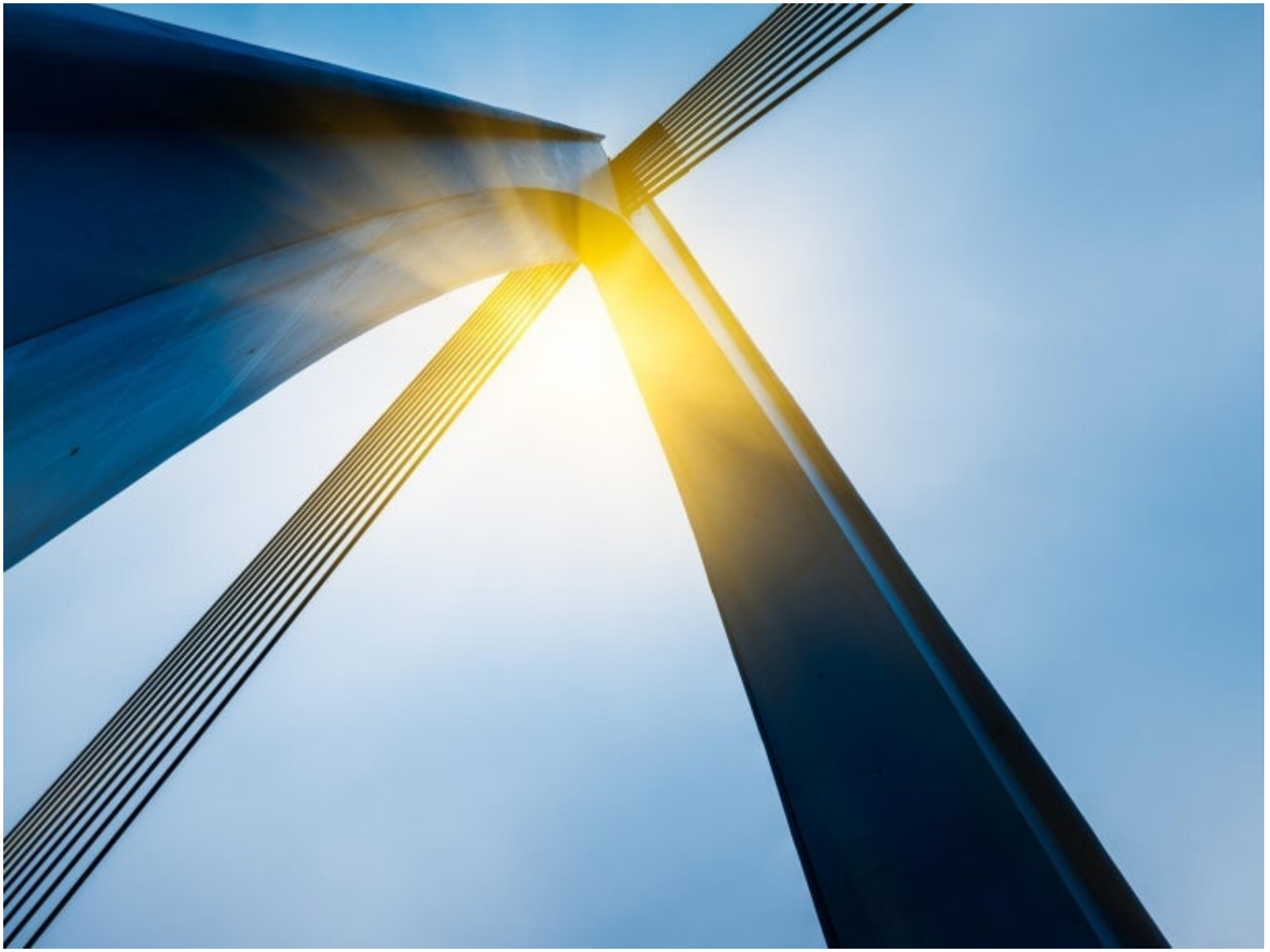

On April 23, 2024, the U.S. Federal Trade Commission (FTC) voted 3-2 to ban the use of nearly all noncompete agreements in America's for-profit businesses (with only a few narrow exceptions). The party-line vote comes after 26,000 public comments flooded the FTC in response to its January 2023 Proposed Rule to ban noncompete agreements. The Final Rule is set to go into effect 120 days following publication in the *Federal Register*, but a series of major challenges to the Rule—and to the FTC's authority to make and enforce the Rule—are expected, with some already underway. Dallas-based tax services and software provider Ryan LLC filed the first lawsuit against the FTC's Final Rule within hours of the vote. The U.S. Chamber of Commerce filed suit this morning, requesting declaratory judgment and for the Final Rule to be permanently enjoined.

In this Update, we cover the details of the FTC's Final Rule, what changed from the Proposed Rule, guidance for employers wondering what they should do now, and what might come next.

Overview: The FTC's Final Rule

The Final Rule prohibits employers from entering into or enforcing a new noncompete with any worker as of the Final Rule's effective date (120 days after publication in the *Federal Register*). The Final Rule also renders nearly all existing workplace noncompetes unenforceable as of its effective date, with the exception of noncompetes previously executed by "senior executive" employees, which remain enforceable if they were entered into prior to the effective date. The Final Rule defines "senior executives" as those earning at least $151,164 annually while wielding "policy-making authority" (authority to control significant aspects of the business). It is expected that this exception will apply to few employees in most organizations.

The ban also does not apply to noncompetes entered into by a person during the "bona fide sale of a business" of the person's ownership interest in a business entity or of all or substantially all of a business's operating assets (discussed in further detail below).

Burdensome notice requirements are also included in the Final Rule. By the effective date, employers must inform all current *and former* employees (other than senior executives) subject to a noncompete now prohibited by the Final Rule that their noncompete is no longer valid. Notices must identify the person who entered into the noncompete and be either hand-delivered, mailed to a known personal street address, or sent to an email address known to belong to the worker. Businesses who use the FTC's form notice are granted a "safe harbor" for compliance. The Final Rule bars employers from thereafter representing that the worker is subject to a noncompete.

