

AGENDA

Questions Abound for Boards After FTC's Noncompete Ban

Directors should work with HR to gather info on who could be affected

By **Nick Muscavage** | May 3, 2024

The **Federal Trade Commission's** noncompete ban was challenged in court last week one day after it was adopted, and while the fate of the rule may be uncertain, boards of directors should be preparing for compliance.

The rule will bar companies from using noncompetes to prevent employees from working at other companies and will prohibit the use of other methods of restraining employees from working for competitors. Directors should work with management teams to gather information on whom the ban could impact — the rule requires companies to notify current and former employees through "individualized" communications that their noncompete agreements are no longer enforceable.

The new policy is estimated to affect 30 million workers and will include the vast majority of industries except for banking, which is exempt from the commission's jurisdiction. Boards of directors will have to play a role in ensuring compliance with this rule and overseeing action plans, according to **Jason Goldman**, a partner at law firm **Davis Goldman**.

Human resources departments should start compiling a list of who will be covered by the rule and ensure they are documenting these efforts, he said. Still, the rule won't become effective until 120 days after it has been published in the Federal Register, and its rollout could be halted by the courts.

"The board might want to have a solution prepared by counsel implementing a plan to actually comply but not necessarily executing the plan until maybe 30 or 60 days pass, as we don't know what will be enjoined or what will shake out in the courts in that period," Goldman said. "But you don't want to be caught with your pants down."

These responsibilities can be delegated to a board committee, and at most companies, that would most likely fall to the compensation committee, according to **Mike Shah**, a partner at law firm **Milbank**.

Management, working with the compensation committee, should begin "identifying individuals that they believe are crucial to protecting the legitimate business interest of the company, should they go compete," he said.

The rule has a carveout for senior executives, defined in the rule as employees earning \$151,164 who are in a "policy-making position." Existing noncompetes can remain in place for senior executives, but companies will be prohibited from entering into new noncompetes with these high-level employees.

Once these employees are identified, typically through an analysis of whether they possess trade secrets, client lists or other information that could impact competitiveness, management and counsel, with board oversight, can craft methods to protect their business interests without using noncompetes, Shah said.

One such method could be offering "garden leave" to exiting employees, he said. So-called garden leave programs allow employers to place departing high-level employees on leave for a period of time, usually six months to a year, while still compensating them in order to allow time to pass before they can work for a competitor.

The FTC stated in its final rule that these policies will not fall under the definition of noncompetes as long as the employees are still receiving the same amount of compensation and benefits while on garden leave.

There are other forms of restrictive covenants that companies may begin to rely on to safeguard coveted information, according to **Jared Cook**, an employment and commercial litigator at law firm **Tully Rinckey**.

"There are nondisclosure agreements and other types of nonsolicitation agreements that can accomplish some of the same things that noncompetes do without actually restraining somebody from working for a competitor. And employers, I'm sure, will still continue to use those types of agreements."

However, companies should be aware that the FTC's rule not only bans noncompetes; it also prohibits employers from using any clause that "functions to prevent" an employee from working for a competitor, according to **Orly Lobel**, a professor at **University of San Diego** School of Law and author of "Talent Wants to Be Free: Why We Should Learn to Love Leaks, Raids and Free Riding."

The FTC's "primary examples of this may include overly broad NDAs and nonsolicitation clauses," she said. "But those aren't straight up void. One would need to go through litigation to show that a specific clause that is an NDA or nonsolicit effectively prevents an employee from accepting a job."

For example, the FTC pointed to nonsolicitation clauses that attempt to cover the entirety of the potential customer market as problematic or NDAs that try to include general knowledge that is known in the industry, she said.

Companies may see an upside to the noncompete ban, though, Lobel said.

The FTC's ban on noncompetes will benefit workers, companies and the economy at large, she said. The move will promote innovation, competition, entrepreneurship and industry growth, she added.

"Companies will benefit from being able to recruit dynamically as they expand their venture. They will be able to get the best fit, the most experienced and valuable employees into the right teams," Lobel said. "The benefits of banning noncompetes also at the executive level are multiple: strengthening talent mobility, knowledge flows, human capital deployment, competition and new market entry."

Additionally, banning noncompetes will also help stem the gender and racial wage gaps, according to Lobel.

"When mobility is artificially suppressed by noncompetes, undervalued talent cannot discover their true market value by receiving external job offers," she said. "The empirical literature shows that noncompetes thus exacerbate market inequality."

Questions and No Answers

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The ban has raised concerns from others because it's "essentially invalidating hundreds of years of case law" that have recognized noncompetes as "a valid way to do business," said **Jason Tremblay**, vice chair of **Saul Ewing's** labor and employment practice.

There are other concerns not addressed in the FTC's final rule, he said.

"What if you had paid \$10,000 as a signing bonus to get an employee to sign a restrictive covenant?" Tremblay said. "Is that employee obligated to pay that dollar bonus back now because it's all of a sudden invalidated?"

Other companies offer tuition repayment programs in exchange for employees' agreeing to remain at the company for a period of time.

"If there is an obligation for that employee to repay that if they don't stay a certain amount of time after receiving that benefit, ... is that going to be construed by the FTC to be a restriction on their ability to go somewhere else?" Tremblay asked. "And if that's the case, will all those be invalidated?"

Other questions abound, too.

If the rule survives the legal challenges, including the **U.S. Chamber of Commerce's** lawsuit brought against the FTC in a Texas federal court, companies may struggle early on with defining who falls under the senior executive umbrella.

The FTC's rule and its guidance "don't really define what a policymaking position is," Cook said. "I could see there could be some litigation on that."

Managers who are merely overseeing people probably won't be included, he said, but "if you are actually writing the policies, then you may qualify, as long as you also satisfy the compensation."

Compensation and Competition

When it comes to compensation, there's a divide on the impact the ban will have.

"It could negatively impact compensation," Goldman said. For instance, companies could be hesitant to pay as high a salary to employees if they believe those employees would just come on board, learn the company's systems, and then "just get out of here and go do it themselves."

However, Lobel has found through her behavioral research that, when employees are not bound by noncompetes, "they are more likely to invest in their own human capital, perform better and manage their career trajectory with the motivating incentives that there will be a tournament over the best talent."

As a result, the noncompete ban means that companies will use carrots of performance-based incentives, such as bonuses, stock options and other vesting rewards and retention efforts as an alternative to "simply using the threat of litigation against employees who want to leave."

"This too will enhance performance of firms," Lobel said. "And in the repeat game of increased talent mobility, more knowledge will circulate in industries, leading to faster rates in innovation, patenting, start-up spinoffs and overall industry growth."

To see how all that plays out, the rule will first have to survive the legal challenges. The case brought by the Chamber of Commerce could eventually go to the **5th Circuit Court of Appeals** and maybe eventually the Supreme Court. It argues that the FTC violated the Administrative Procedure Act by acting beyond the bounds of its statutory authority.

Until then, though, companies "really do need to kind of take this wait and see approach," Tremblay said.

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