

Summary of FTC Final Rule Banning Most Non-Competes and Frequently Asked Questions

What clauses/non-competes are impacted by the Final Rule?

Answer: The Final Rule defines a prohibited “non-compete clause” as any contract term, workplace policy, or term or condition of employment, written or oral, that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from seeking work, accepting work, or operating a business after prior employment ends. Other types of post-employment covenants (*e.g.*, non-solicitation) *could* be attacked under the Rule if they have the effect of a non-compete.

What conduct is prohibited by the Final Rule?

Answer: The Final Rule prohibits employers from: (1) entering into or attempting to enter into a non-compete clause, (2) enforcing or attempting to enforce an existing non-compete clause, and (3) representing that a worker is subject to a non-compete clause. The Final Rule applies to non-compete clauses entered before the Effective Date of the Final Rule unless the non-compete clause affects a “Senior Executive” (see next question below).

Are there any exceptions available under the Final Rule?

Answer: As explained earlier, the Final Rule does not apply to non-profits and certain other employers. There are also some limited exceptions:

The exception for “Senior Executives”: Unlike the proposed rule, the Final Rule provides an exception for non-compete clauses entered into with Senior Executives **before the Effective Date**. A Senior Executive means a worker receiving total annual compensation (excluding fringe benefits) of at least \$151,164 in the preceding year, and was “in a policy-making position” — meaning the entity’s president, CEO, officer, or other person who has final authority to make policy decisions that control significant aspects of the entity (and not just a subsidiary or affiliate).

The exception for “bona fide sales of business”: The Final Rule does not apply to non-compete clauses entered into “pursuant to a bona fide sale of a business entity, of the person’s ownership interest in a business entity, or of all or substantially all of a business entity’s operating assets.” The Final Rule does *not* limit this exception to only those holding at least 25% ownership interest in a business, like the proposed rule did.

What employers and workers are impacted by the Final Rule?

Answer: Generally, the Final Rule will impact all employers other than non-profits, certain banks, savings and loan companies and common carriers, which are not subject to the FTC's authority by law. The Final Rule applies to paid and unpaid workers, including employees, independent contractors, externs, interns, volunteers, apprentices, and sole proprietors. The Final Rule does not apply to the franchisee in a franchisor relationship.

Are non-profit hospitals covered by the Final Rule?

Answer: In most cases, charitable and other 501(c)(3) organizations, including tax-exempt hospitals, will be exempt from the Final Rule. However, the FTC has taken the position that a nonprofit corporation will be subject to the FTC's jurisdiction if it is a "corporation," defined, in part, under the Final Rule as an entity that is "organized to carry on business for its own profit or that of its members."

How will the FTC determine whether a nonprofit is subject to the Final Rule?

Answer: The FTC will apply a two-part test to determine whether an entity is organized for profit and thus within the FTC's jurisdiction. As explained by the FTC, "The not-for-profit jurisdictional exemption under Section 4 requires both that there be an adequate nexus between an organization's activities and its alleged public purposes and that its net proceeds be properly devoted to recognized public, rather than private, interests." In other words, the FTC will look to both the: (1) source of the income (i.e., whether the corporation is organized for and actually engaged in business for only charitable purposes); and (2) the destination of the income (i.e., whether either the corporation or its members derive a profit).

What factors might cause a nonprofit to fall under the FTC's jurisdiction?

Answer: Even if an organization has received a favorable 501(c)(3) determination letter from the IRS, the FTC noted that the presence of private benefit or private inurement could cause an organization to be subject to the Final Rule. Administrative proceedings and judicial decisions involving the FTC or the IRS have identified numerous private benefits that, if offered, could result in the FTC concluding that the entity a corporation was "organized to carry on business for its own profit or that of its members" under the FTC Act, thereby bringing it within the FTC's jurisdiction. Importantly, the FTC may find persuasive determinations from the Tax Court and from the IRS that a tax-exempt organization is not organized and operated exclusively for 501(c)(3) purposes.

Does the Final Rule contemplate private benefit specifically in the healthcare/healthcare joint venture context?

Answer: It does. The FTC declined to adopt a blanket exemption for the healthcare industry. The FTC also declined to agree with certain commentators that the final rule would result in a disparity between for-profit and tax-exempt healthcare entities, reinforcing its position that not “all hospitals and healthcare entities claiming tax-exempt status as nonprofits fall outside the FTC’s jurisdiction.” The FTC provided three examples of tax-exempt healthcare organizations that would be subject to its jurisdiction because of the presence of private benefit and a fourth example related to excessive compensation:

1. The FTC has exercised jurisdiction over a physician-hospital organization because the organization engaged in business on behalf of for-profit physician members. In this example, the tax-exempt organization consisted of over 100 private physicians and one non-profit hospital.¹
2. Similarly, the FTC has exercised jurisdiction over an independent physician association claiming tax-exempt status. The association consisted of private, independent physicians and private, small group practices. That association was organized for the pecuniary benefit of its for-profit members because it “contract[ed] with payers, on behalf of its [for-profit] physician members, for the provision of physician services for a fee.”²
3. In addition, under IRS precedent in the context of tax-exempt nonprofit hospitals and other related entities that partner with for-profit entities, where the purportedly nonprofit entity “has ceded effective control” to a for-profit partner, “conferring impermissible private benefit,” the IRS has found that the entity loses tax-exempt status.³
4. Finally, the IRS has also rejected claims of tax-exempt status for entities that pay unreasonable compensation to founders, board members, their families, or other insiders.⁴

¹ In the Matter of Preferred Health Servs., Inc., FTC No. 41-0099, 2005 WL 593181, at *1 (Mar. 2, 2005).

