It's not fair — FTC bans non-compete clauses

The Federal Trade Commission (FTC) issued a final rule banning non-compete clauses on April 23, 2024, just over a year after receiving more than 26,000 comments on the proposed rule. Within several days, multiple lawsuits challenging the rule had been filed, including one seeking a stay of enforcement while the issue is litigated. Subject to the pending litigation, the rule will go into effect September 4, 2024 (effective date).

The rule bans non-compete clauses in all employment contracts after the effective date. It also bans the enforcement of existing non-compete clauses, with a few exceptions, as of that date. Existing non-compete agreements with senior executives, defined as those who 1) earn at least $151,164 and 2) have policy-making authority, will remain enforceable. Existing and new non-compete agreements as part of a bona fide sale transaction are also permitted under the rule, and any non-compete subject to a cause of action prior to the rule's effective date may still be enforced. All other non-compete agreements cannot be enforced after the effective date, and the employer must notify their employees by the effective date that the agreement will not be enforced.

The rule defines a non-compete clause broadly as any condition on employment that "prohibits a worker from, penalizes a worker for, or functions to prevent a worker from" working for another company or starting a related business "after the conclusion of the employment". This extends not just to non-compete clauses but includes forfeiture for competition provisions and could even encompass non-solicitation and nondisclosure agreements that are not narrowly drafted. Garden leave arrangements, where workers are paid by the company for a contractual period, are not implicated because the workers are still employed by the company during the garden leave term; fixed-term contracts with non-competes are also outside the scope of the rule.

In contrast, the "senior executive" exception appears to be narrow. The definition of "policy-making position" includes anyone with policy-making authority, regardless of title; however, if the individual has policy-making authority only over a subsidiary, and not the common enterprise, then they are not a senior executive for purposes of this rule. This likely excludes many senior officers who would be included under the SEC's definition of "executive officer" or under the IRC's definition of "officer." The commentary to the rule estimates that only 0.75% of workers should be classified as senior executives, although with the uncertainty around the definition, it is not clear how they arrived at that number. That uncertainty will also make applying the rule challenging for employers; the interpretation of close cases will likely be decided by courts.

The FTC's authority is limited by statute to for-profit enterprises; the statute also excludes banks, savings and loan institutions, federal credit unions, common carriers, air carriers (foreign and domestic), and those subject to the Packers and Stockyards Act from the agency's scope. The commentary to the rule, however, notes that not all entities that claim tax-exempt status as non-profits fall outside of the FTC's jurisdiction. Relying on agency precedent and judicial decisions, the FTC will look both to the entity's charitable purpose and whether either the entity or its members derive a profit. Given the prevalence of both nonprofit hospitals and non-compete agreements for healthcare providers, this appears to be another area ripe for litigation.

The FTC Act also does not address whether the agency can seek monetary remedies for a violation of unfair methods of competition. In contrast, the Act does specifically authorize monetary relief for unfair or deceptive practices. If monetary relief is not available, enforcement may be limited to equitable remedies, like injunctions.

This uncertainty, coupled with what will likely be protracted legal challenges, creates problems for businesses. Employers will have just four months, and little guidance, to determine whether an existing employee either 1) is a senior executive whose non-compete can be enforced or 2) is not a senior executive and must be given notice that the non-compete will not be enforced. For new hires, they will not be able to use non-compete agreements at all.

Alternatives to attracting and retaining top talent could take the form of a carrot, rather than a stick. Nonqualified deferred compensation (NQDC) arrangements can be designed in a way that does not violate the FTC's ban on non-compete agreements; in addition to providing "golden handcuffs" to retain existing employees, they can also be used to recruit new employees. Instead of relying on a non-compete agreement (that may not be enforceable) to penalize an employee for leaving, employers can instead offer an incentive to stay. A restrictive endorsement bonus arrangement (REBA) is one option, where the employer pays the premium on a life insurance policy owned by the employee through a bonus arrangement. As part of the agreement, the employee signs a restrictive endorsement with the carrier, limiting their access to the policy for a certain period. After the restricted period ends, the employer can continue bonusing the premiums as an added incentive for the employee to stay. This offers the employer an administratively simple way to reward select employees and provides the employee with valuable life insurance coverage that can also be structured as a source of supplemental retirement income.
This is one of many ways to create incentives to retain and reward key employees — other solutions like split dollar, salary deferral and even supplemental executive retirement plans can also be considered. These types of plans are customizable and can be offered as incentives to stay — which given recent legislation, might be the carrot employers need to keep employees from leaving their organizations. Note, there may be situations where restrictive covenants in a SERP or other deferred compensation plan may be unenforceable in light of these updates. Clients should discuss with their attorney.

The FTC ban is just the latest attack on non-compete agreements and follows many state efforts to restrict or even prohibit their use. Employers who take a proactive approach to retaining employees through incentives may be the ultimate beneficiaries of the FTC's new rule.