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Non-compete Agreements: What Businesses Need to Know After the FTC's New Ruling

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On April 23, 2024, the Federal Trade Commission ("FTC") issued a Final Rule banning non-compete agreements ("NCAs") nationwide. The rule, although expected to face numerous legal challenges,[1] will go into effect 120 days after its publication in the Federal Register.

The Final Rule was developed after a comprehensive review of empirical research and more than 26,000 public comments.[2] The FTC determined that NCAs are an unfair method of business competition, and therefore violative of Section 5 of the Federal Trade Commission Act.[3] The FTC's Chair, Lina Khan, states that banning NCAs will lead to the formation of more than 8,500 new businesses each year, increased earnings for workers, and lower health care costs over the next decade.[4]

Scope: To Whom Does the Rule Apply?

Pursuant to the Rule, all prospective NCAs are prohibited, and existing non-competes are no longer enforceable. There is one notable exception: existing NCAs between employers and senior executives, which may remain in place. The FTC defines senior executives as employees in "policy-making positions," whose annual salary is at least $151,164.[5] The Rule also does not apply to NCAs entered into by a person pursuant to a bona fide sale of a business entity, ownership interest in a business, or all or substantially all of a business's assets.[6] Finally, it also does not apply to any entities that fall outside of the FTC's enforcement jurisdiction.[7]

What Kind of Agreements Are Impacted?

Under the Final Rule, NCAs encompass both contractual terms as well as workplace policies, whether written or oral.[8] While the FTC did not adopt the language regarding de facto NCAs as was originally in its Proposed Rule, the Final Rule uses the term "functional non-competes" to describe any overly broad NDAs, workplace policies, or other clauses in contracts that in essence have the effect of an NCA. The FTC determined this term "more clearly conveys that certain terms are considered non-competes under the final rule where they function to prevent workers from seeking or accepting other work or starting a business after their employment ends."[9] Essentially, if an NCA or other employment agreement is broad enough that it is considered a "functional non-compete," it will also be prohibited under the Final Rule.[10]

How Are Businesses and Employers Affected?

Employers with existing NCAs in place - except for those affecting senior executives - should notify their employees that such NCAs will not be enforced against them.[11] In addition, employers should consider alternatives to the many protections that NCAs provide for their businesses, such as:

(1) Safeguarding trade secrets and client lists;

(2) Ensuring a return on investment in training employees;

(3) Preserving the value of a company during a merger or sale.[12]

According to the FTC, employers can instead rely on trade secret laws, non-disclosure agreements ("NDAs"), fixed duration contracts, or consider increasing employee incentives such as salary and working conditions.[13] However, employers must be mindful of accidentally entering into "functional non-competes."

The Uniform Trade Secrets Act ("UTSA") is adopted by 47 states and the District of Columbia and provides for a civil cause of action for trade secret misappropriation by a former employee.[14] The Defend Trade Secrets Act ("DTSA") was adopted in 2016 and is the federal counterpart, but does not preempt state law.[15] However, New York has not adopted the UTSA and relies only on common law and the DTSA. The Second Circuit has held that to succeed on a claim of misappropriation of trade secrets under the DTSA and New York common law, the owner of the trade secret must take "reasonable measures" to keep the proprietary information secret, such as providing so in an employment contract or a standalone licensing agreement.[16] As a result, New York employers seeking to turn to trade law for protection once the NCA ban is effective will need to walk the line between taking "reasonable measures," without creating a "functional non-compete." For example, a California appeals court struck an NDA where "confidential information" was defined as "all information that is 'usable in' or that 'relates to'" the employer's industry because the NDA effectively perpetually barred the former employee from working in his industry.[17]

Accordingly, while employers will not be without any recourse to prevent against misappropriation of their trade secrets, client lists, goodwill, and other confidential or intangible business assets, there will be significantly fewer contractual protections for employers once the rule is effective. Employers are encouraged to start considering alternative solutions to protecting their businesses from unwanted litigation or employment disputes.

Cullen and Dykman LLP is here to assist you in adapting your business to the FTC's Final Rule. Should you have any questions about its impact, please contact Richard Coppola (rcoppola@cullenllp.com), Julie van Westendorp (jvanwestendorp@cullenllp.com), or Sarah Franzetti (sfranzetti@cullenllp.com).

This advisory provides a brief overview of the most significant changes in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient.

Thank you to Sarah Franzetti, an Associate at Cullen and Dykman LLP, for her significant efforts in co-authoring this legal alert.

Footnotes

[1] The Chamber of Commerce released a statement declaring its intent to sue the FTC over its "blatant power grab that will undermine American businesses' ability to remain competitive." *See* U.S. Chamber to Sue FTC Over Unlawful Power Grab on Noncompete Agreements Ban | U.S. Chamber of Commerce (uschamber.com) (accessed April 29, 2024).

[2] *See* Federal Trade Commission, Non-Compete Clause Rule (April 23, 2024) at 2 (accessed April 29, 2024).

[3] *Id.*

[4] *See* "FTC Announces Rule Banning Noncompetes," (Apr. 23, 2024), FTC Announces Rule Banning Noncompetes | Federal Trade Commission (accessed April 29, 2024).

[5] Non-Complete Clause Rule (Apr. 23, 2024) at 218-19.

[6] *Id*. at 336-39.

[7] *See id*. at 48; 15 U.S.C. 45(a)(2).

[8] Non-Complete Clause Rule (Apr. 23, 2024) at 4.

[9] *Id*. at 69, n.329.

[10] *Id*. at 78.

[11] The FTC provides model notices at Noncompete Rule | Federal Trade Commission (ftc.gov).

[12] *See* 12-2023 Antitrust Src. 1 (2024).

[13] *Id.*

[14] *Id.*

[15] *Id.*; 18 U.S.C. § 1836, et seq.

[16] *See, e.g.*, *Mason v. AmTrust Fin. Servs.*, 848 Fed. Appx. 447, 450 (2d Cir. 2021).

[17] Although the FTC stated it removed the "de facto" language from its proposed rule in place of "functional," the FTC adopted this standard, found in *Brown v. TGS Management Co., LLC*, which does use the term "de facto non-compete." *See* Non-Complete Clause Rule (Apr. 23, 2024) at 81, n. 346 (citing *Brown v. TGS Management Co., LLC* 57 Cal. App. 5th 303, 319 (2020)).

Practices

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