² In the Matter of Boulder Valley Individual Prac. Assoc., 149 F.T.C. 1147, 2010 WL 9434809, at *2 (Apr. 2, 2010).

³ Redlands Surgical Servs. v. Comm’r, 242 F.3d 904, 904-05 (9th Cir. 2001).

⁴ See Fam. Tr. of Mass., Inc. v. United States, 892 F. Supp. 2d 149, 155-156 (D.D.C. 2012); I.R.S. G.C.M. 39,674 (Oct. 23, 1987); Bubbling Well Church of Universal Love, Inc. v. Comm’r, No. 5717-79X, 1980 WL 4453 (T.C. June 9, 1980).

What about organizations described in 501(c)(4), 501(c)(6), and others?

Answer: A nonprofit corporation exempt under another 501(c) section would be exempt so long as it is not “organized to carry on business for its own profit or that of its members.”

What happens to existing lawsuits?

Answer: The Final Rule does not apply to causes of action related to non-compete clauses that have accrued prior to the Effective Date. In other words, the Final Rule likely will not change cases involving alleged violations of non-compete clauses occurring before the Effective Date.

Is there still risk when hiring a competitor’s employees?

Answer: Yes. The Final Rule does not take effect for months and may never take effect if the court challenges are successful, so in that event, existing non-competes would still be effective. Thus, prior to the Effective Date (if ever), hospitals still need to ensure that potential job candidates are not subject to a non-compete before considering hiring them. Additionally, it is important to note that the Final Rule generally does not eliminate all risk to hiring employees from a competitor because even without non-compete clauses, employers can still bring suit based on other contract terms (non-solicitation and non-disclosure clauses), trade secrets, and legal theories, to protect their interests when former employees go to work for a competitors. As discussed above, even under the Final Rule, non-competes with Senior Executives entered into before the Effective Date are enforceable.

What do we expect next?

Answer: Lawsuits challenging the Final Rule were filed within hours of the vote, including one by the U.S. Chamber of Commerce. Given the scope of the Final Rule and its impact, it is anticipated that at least some courts will enjoin the Final Rule from taking effect until the U.S. Supreme Court has an opportunity to weigh in on the Final Rule’s validity and constitutionality. However, it remains to be seen whether courts will be able to impose a *nationwide* injunction of the Final Rule, or whether the injunctions will be localized to particular states and/or jurisdictions.

What does the Final Rule require employers to do now?

Answer: Unless the Final Rule is enjoined, on or before the Effective Date, employers are required to provide all workers with impacted non-compete clauses clear and conspicuous notice that the non-compete clause will not be, and cannot be, legally enforced against them. Employers must provide this notice in writing by

hand delivery, mail, email or text message, and group communications are permissible. The Final Rule provides model notice language.

Additionally, our hospital members may wish to:

- Examine your activities for the presence of private inurement, private benefit, or any other indication that the organization is organized for its own profit or that of its members. Assuming none of these are present, the FTC should have no jurisdiction over your organization, including the ability to enforce the Final Rule.
- Pay special attention to joint ventures with for-profits and private individuals for the presence of private benefit and/or private inurement. Review any agreements, governing documents, and/or other documentation to ensure appropriate safeguards are in place.
- For tax-exempt hospitals, the FTC mentions in the Final Rule that it is aware of the increasing public scrutiny tax-exempt hospitals are under and points to studies which, according to the FTC, “reveal that some such hospitals are operating to maximize profits, paying multimillion-dollar salaries to executives, deploying aggressive collection tactics with low-income patients, and spending less on community benefits than they receive in tax exemptions.” Accordingly, you may want to confirm compliance with Section 501(r) of the Code.

Specifically:

- Ensure the system and its hospitals are capturing all community benefit and investment activities and expenses, and reporting those on Form 990, Schedule H.
- Review and refresh financial assistance and debt collection policies and procedures and ensure they are publicly posted.
- Train and refresh employees in areas that impact compliance, such as revenue cycle, on your organization’s policies and procedures.
- Self-audit newly acquired facilities to ensure they are compliant with your system’s policies and procedures.
- Confirm that all compensation paid by the organization to employees and others is reasonable and approved in accordance with a conflict of interest policy. Common best practices include an annual review of compensation paid to officers, directors, and others in a position to exercise substantial influence over the organization; benchmarking studies from outside consultants that examine comparable compensation data; approval by an independent authorized body; and appropriate documentation.