Changes From the Proposed Rule

The Final Rule contains notable deviations from the January 2023 Proposed Rule. The Proposed Rule did not contain any exception for senior executives. It contained a narrower scale of the business exception, which applied only to noncompetes for an individual that owned at least 25% of the business. Additionally, the Proposed Rule would have required employers to formally rescind existing worker noncompete agreements (rather than just providing notice of unenforceability).

The Bona Fide Sale of Business Exception

The Final Rule carves out an important business exception, which allows for noncompetes that are ancillary to the "bona fide sale of a business." The FTC considers a transaction to be bona fide where it is "made in good faith" and "between two independent parties at arm's length, and in which the seller has a reasonable opportunity to negotiate the terms of the sale." Courts have long recognized that some noncompete agreements must be permitted "as an incentive to industry and honest dealing in trade." In the seminal case *United States v. Addyston Pipe Steel Co.,* future President and Chief Justice Howard Taft emphasized that "for the good of the public and trade," a person that "had built up a business with an extensive good will . . . should be able to sell his business and good will to the best advantage, and he could not do so unless he could bind himself by an enforceable contract not to engage in the same business in such a way as to prevent injury to that which he was about to sell." However, companies should be aware of the FTC's warning that "sham transactions, stock-transfer schemes or other mechanisms designed to evade the rule" do not qualify for this exception and are therefore unlawful.

"Functional" Noncompete Agreements

A version of a controversial provision in the Proposed Rule made its way into the Final Rule, and employers should be careful to consider its impact on agreements other than traditional noncompetes, such as clawbacks in

equity grants or bonus plans and nondisclosure agreements. In defining impermissible noncompetes, the Final Rule bans the use of any provision in an employment agreement that "prohibits a worker from, penalizes a worker for, or *functions* to prevent a worker from" working for a different entity or individual after the end of their employment.

