

FTC Final Rule Banning Most Non-Competes Passes – What Nonprofits Need to Know

On April 23, 2024, the Federal Trade Commission (“FTC”) conducted a special Open Commission Meeting to vote on a Final Rule (the “Rule”) banning most non-compete clauses as an “unfair method of competition.” By a vote of 3-2, the Rule was approved for publication in the Federal Register. The Rule becomes effective 120 Days from Publication in the Federal Register (the “Effective Date”).

In a separate Polsinelli [Update](#), we summarized significant provisions of the Rule, including what employers and workers are impacted by the Rule, what conduct is prohibited by the Rule, and other important takeaways. Below we are focused specifically on the Rule’s application to nonprofit corporations.

Are nonprofit corporations described in Section 501(c)(3) of the Internal Revenue Code (the “Code”) exempt from the Rule’s requirements?

In most cases, charitable and other 501(c)(3) organizations, including tax-exempt hospitals, will be exempt from the Rule. However, the Commission has taken the position that a nonprofit corporation will be subject to the Commission’s jurisdiction if it is a “corporation,” defined, in part, under the 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 Rule?

The Commission will apply a two-part test to determine whether an entity is organized for profit and thus within the Commission’s jurisdiction. As explained by the Commission, “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.” Put another way, the Commission 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?

Even if an organization has received a favorable 501(c)(3) determination letter from the IRS and is otherwise exempt from the Rule, the presence of private benefit or private inurement could cause an organization to be subject to the Rule. “Administrative proceedings and judicial decisions involving the Commission or the IRS have identified numerous private benefits that, if

offered, could render an entity a corporation organized for its own profit or that of its members under the FTC Act, bringing it within the Commission's jurisdiction." Importantly, the Commission 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 Rule contemplate private benefit specifically in the healthcare / healthcare joint venture context?

It does. The FTC declined to adopt a blanket exemption for healthcare industry. The FTC also declined to agree with certain commentators that a disparity would be present 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 Commission's jurisdiction." The FTC provides three examples of tax-exempt healthcare organizations that would be subject to the Commission's jurisdiction because of the presence of private benefit and a fourth example related to excessive compensation:

1. The Commission 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 Commission 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. 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 entity loses tax-exempt status.³
4. 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

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

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."

Takeaways:

- Your organization should examine its activities for the presence of private inurement, private benefit, and 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 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 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 multi-million-dollar salaries to executives, deploying aggressive collection tactics with low-

income patients, and spending less on community benefits than they receive in tax exemptions.” This is a good opportunity to confirm compliance with Section 501(r) of the Code because of recent attention from the IRS’ Tax-Exempt and Government Entities division, as described in a separate Polsinelli [Update](#). 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.
 - 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.

Contact your Polsinelli attorney if you have questions about your organization’s 501(c)(3) tax exemption or need guidance reviewing your non-compete agreements or strategy around restrictive covenants.

[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).