FTC Votes to Ban Non-Compete Clauses: What Does this Mean for Employers?

Labor & Employment Law Update

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The Federal Trade Commission (FTC) voted 3-2 on April 23 to issue its final noncompete rule. The Rule becomes effective in 120 days. However, it already has been challenged in federal court in the State of Texas, and more suits are anticipated. There are serious concerns as to whether the FTC has the authority to regulate this area of the law.

If and when it goes into effect, the Rule would ban the use of non-compete clauses, including "de facto" non-compete clauses, and require employers to notify employees about the new rule and its impact on existing agreements. The FTC provided form language on how to provide notice that workers' non-competes will no longer be enforceable.

The Rule does not require rescission of existing agreements with "senior executives," although it does purport to ban agreements even with "senior executives" going forward. A senior executive is defined as "a worker who was in a policy-making position" and who received total annual compensation of more than $151,164.

The final Rule would apply to any contractual provisions that have the effect of prohibiting a worker from seeking employment in a competitive capacity after termination of his or her current employment. The rule defines a "non-compete" as "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer."

Furthermore, the Rule also establishes a category of "de facto" non-competes, meaning any contract clause that "has the effect of prohibiting the worker from seeking or accepting employment." According to the FTC, "de facto" non-competes include clauses such as non-disclosure clauses if they are drafted so broadly that they effectively would bar an employee from seeking employment with a competitor. As nondisclosure clauses are typically drafted very broadly, this also is an area that employers should review closely.

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Importantly, the rule does not bar non-solicitation clauses, either for customers or employees, although the concept of "de facto" non-competes leaves the door open to challenges to such clauses if the plaintiffs think that they effectively bar competition. A non-solicit qualifies as a de facto non-compete if it "is so broad or onerous that it has the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work … such a term is a non-compete clause under the final rule."

The Rule includes an exception for non-compete agreements entered into as part of the sale of a business. There also is an exception for pending noncompete litigation.

The FTC typically does not have jurisdiction to regulate non-profits, which includes many healthcare providers. However, the FTC stated that, "not all entities claiming tax-exempt status as nonprofits fall outside the Commission's jurisdiction." The FTC noted that it "looks to the source of the income, i.e., to whether the corporation is organized for and actually engaged in business for only charitable purposes, and to the destination of the income, i.e., to whether either the corporation or its members derive a profit." Unless an organization passes this "two-prong test," it may be subject to the new Rule.

As discussed above, the Rule already has been challenged in court and likely will be subject to additional challenges. It could be tied up in court for years. However, in terms of planning, employers should review their existing contracts and going forward, consider eliminating non-compete clauses in favor of narrowly drawn non-solicitation clauses, both as to customers and employees. Furthermore, employers should review their non-disclosure clauses to ensure that they are not overly broad. Typically, well-drafted non-solicitation and NDA provisions provide employers with protection of their customer and employee relationships and their competitively sensitive information - - which typically is what they want to protect. If an employer does not want to risk that its agreement will end up being invalidated, it can have its existing employees sign new agreements. Even without the new Rule, changes made by state legislature over recent years make such a review prudent.

Finally, we anticipate that many employees will read news reports about the new Rule and assume that their contracts are no longer enforceable. We would suggest that employers make a statement to their workforces to clarify that the Rule has not gone into effect, may never go into effect, and that employees should not assume that their restrictions are unenforceable until there is final confirmation that the Rule is valid and effective.