes* (January 9, 2023), available here.

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The Final Rule

Generally. As of the effective date, the FTC's final rule bans *employers* from (1) entering into or attempting to enter into and (2) enforcing or attempting to enforce all post-employment *noncompetes* between employers and *workers* – whether entered into before or after the effective date. It also prevents an employer from representing that a worker is subject to a noncompete.

— An *employer* is defined expansively and is essentially any person or business entity that hires or contracts with a worker. Under the final rule, *employer* is intended to be significantly broader than a typical employer in an employee-employer relationship and covers all persons and entities to whom or for whom a worker provides services, including partnerships, limited liability companies and corporations.

— A *worker* is defined expansively as well and includes any person regardless of title or status, which, according to the preamble of the final rule, includes partners, members and stockholders. It does not depend on the individual's status under any other federal or state law, including the Internal Revenue Code or the Fair Labor Standards Act, and includes former employees, workers hired by a staffing agency or professional employer organization and independent contractors.

— A *noncompete* is defined to mean any term or condition that "prohibits a worker from, penalizes a worker for, or functions to prevent a worker from" (1) seeking or accepting work in the U.S. with a different employer or (2) operating a business in the U.S., in each case, after the worker's employment or engagement with the current employer ends.

Grandfathered Noncompetes for Senior Executives. Importantly, with respect to *senior executives*, the FTC's final rule bans the above actions only for noncompetes entered into after the effective date. A senior executive is a worker who earns more than $151,164 annually and who holds a *policy-making position*.

— A *policy-making position* means the employer's president, CEO or equivalent position, and any other officer or natural person who has *policy-making authority*.

— *Policy-making authority* for officers and other natural persons means final authority to make policy decisions over the employer as a whole and not merely over a subsidiary or affiliate.

Exceptions. There are three exceptions to the ban contained in the final rule.

— *Sale of Business.* Noncompetes entered into in connection with the bona fide sale of a business continue to be enforceable. There is no minimum ownership percentage threshold requirement (the proposed rule required a minimum ownership percentage of 25%).

— *Franchisee and Franchisor Contracts.* The final rule does not apply to contracts between a franchisee and a franchisor, but does apply to workers providing services to a franchisee or franchisor.

— *Certain Employers.* Employers not subject to the FTC's authority are not subject to the final rule. These employers include banks, savings and loan institutions, federal credit unions, certain common carriers, certain nonprofit entities and persons, partnerships or corporations subject to the Packers and Stockyards Act.

Notification. For each noncompete subject to the final rule, prior to the effective date, an employer must notify each current and former worker subject to the noncompete that the noncompete can no longer be enforced against the worker. Helpfully, the final rule provides model language that employers can use, but employers are also free to craft their own notice. The notice must be sent to affected workers on paper or in a digital format, such as email or text message.

Enforcement. The FTC has limited enforcement authority and can seek direct penalties only for (1)

violations of cease and desist orders and (2) under certain circumstances, violations related to "unfair or deceptive practices." Because the final rule categorizes noncompetes as "unfair methods of competition," rather than "unfair or deceptive practices," the FTC's enforcement ability is limited to judicial enforcement through court-ordered injunctions or civil penalties. There are also two exceptions to enforcement contained in the final rule.

— Claims for noncompete violations that accrued prior to the effective date may still be pursued.

— If the employer has a good faith belief that the final rule does not prevent enforcement of a noncompete, then the employer will not violate the final rule by enforcing the noncompete or by making representations about its enforcement.

For states that have adopted mini-FTC acts, which impose actual penalties for violations thereof, it remains to be seen whether a state's attorney general could use the final rule to bootstrap the employer into a violation of that state's mini-FTC act.

Insights

Defining Noncompetes

While the final rule defines a noncompete to include provisions that are typically considered noncompetes, *e.g.*, provisions in an employment agreement, restrictive covenant agreement or equity arrangement that expressly prohibit a worker from seeking employment with a competitor after the current employment ends, the final rule's prohibition goes beyond these traditional provisions. Forfeitures of compensation or benefits if the worker provides services to a competitor after the current employment ends would also be banned. This aspect of the final rule would prohibit enforcement of so-called forfeiture for competition provisions and the employee choice doctrine, as well as post-termination payments that are only made if the worker does not compete after the current employment ends.

