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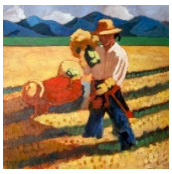

Employment Law Note

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New FTC Rule Bans Noncompetition Covenants for Almost All Workers

By Matthew Coughlan, mcoughlan@sbj.law

On April 24, 2024, the Federal Trade Commission ("FTC") voted to finalize a rule that would ban most noncompetition (or "noncompete") covenants. The new final rule would 1) prohibit employers from entering new noncompete agreements with employees; and 2) prohibit employers from enforcing almost all existing noncompetition agreements between employers and employees.

Background

Employers have long relied on noncompete covenants to protect their trade secrets and proprietary information. Over the last several years, however, numerous state governments and the federal government have whittled away at the enforceability of restrictive covenants. In Washington and elsewhere, legislatures have limited the circumstances when noncompete agreements may be used as an enforceable contractual provision between employers and employees. New restrictions imposed on employers have included 1) salary thresholds; 2) notice requirements; and 3) civil penalties for attempts to enforce unenforceable agreements.

In late April, the FTC issued a new rule in which it determined that noncompete covenants are an unfair method of competition and therefore a violation of Section 5 of the FTC Act. The agency ruling holds that noncompete agreements constitute an unfair restraint on trade, harm employees' bargaining power, and even reduce innovation. The ruling (if it survives pending court cases) will spell the end of noncompetition agreements in the future except in narrow circumstances.

The New FTC Rule

The new rule will eliminate employers' ability to enter new noncompete agreements and to enforce nearly all existing ones. Under federal law, a noncompete agreement is defined as a "term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from either seeking or accepting work after the conclusion of employment, or operating a business after the conclusion of employment." Any agreement with a provision that falls under this definition—even if it is not referred to or written as a "noncompete"—will be unenforceable except in a few circumstances. The new FTC rule states that any clause or provision serves as a noncompete clause if it "functions to prevent" an employee from seeking or accepting other work or starting a new business after the employee's employment with a company ends. The new rule's ban on noncompetes will apply to any and all noncompete agreements entered into between an employer and employee after the rule's effective date in September of this year. It additionally bars employers from enforcing existing noncompete agreements with the exception of existing agreements with senior executive employees—that is, employees earning more than $151,164 annually who are in policy-making positions. The rule also does not apply to noncompete provisions for which a cause of action accrued prior to the rule's effective date. Finally, the rule does not ban noncompete covenants in agreements that involve the "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."

Effects on Other Contract Terms

The new FTC rule does not *per se* prohibit employers from entering into or enforcing other types of restrictive covenants and contract provisions with employees, including but not limited to non-solicitation and nondisclosure provisions. That said, if such a provision is overbroad and found to prevent an employee from accepting other work or starting a business, the clause will be viewed as an unenforceable noncompete.

Employers' Notice Requirement

The FTC's new final rule does not include any rescission requirement for existing noncompetition agreements. It does, however, require employers to provide notice to employees with existing noncompete agreements that their existing noncompete clauses are unenforceable and provide the employer's assurance that it will not attempt to enforce the provision. The rule requires that the notice "be on paper." The requirement can be fulfilled by delivering the notice by hand to the worker in person, by mail to the worker's last known personal street address, or by email or text message.

Pending Court Cases

If unimpeded, the new FTC rule will take effect on September 4, 2024 (120 days after its May 7, 2024, publication date in the federal register). There are, however, several pending court cases that could delay the rule from taking effect or otherwise upend it altogether. To date, three federal cases have been filed—two in Texas and one in Pennsylvania—challenging the rule and seeking injunctive relief. At least one of the courts may grant preliminary injunctive relief while the merits of the cases are in dispute. The result would be a delay in the implementation of the rule. The legal challenges will center on whether the FTC exceeded its rule-making authority and effectively passed a new law, a function that rests solely with Congress.

What Employers Need to Know

The subsequent weeks and months will prove vital for the future—if any—for noncompetition agreements. By September of this year, employers could see such covenants nearly eliminated or substantially curtailed, or the courts could rule against the FTC and maintain the status quo. In the meantime, while the future of the FTC's new rule remains unknown, there are multiple steps employers should take to leave them better suited for any outcome.

1. Track all existing noncompetition agreements to prepare to fulfill the notice requirement if the FTC final rule stands.
2. Prepare enforceable nondisclosure and non-solicitation provisions to protect trade secrets and proprietary information.
3. Review past employment and severance agreements for other provisions that may constitute noncompete clauses even if such clauses are not explicitly referred to as noncompetition covenants.

When drafting employment or severance agreements, employers should continue to consider the inclusion of alternative forms of restrictive covenants—including non-solicitation and nondisclosure provisions. An alternative provision may serve as an adequate substitute with less risk going forward.

Employers with questions about the FTC's ruling or other questions involving noncompete covenants should call Matt Coughlan at 425-460-2292 or email him at mcoughlan@sbj.law.

For more information about this month's Employment Law Note
contact us at **425-454-4233**