The functional definition for employee noncompetes has been a great source of concern for employers due to the broad range of standard employment provisions potentially implicated by the flexible definition. Although standard employee noncompetes are clearly disallowed under the Final Rule, the Final Rule may also weaken some uses of other key provisions, including employee confidentiality agreements, nonsolicitation agreements, training repayment agreements, and no-hire agreements. The FTC's explanation for rulemaking identifies especially "broad or onerous" uses of these provisions as being barred by the Final Rule. As discussed below, employers revising workplace agreements or policies in response to the Final Rule will need to consider how to strengthen remaining trade secrets protections without implicating the Final Rule's functional test. Note that the commentary to the Final Rule also specifies that "forfeiture-for-competition" clauses are prohibited under the "penalizes" prong of the ban.

What Employers Should Do Right Now

As discussed above, challenges to the FTC's authority to make and enforce the Final Rule have already been filed, and these challenges may prevent the Final Rule from going into effect. The hot-button issue of the scope of agency authority has been percolating in the lower courts for some time, and recently, the Supreme Court of the United States has granted *certiorari* in two cases that may upend the Court's history of deference to expansive agency authority, *Loper Bright Enterprises v. Raimondo* and its companion case *Relentless, Inc. v. Department of Commerce.* The FTC's final rule will, no doubt, increase calls to limit the outer bounds of agency authority.

For now, though, employers can take prompt and proactive steps to prepare themselves in case the FTC defeats its expected challengers, and the Final Rule is implemented. And many of these suggested steps would be beneficial in protecting trade secrets regardless of whether the Final Rule is ultimately implemented. Employers may want to consider the following steps:

- **Shore-up noncompetes for senior executives.** Although the Final Rule bars the use of noncompetes for all employees, it includes an exception for noncompetes with senior executives that were entered into *before* the effective date of the Final Rule. This carveout for senior executive employees provides businesses with a small opportunity over the next 120 days to negotiate and/or revise noncompetes agreements for these individuals. Given the high frequency with which executives interact with trade secrets and their value to the business, this should be a top priority for businesses in the short term.
- **Shore-up other restrictive covenants.** As discussed above, although the Final Rule purports to ban agreements that are "functional equivalents of non-competes," the Commentary to the Final Rule is clear that the Final Rule does not prohibit "restrictive employment agreements other than noncompetes" such as confidentiality agreements, nonsolicitation agreements, and training repayment agreements that "do not by their terms or necessarily in their effect prevent a worker from seeking or accepting work with a person or operating a business after the worker leaves their job." Thus, businesses should consider utilizing other restrictive covenants in ways that would not run afoul of the Final Rule's functional standard but would aid in protecting trade secrets and protectable client relationships and investments.
- **Implement mechanisms and procedures to better protect trade secrets and information security.** There are many practical steps businesses can take to better protect trade secrets in the workplace, including by implementing and strengthening IT and data use policies; performing regular trade secret and information security audits; utilizing monitoring software or other protections where highly proprietary information is concerned, including tracking instances of unauthorized accessing of documents or attempts

at unauthorized access, mass downloads, irregular use of personal email, or other unusual access patterns; and improving onboarding and offboarding procedures (including immediate data restriction and wiping procedures) and quick response plans if trade secrets are found to have been compromised.
- **Prepare human resources personnel to respond to inquiries about the ban and for the potential sending of required FTC notices.** Businesses should train their leaders and HR personnel on how to respond to inquiries related to the ban, including that the ban will not go into effect until 120 days after publication in the *Federal Register* and is also already subject to legal challenge. Businesses should also consider preparing to comply with the notification requirements, starting with developing a process to identify current and former workers with noncompetes and their contact information.

Perkins Coie LLP will continue to closely monitor implementation of the FTC's blockbuster Final Rule to assist our clients in being prepared to timely implement necessary changes.

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