

CLIENT ALERT

Navigating Compensation Governance

FTC Adopts Broad Ban on Noncompete Provisions

The Federal Trade Commission has banned the use of noncompete provisions, with limited exceptions.

The ban is based on the FTC's determination that noncompete provisions are an unfair method of competition and therefore represent a violation of Section 5 of the Federal Trade Commission Act.

Business interests have already sued the FTC to bar implementation of the ban on noncompete provisions claiming the FTC lacks the legal authority to enact such a prohibition.

Overview of FTC Ban on Noncompete Provisions

On April 23, 2024, in a special meeting the FTC in a 3-2 vote (along party lines) adopted final rules which generally ban noncompete provisions. The new FTC rule declares noncompete provisions to be unfair methods of competition under Section 5 of the FTC Act. The rule bars nearly all types of business entities, including private and public companies, from entering into noncompete provisions with workers, including "senior executives." Covered companies will be required to notify workers covered under a noncompete provision that the provision is unenforceable and will not be enforced.

*However, a noncompete provision entered into with a senior executive **prior to the Effective Date** is **not** subject to the prohibition and continues to be enforceable.*

Although the ban expressly relates to noncompete provisions, the FTC notes that under certain circumstances the ban could extend to other restrictive covenants, such as nonsolicitation of clients, when such covenants effectively impede a worker's change of employment.

Exempted from the prohibition on noncompete provisions are:

- Noncompete provisions entered into with senior executives prior to the effective date of the final rule and
- Noncompete provisions entered into in connection with the sale of a business.

The prohibition on noncompete provisions becomes effective 120 days after the final rule is published in the Federal Register ("Effective Date" – expected to be in late August 2024), which has yet to occur.

Legal Challenges and Status of FTC Ban

As promised, the U.S. Chamber of Commerce along with other business interests¹ have filed suit against the FTC seeking a federal district court order to bar implementation of the FTC's ban on noncompete provisions and to declare that the FTC exceeded its legal authority in promulgating the ban.

On its website, the Chamber notes the following reasons for filing this lawsuit:

- The FTC's ban on noncompete agreements is another attempt at aggressive regulatory proliferation. That's why we're suing the FTC to block this unnecessary and unlawful rule and put other agencies on notice that such overreach will not go unchecked.
- Since its inception over 100 years ago, the FTC has never been granted the constitutional and statutory authority to write its own competition rules. This decision sets a dangerous precedent for government micromanagement of business.
- In addition to the nation's capital, 46 states permit noncompete clauses, which have traditionally been an issue of state law.

The federal district court may rule shortly on the Chamber's request to bar implementation of the ban on noncompete provisions. A number of legal commentators have already weighed in and believe the court is highly likely to grant the requested injunction.

Before taking any action in response to the FTC final rule, we recommend that companies wait until the district court has ruled on the injunction request (assuming that this occurs prior to the Effective Date). If as expected the district court issues an injunction, the status quo will remain unchanged, and companies can continue to enter into and enforce noncompete provisions (unless otherwise prohibited by state law).

Key Provisions of FTC Final Rule Prohibiting Noncompete Provisions

Outlined below are the key provisions of FTC final rule prohibiting noncompete provisions.

Prohibition of Noncompete Provisions

The final rule prohibits a "covered business entity" from:

- Entering into or attempting to enter into a "noncompete provision" with a worker²,
- Enforcing or attempting to enforce a noncompete provision with a worker, or
- Representing that a worker is subject to a noncompete provision.

However, a noncompete provision entered into with a "senior executive" **prior** to the Effective Date is **not** subject to the prohibition and continues to be enforceable.

The definition of "worker" includes an individual who works for a franchisee or franchisor, but it does not include a franchisee in the context of a franchisee-franchisor relationship.

¹ The Chamber's suit includes the following additional plaintiffs: Business Roundtable, Texas Association of Business and Longview Chamber of Commerce.

² The final rule defines "worker" as "a 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."

Definition of Noncompete Provisions

The final rule defines noncompete provision to mean a term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from:

- Seeking or accepting work in the United States with a different “person” where such work would begin after the conclusion of the employment; or
- Operating a business in the United States after the conclusion of the employment.

A term or condition of employment includes, but is not limited to, a contractual term or workplace policy, whether written or oral.

“Person” means any natural person, partnership, corporation, association, or other legal entity within the FTC’s jurisdiction, including any person acting under color of authority of State law.

In the release to the final rule, the FTC has indicated the prohibition on noncompete provisions generally would not apply to other restrictive covenants on employment, such as nonsolicitation and nondisclosure agreements, unless a restriction is so broad in scope that it **functions as a noncompete clause**.³ For example, a nondisclosure agreement between an employer and a worker that is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker’s employment with the employer would be treated as a prohibited noncompete provision.

Definition of Covered Business Entities

The final rule applies to nearly all forms of business organizations, including partnerships, corporations, associations, limited liability companies and other legal entities, or a division or subsidiary of business entities.⁴

Definition of Senior Executive

Senior executive means a worker who (i) was in a “policy-making position” and (ii) received “total annual compensation” of at least \$151,164 in the preceding year:

- Definition of policy-making position. Policy-making position means a covered business entity’s president, chief executive officer or the equivalent, and any other “officer” of a business entity who has “policy-making authority.”

Officer means a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any individual 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. However, policy-making authority 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.

- Determination of total annual compensation. Total annual compensation is based on the worker’s earnings over the preceding year. Total annual compensation may include salary, commissions,

³ The FTC’s final rule adopts a functional test for whether a contractual term is a noncompete clause – i.e., whether the provision has the effect of prohibiting 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.

⁴ The final rule does not apply to certain entities including certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers and foreign air carriers, and persons subject to the Packers and Stockyards Act of 1921, as well as an entity that is not organized to carry on business for its own profit or that of its members and State and local government entities when engaging in activity protected by the State action doctrine.

nondiscretionary bonuses and other nondiscretionary compensation earned during the covered 52-week period. Total annual compensation does not include board, lodging and other facilities, and does not include payments for medical insurance, payments for life insurance, contributions to retirement plans and the cost of other similar fringe benefits.

If a senior executive was employed during only part of the preceding year, the determination of total compensation would be based on the executive's annualized compensation for that year.

Notice Requirement for Existing Noncompete Provisions

A covered business entity that maintains a noncompete provision subject to prohibition under the FTC's final rule must provide a "clear and conspicuous notice" to each affected worker by the Effective Date that the worker's noncompete provision will not be, and cannot legally be, enforced against the worker. The final rule includes model language that a covered business entity may use to comply with the notice requirement.

Sale of Business Exception

The prohibition on noncompete provisions does **not** apply to a noncompete provision that is entered into by an individual pursuant to a bona fide sale of the person's ownership interest in a business entity. This exemption applies irrespective of the person's level of ownership (under the proposed rule, the exemption would apply only if the person held at least a 25% ownership interest).

Preemption of State Laws

The final rule preempts state laws governing noncompete provisions to the extent inconsistent with the final rule but does not preempt state laws that provide greater protections to workers.

Effective Date

The final rule becomes effective 120 days after its publication in the Federal Register, which has yet to occur as of the date of this update. The Effective Date is expected to be in late August 2024.

The *Client Update* is prepared by Meridian Compensation Partners' Governance and Regulatory Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-347-2524 or dkalfen@meridiancp.com.

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