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# FTC Rule to Ban Non-Competes Draws Swift Challenge

## The Bottom Line

- The FTC Rule would drastically alter the noncompete agreement landscape and "federalize" this area of law, previously solely governed by state law.

- If the rule survives the pending legal challenge or any other, employment noncompete agreements would be banned nationwide.

- Even if the FTC Rule does not become law, the rule signals that noncompete agreements are increasingly disfavored.

- Employers should monitor the developments and assess potentially utilizing alternatives to industry noncompetes to protect their legitimate business interests.

The U.S. Federal Trade Commission (FTC) issued a final rule purporting to ban employment noncompete agreements nationwide. The FTC Rule passed with a 3-2 vote on April 23, 2024, and is scheduled to become effective 120 days after it is formally published in the Federal Register. The rule is expected to be formally published on May 7, 2024, which would make the effective date September 4, 2024.

If enacted, the FTC Rule would represent a seismic shift in the enforceability of noncompete agreements across the country. However, at least two lawsuits have already been filed seeking to invalidate the rule. Therefore, it is very much an open question as to whether the rule will ultimately become law.

### U.S. Non-Compete Law Before the FTC Rule

Currently, the enforceability of noncompete agreements in the U.S. is governed by the applicable state law, and states have taken a variety of different approaches to regulating such agreements. In addition, states generally have regulated noncompete agreements more strictly than they have other types of restrictive covenant agreements, such as customer non-solicitation and non-servicing agreements and employee non-solicitation agreements.

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Certain states, such as California, Minnesota and Oklahoma, have *per se* bans of noncompetes, similar to the ban endorsed by the FTC Rule. Other states, such as Illinois and Massachusetts, have placed statutory limits on the enforcement of noncompetes rather than a *per se* ban. Examples of statutory limitations include permitting noncompetes only for highly compensated employees and imposing specific employee notice requirements for a noncompete to be enforceable. The rest of the states, including New York and Delaware, generally enforce "reasonable" noncompetes, as interpreted by the courts.

## The FTC Rule

The FTC Rule purports to eliminate the state-by-state regulation of noncompetes. Relying on Section 5 of the FTC Act, the FTC Rule broadly:

1. prohibits noncompetes,

2. prohibits enforcing or attempting to enforce noncompetes and

3. prohibits representing that a worker is subject to a noncompete.

The FTC Rule also imposes a requirement that employers notify any employee subject to an unenforceable noncompete that the noncompete is unenforceable. The final rule followed a 90-day public comment period, during which the FTC received more than 26,000 comments.

The FTC Rule is sweeping in scope and includes only narrow exceptions. The primary exception is for noncompetes entered in connection with a "bona fide sales of business." This is consistent with the law in many states where noncompetes agreed upon in connection with the sale of a business are treated more leniently than standard employment noncompetes.

Importantly, the FTC Rule has a retroactive effect. This means that it not only purports to ban noncompetes moving forward, but it also bans noncompetes that are already in effect. The only exception to this retroactive effect is for so-called "senior executives." For senior executives, noncompetes are banned moving forward, but existing noncompetes may still be enforceable. A senior executive is defined as an employee in a "policy-making" position who had total nondiscretionary compensation of $151,164 in the "preceding year." Preceding year is defined as the employer's "choice among the following time periods: the most recent 52-week year, the most recent calendar year, the most recent fiscal year, or the most recent anniversary or hire year."

Although the FTC Rule has a retroactive effect, it does not affect existing claims or "causes of action" in which the claim or cause of action related to a noncompete accrued prior to the FTC Rule effective date. Therefore, the rule should not impact situations where an employee has already breached an existing noncompete.

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The comments to the FTC Rule indicate that the FTC considers "forfeiture for compensation" provisions to fall within its definition of noncompete, but the rule does not explicitly ban some important current protections over customer or employee non-solicitation agreements, customer non-servicing agreements, garden leave agreements or non-disclosure agreements. The comments to the rule, however, indicate that such agreements may still be covered where the relevant agreement "function[s] to prevent a worker from seeking or accepting other work or starting a business after their employment ends." As a practical matter, it is expected that this standard would only be met in extreme cases where, for example, the relevant market is highly concentrated.

## The FTC Rule Already Faces Legal Challenge

Just one day after the FTC voted to approve the FTC Rule, the United States Chamber of Commerce and other groups filed a lawsuit seeking to invalidate the rule. Filed in the U.S. District Court for the Eastern District of Texas, the lawsuit asserts that the FTC exceeded its authority in promulgating the FTC Rule. There is also another lawsuit seeking the same relief, filed in the U.S. District Court for the Northern District of Texas by Ryan LLC, a tax services and software provider.

Given the pending litigation, it is unclear when, or if, the FTC Rule will become effective. However, if the FTC Rule does become effective, it is expected that employers will seek to protect their competitive interests through increased attention to other forms of restrictive covenant agreements. Such agreements will likely include narrowly tailored provisions addressing the non-solicitation and non-servicing of clients and prospects, the non-solicitation of employees, non-disclosure agreements and trade secrets protections.

## For More Information

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