But the final rule goes one step further. It also prohibits terms and conditions of employment that *function* to prevent a worker from competing after the current employment ends. This aspect is designed to ban restrictions that are "so broad or onerous that [they have] the same functional effect" as an explicit noncompete. The FTC did not categorically ban these types of arrangements, which include nondisclosure agreements ("***NDAs***"), non-solicitation agreements, training repayment agreement provisions ("***TRAPs***") and garden leave provisions, but the FTC noted that they can be scrutinized under a facts and circumstances test as to whether the provision would be a noncompete. Such a fact-intensive standard poses a notable uncertainty for restrictive covenants that, on their face, remain permissible under the final rule. The FTC provides the following clarifications to certain arrangements in the preamble to the final rule:

— For NDAs, the FTC provides that an NDA would not be a noncompete if the agreement did not apply to the worker's general knowledge or information that is readily ascertainable to other employers or the general public. The FTC provides some examples of NDAs that may function as noncompetes, including any NDA that bars a worker from disclosing, in a future job, any information that is "usable in" or "relates to" the industry in which the worker works or any NDA that bars a worker from disclosing *any* information or knowledge the worker may obtain during their employment whatsoever, including publicly available information.

— For non-solicitation agreements, the FTC does not provide any examples of where these agreements could be an issue, but it seems that employers should be cautious of such agreements for salespersons that effectively operate as noncompetes.

— For TRAPs, the FTC provides that the provision could be a noncompete where the agreement effectively operates as a liquidated damages clause or requires the worker to pay a significant penalty for leaving employment (*e.g.,* the penalties are disproportionate to the value of training the worker received). However, a typical clawback of a sign-on bonus where the worker terminates employment (which is not tied to who the worker

subsequently works for) would not be a noncompete.

- For garden leave provisions, the FTC provides that a provision would not be a noncompete where the worker remains employed and continues to receive the same compensation and benefits, on a pro rata basis. This is the case even where the worker's job duties or access to colleagues or the workplace is curtailed, and where bonuses do not become payable because a condition related to a bonus would not be satisfied.
- For fixed term contracts, *i.e.*, contracts where the worker agrees to remain employed by the employer for a fixed term and the employer agrees to retain the worker for that period, the FTC helpfully provides that such provisions are not noncompetes because they do not restrain post-employment activities.
- For severance and separation agreements that provide severance (or noncompete payments) only where the worker does not compete, these arrangements would no longer be enforceable because the severance entitlements would be forfeited if the worker competes. It may be possible to revise these provisions so that severance is eliminated if the worker obtains any new employment. However, any course of conduct whereby the employer continues to make payments and only eliminates them where the worker competes could result in a violation of the final rule.

Grandfathered Noncompetes for Senior Executives

Recognizing the practical concerns with banning existing noncompetes for senior executives and the complexities of unwinding arrangements for which substantial consideration may have already been paid or provided, the final rule only prohibits entering into or enforcing *new* noncompetes with such executives. As such, noncompetes with senior executives in effect as of the effective date will remain enforceable. As noted above, a person is a senior executive and can continue to be subject to a noncompete if the worker (1) earns more than $151,164 annually, including commissions and non-discretionary bonuses or compensation, but excluding benefits, and (2) has policy-making authority. The annual salary threshold is met if the worker received total annual compensation of at least $151,164 (i) in the preceding year, (ii) when annualized if the worker was employed during only part of the preceding year or (iii) when annualized in the preceding year prior to the worker's departure, if departed prior to the preceding year. *Preceding year* is defined as a person's choice among the most recent 52-week year, the most recent calendar year, the most recent fiscal year, or the most recent anniversary of hire year. Based on this formulation, we believe that whether a worker qualifies as a "senior executive" is determined as of the effective date, not as of the date of entering into the noncompete, though the final rule is not entirely clear on this point. The FTC estimates that approximately 0.75% of workers would qualify as senior executives.

In order to have policy-making authority, the senior executive must have the "final authority to make policy decisions that control significant aspects of a business entity or common enterprise" and such authority is assessed based on the business as a whole, rather than a particular office, department or other sublevel. The FTC notes that managers of small departments who do not have policy-making authority over significant aspects of a business entity as a whole without needing a higher-level worker's approval would not be senior executives.

In determining who has this authority, the final rule provides that an entity's ultimate president, chief executive officer and those with equivalent positions are presumed to be senior executives, and employers do not need to determine whether they have policy-making authority.

However, whether any other officer or natural person of a business entity can be considered a senior executive is a facts-and-circumstances analysis. The final rule looks to the Securities and Exchange Commission's (the "***SEC***") Rule 3b-7 to define officer and, as such, for U.S. public companies, this analysis will feel familiar and will in large part mirror the analysis conducted to determine "Executive Officers"

for purposes of SEC filings. It will also feel familiar to U.S. foreign private issuers who undertook a similar exercise during 2023 in connection with the implementation of Dodd Frank-compliant clawback policies. However, there are important differences between the two rules:

— Because the final rule extends to non-public companies, it does not include any person in charge of a principal business unit, division or function (such as sales, administration or finance). To be a senior executive under the final rule, the officer must have the final authority to control significant aspects of the entire common enterprise, taken as a whole. The FTC highlighted certain facts and circumstances that are helpful in considering how to define the common enterprise in more complex corporate structures (*e.g.*, alternative asset managers with multiple fund platforms and strategies), including where the various components of the common enterprise have the following characteristics: maintaining officers, directors and workers in common, operating under common control, sharing offices, commingling funds and sharing advertising and marketing.

