Alert

April 25, 2024

COZEN O'CONNOR

FTC Issues Final Rule Banning Employee Noncompete Agreements

This issue was first discussed in our January 9, 2023 Client Alert when the Federal Trade Commission (FTC) issued its Proposed Rule Banning Noncompetes. The FTC has now issued its Final Rule on April 23, 2024. As predicted, the FTC's Final Rule bans all new noncompete agreements for all workers after the date the Final Rule becomes effective.

In the FTC's press release describing the Final Rule, it notes that "existing noncompetes for the vast majority of workers will no longer be enforceable [but] existing noncompetes" for senior executives can remain, "but employers are banned from entering into or attempting to enforce any new noncompetes, even if they involve senior executives."

The Final Rule

The Final Rule bans new noncompetes with all workers, including senior executives, after the effective date. The Final Rule would take effect 120 days after publication in the Federal Register. The Final Rule supersedes any State statute, regulation, order, or interpretation that is inconsistent.

Noncompetes will remain in place for a senior executive, defined as an employee who earns more than $151,164 annually and is in a policy-making position, so long as the noncompete was executed prior to the effective date of the Final Rule. A policy-making position is essentially a C-Suite position and is defined as "president, chief executive officer or the equivalent" officer or natural person "who has policy-making authority for the business" similar to an officer. Further, to qualify, the senior executive must earn more than $151,164, excluding discretionary bonuses, board, lodging, payments for medical, dental, or vision insurance, retirement contributions, or other fringe benefits. After the effective date, however, no new noncompete agreements are allowed, even for senior executives.

Revising its Proposed Rule, the FTC's Final Rule does not require employers to rescind existing noncompetes. Instead, the Final Rule adopts a requirement that employers notify workers who are not senior executives that it will not enforce their noncompete agreements. The FTC has provided model notices in English and other languages. The FTC has also provided a Fact Sheet.

The FTC also slightly modified the de facto test from the rule it proposed last year. The FTC stated that when other agreements (such as nondisclosure and nonsolicitation agreements, among others) are "so broad or onerous that [they have] the same functional effect as a term or condition prohibiting or penalizing a worker from seeking or accepting other work or starting a business after their employment ends, such a term is a noncompete clause under the final rule."

The rule lists three exemptions:

- Noncompetes entered into by a person pursuant to a bona fide sale of a business, of a person's ownership interest in a business entity, or of all or substantially all of a business entity's operating assets.
- Causes of action concerning noncompetes that accrued prior to the effective date.
- Enforcement or attempts to enforce a noncompete, or making representations about a noncompete, where the person has a good-faith basis to believe that the ban is inapplicable.

The Rule will operate retroactively for all noncompetes except those agreed to by senior executives with noncompetes executed prior to the effective date of the Final Rule.

What Next?

Aaron Holt

Member

aholt@cozen.com
Phone: (832) 214-3961
Fax: (832) 214-3905

David L. Barron

Member

dbarron@cozen.com
Phone: (713) 750-3132
Fax: (832) 214-3905

Janice Sued Agresti

Associate

jagresti@cozen.com
Phone: (212) 453-3978
Fax: (212) 509-9492

Related Practice Areas

- Labor & Employment
- Trade Secrets, Restrictive Covenants, and Computer Abuse

The Rule must be published in the Federal Register, after which the rule will become effective 120 days from publication, but legal challenges are already being made.

The FTC stated it has authority to issue the Final Rule pursuant to Sections 5 and 6(g) of the Federal Trade Commission Act. Section 5 declares "[u]nfair methods of competition" unlawful, and Section 6(g), titled "Classification of Corporations; regulations," grants the FTC authority "to make rules and regulations for the purpose of carrying out the provisions of" the subchapter of the U.S. Code concerning the FTC. The FTC's Final Rule was approved by a vote of 3-2, with the two Republican Commissioners dissenting. The FTC's authority to issue such a rule has been heavily debated among FTC Commissioners ever since the Proposed Rule was issued in January 2023. In fact, the FTC's statutory authority to issue such far-reaching rulemaking has already been challenged in Court in the Northern District of Texas by Ryan, LLC, a global tax services company on, April 23, 2024, and by the U.S. Chamber of Commerce.

What Should Employers Do Now?

Although the FTC's Final Rule seeks to largely eliminate restrictive covenants across the country, which would be a groundbreaking change in the law, there is no need to take any immediate action. Lawsuits are being filed, and the courts will be weighing in quickly on anticipated efforts to enjoin the Final Rule. That said, the FTC's effort is part of a growing trend that every employer should recognize. States such as Oklahoma, California, North Dakota, and Minnesota already prohibit noncompetes. Other states, such as Illinois and Colorado, have passed restrictive laws limiting the use of such agreements. Even in states where such agreements are generally allowed, individual judges have wide discretion in enforcement, and many are elected, making them susceptible to changes in the mood of the population. Make no mistake – it is getting harder to enforce noncompete agreements and most cases come down to whether the employee has engaged in clear wrongdoing (*e.g.* misappropriating confidential information), sufficient to raise the judge's ire enough to outweigh the inherent sympathy for an employee who just wants to work.

In light of these clear trends in legislation and rule-making, we suggest employers take the following steps:

1. Conduct a regular review of the use of restrictive covenants in your organization to ensure they are lawful and appropriate in light of changing local and state laws, especially for employers with a large geographic footprint. Some states penalize employers who merely issue such an agreement, even if it is never enforced.
2. Consider what levels of restrictions are necessary. Would a strong confidentiality agreement suffice? Would a restriction on soliciting customers and employees serve the same practical effect and provide adequate protections?
3. Consider tiering the types of agreements used in your organization, reserving the most onerous restrictions for those at the highest levels of your organization with access to the most critical information to the long-term vitality of your business. The clear trend of state legislation cuts against enforcing a noncompetes on a low income workers and non-management employees.
4. Investigate what is typical in your industry. Good employees are hard to find and retain. Are your restrictive covenants helping or hurting your recruitment and retention strategies?
5. Lastly, consider tying restrictive covenants to bonuses, stock options or other benefits reserved for key employees. This allows the employer to not only seek to restrict competition (which may not succeed) but to also claw back financial payments.