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Texas Court Invalidates FTC Noncompete Rule Nationwide

The Federal Trade Commission's (FTC) final rule banning nearly all noncompete agreements will not take effect on September 4 as planned. In an August 20 decision, a Texas federal court found the final rule to be unlawful and ordered that it may not take effect nationwide, ending the uncertainty that has swirled around this issue for months.

Similar to its decision last month enjoining the final rule with respect to the parties to the case (which we discussed in a previous alert), the U.S. District Court for the Northern District of Texas concluded in *Ryan LLC v. FTC* that the plaintiffs are entitled to summary judgment because the FTC exceeded its statutory authority in implementing the final rule and because the final rule is arbitrary and capricious. Unlike the previous decision, however, the new decision precludes the final rule from taking effect nationwide.

The August 20 decision is the latest in a series of decisions regarding the final rule. A court in Pennsylvania rejected a challenge to the final rule, and a court in Florida issued a ruling similar to the Texas court's preliminary injunction ruling, by granting a preliminary injunction prohibiting the final rule from being enforced against the parties to that case. The August 20 decision puts an end to the uncertainty over the fate of the final rule, with what would have been its effective date just two weeks away.

The Texas Court's Decision

Based on the text and structure of the FTC Act, the court concluded that the FTC lacks the authority to create substantive rules regarding unfair methods of competition. The court based that conclusion, in part, on the lack of a statutory penalty for violating rules promulgated under Section 6(g) of the FTC Act, which the FTC had cited as the source of its rulemaking authority. The court also relied on the history of the FTC Act, including the fact that the FTC had explicitly disclaimed substantive rulemaking authority for the first 48 years of its existence. Amendments to the FTC Act in 1967 and 1968 expressly allowed rulemaking related to other subjects, which, the court explained, would have been superfluous if the FTC Act had already given the FTC substantive rulemaking power.

The court also concluded that the final rule is arbitrary and capricious because its "one-size-fits-all approach with no end date" is overbroad without a reasonable explanation. The court explained that while the FTC's enactment of the final rule was based on studies that examined the economic effects of various state policies toward noncompetes, no state had enacted a noncompete rule as broad as the FTC rule. The court noted that the FTC had not considered the positive benefits of noncompete agreements and that it had disregarded the substantial body of evidence supporting them. As a result, the court concluded that a lack of evidence as to why the FTC chose to prohibit virtually all noncompetes, rather than targeting only specific, harmful noncompetes, renders the final rule arbitrary and capricious. The court also concluded that the FTC had not sufficiently addressed less disruptive alternatives to the final rule.

Based on its conclusions that the FTC lacks statutory authority to promulgate the final rule and that the rule is arbitrary and capricious, the court granted the plaintiffs' motions for summary judgment. The court held the final rule to be unlawful and set it aside under the Administrative Procedure Act. Unlike the court's earlier decision granting a preliminary injunction to the plaintiffs, the court instead ruled that its decision declaring the final rule unlawful applied nationwide. Putting an end to the uncertainty (at least for now), the court concluded, "The Rule shall not be enforced or otherwise take effect on its effective date of September 4, 2024, or thereafter."

Takeaways

While the FTC has stated that it is "seriously considering a potential appeal," the final rule will not take effect as planned on September 4. The lack of a federal standard means that enforcement of noncompetes will continue to depend on state law, with different states approaching the issue using varying considerations. Employers need to make sure their noncompetes are narrowly tailored to protect their legitimate business interests, particularly in light of many states' recent focus on restricting the use of noncompetes and the FTC's likely continued interest in the subject.

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