— The final rule also uses the term "policy-making authority" instead of SEC Rule 3b-7's term, "policy-making function". The FTC believed that defining the term "policy-making authority" would provide greater clarity and facilitate compliance. As noted, the final rule applies to a wider range of business entities and the FTC wanted to minimize the need to consult with counsel about the meaning of this term. The FTC was also concerned that if the term was left undefined, employers could label too many workers as senior executives.

— Finally, the FTC looked to the limited case law interpreting SEC Rule 3b-7 and found that only those who had the authority to make company policy and ultimate decisions on significant issues would qualify as officers, and not those solely involved in discussing company strategy and policy. For example, if the head of a marketing division in a manufacturing firm only makes policy decisions for the marketing division, and those decisions do not control significant aspects of the business (which would likely be decisions that impact the business outside the marketing division), that worker would not be considered a senior executive.

As a result, there is likely to be some tension for public company employers to merely deem their suite of "Executive Officers" as senior executives under the final rule, as this approach may capture too many individuals for purposes of the final rule.

For private companies, this analysis will be new and will require careful consideration, particularly in the event a go-public transaction is on the horizon. As noted above, the final rule does provide a good faith standard, which allows employers to enforce, attempt to enforce or make representations about a noncomplete clause where there is a good-faith belief that the final rule is inapplicable.

One additional point is that as the final rule's definition of *worker* is not limited to individuals serving in a pure employment relationship. Helpfully, the FTC does provide that partners in a business would likely qualify as senior executives, assuming the partners have authority to make policy decisions about the business. Because of the breadth in the definition of worker, the final rule also leaves open the possibility that a director may be considered a *senior executive* for which an existing noncompete would be grandfathered.

All employers should consider keeping a detailed internal record of the decision-making process around which of their workers qualify as senior executives—in particular the rationale for determining whether an individual is in a policy-making position—in the event the final rule's good faith standard needs to be relied upon.

One question not answered by the final rule is whether a grandfathered noncompete will lose its exemption if the agreement containing the noncompete is amended. As long as the noncompete itself is not amended and any consideration underlying that noncompete is not

reduced, we would anticipate that the noncompete would continue to be grandfathered.

Sale of Business Exception

The most important exception in the final rule is for noncompetes entered into 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.” This exception was designed, without a percentage ownership threshold, to capture those noncompetes that are critical to effectively transferring goodwill between the seller and buyer of a *business entity*, which is broadly defined as any partnership, corporation, association, limited liability company or other legal entity, or a division or subsidiary thereof.

This exception is noteworthy for several reasons. First, there is no longer any minimum required ownership percentage to qualify for the exception, while the proposed rule required the seller to hold at least 25% of the business entity. In addition, the inclusion of a division or subsidiary of a business entity in the business entity definition will permit buyers to obtain noncompetes when less than all of a business is being sold. However, and notably in the private equity context, the FTC explicitly provides that ‘springing’ noncompetes and noncompetes arising out of repurchase rights or mandatory stock redemption programs do not qualify for this exception. Its rationale is that the worker is not exchanging goodwill for the noncompete and does not have knowledge of or the ability to negotiate the terms or conditions of the sale at the time of contracting. This position will prevent employers from relying on the exercise of “call rights” as consideration for a noncompete arrangement. Any noncompete subject to this exception will continue to be subject to applicable state law.

State Preemption and International Application

The final rule preempts state laws to the extent that the state law is less restrictive (*e.g.*, permits worker noncompetes) than the final rule. However, where state laws do not conflict with the final rule, enforcement of state laws restricting noncompetes is not limited or affected. For example, California’s restrictions on noncompetes and its related rules on customer non-solicits would not be affected, as well as Washington state’s requirement that the sale of business exception would only apply to a sale of one percent or more of a business.

The final rule only applies to restrictions on working in the U.S. or operating a business in the U.S. Accordingly, employers are still permitted to enter into noncompetes in non-U.S. markets. The FTC declined to include language in the final rule stating that it would not apply to overseas employers, reserving the possibility that the final rule could apply to overseas employers if a noncompete purports to restrict work or starting a business in the U.S. and the reviewing court applies U.S. law. As such, U.S. and overseas employers are not prohibited from entering into noncompetes with non-U.S. workers, as long as they do not restrict a worker’s ability to work or start a business in the U.S. Given the increasing and prevailing nature of remote work, the jurisdictional perimeter of the final rule raises interesting and difficult questions as to where, exactly, work or operation of a business is being restricted, in particular for U.S. based companies with workers outside of the U.S. Without additional guidance—the FTC declined to include any choice of law/conflicts provisions—the answer may depend on the governing law of the document that includes the noncompete and the location of the court that would hear any such dispute.

Notification Requirements

The final rule does not require rescission of any existing noncompete. However, the final rule does require employers to notify current and former workers that their noncompete is no longer enforceable against them. Helpfully, the final rule provides a model safe harbor notice.

The model notice must identify the employer who entered into the noncompete with the worker (but not the worker), which means that employers do not need to determine which of their workers are subject to noncompetes and instead can simply send a mass notice communication to current and former workers.

The model notice also refers broadly to "any non-compete clause" without enumerating the other arrangements that could be functional equivalents, giving employers the ability to defer making an immediate judgment call on the types of arrangements the final rule prevents.

Because the noncompete ban does not apply outside the U.S., employers may want to consider revising the model notice to clarify that noncompetes continue to be enforceable during employment and are permitted insofar as the restrictions apply only outside the U.S. Employers should also consider whether modifications to the model notice referring to the sale of business exception or grandfathered noncompetes are necessary because if the employer were to deliver the model notice verbatim (which states that the employer will not enforce *any* noncompete) to a worker covered by the sale of business exception or a senior executive, that notice could serve to end enforcement of any noncompete. However, this revision could have a chilling effect on workers in contravention of the FTC's stated goals because the worker may not be able to figure out whether the worker continues to be bound by a noncompete. As a result, it may be best to carefully consider the make-up of the employee populations that are subject to noncompetes and tailor the notice accordingly.

Finally, any notice must be delivered on paper, either by hand to the worker or by mail at the worker's last known personal street address; by email to an email address belonging to the worker, including the worker's current work email address or last known personal email address; or by text message to a mobile telephone number belonging to the worker.

What Comes Next

Whether or not the final rule's effective date is delayed pending current and anticipated legal challenges, employers should begin to take stock of current employee restrictive covenant arrangements and prepare to comply with the notice requirement. In particular, employers should consider the documents that may contain a noncompete or, perhaps more importantly, provisions that could *function* as noncompetes, including offer letters, employment and consulting agreements, standalone restrictive covenant agreements, non-disclosure arrangements, employee handbooks and severance and separation agreements, and what modifications to such arrangements would need to be made to bring them into compliance with the final rule (*e.g.*, for severance and separation agreements, removing any forfeiture of payments if the worker competes in favor of provisions that result in forfeiture if the worker obtains new employment generally). Special care should also be taken to examine other worker arrangements that may typically involve a noncompete, but may not be top of mind, such as employee incentive equity and carried interest arrangements and co-investments. Stock should also be taken of those noncompetes exempt from the final rule, including those subject to the sale of business exception and grandfathered noncompetes for senior executives.

Although revisions to pre-existing arrangements are not required (given the notice requirement), employers will not be permitted to rely on any such arrangements prohibited by the final rule following the effective date (except for senior executives). In the event employers have relied solely on noncompete arrangements for protection, consideration will need to be given to other permissible means of protection for the employer, for example, non-disclosure arrangements and invention assignment arrangements, and whether any additional consideration will need to be paid or provided to ensure enforceability of the new or enhanced arrangement (however, in many states, continued employment can be sufficient consideration).

As legal challenges unfold, it remains to be seen what other ripple effects the final rule might have. For example, a prohibition on noncompetes has the potential to impact the ability to offset payments in a corporate transaction that would otherwise be considered "parachute payments" under the Internal Revenue Code's Section 280G with a noncompete arrangement and result in more executives paying Section 280G's excise tax (and employers losing the corresponding deduction) in connection with corporate transactions. Because employers will no longer

benefit from the value of post-employment noncompetes, there is a possibility of resulting downward pressure on compensation arrangements, particularly with respect to senior employees who would traditionally receive substantial consideration, including severance payments, in exchange for a noncompete. Alternatively, due to the increased risk of competition, compensation arrangements could become more generous and intended for longer-term employee retention. Finally, the FTC does not take a stance on the interaction of the inevitable disclosure doctrine with the final rule and there could be a rise in lawsuits attempting to enjoin work for a competitor in situations where it is "inevitable" that a worker will disclose trade secrets in the performance of the worker's job duties (though only about half of the states recognize this doctrine).

We will continue to monitor developments and consider the evolving compliance landscape for businesses under the final rule. Please feel free to contact us about how the final rule affects your business.

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