NON-COMPETE CLAUSES

The Changing Landscape of Managing Competitive Risk

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Non-compete agreements have long played a role in companies' efforts to manage the risk of competitive harm caused by departing employees. The FTC's rule banning non-compete clauses as unfair methods of competition threatened to upend the use of this tool. The United States District Court for the Northern District of Texas recently issued a nationwide injunction setting aside the rule and barring its enforcement. Nonetheless, employers should both prepare for the legal landscape the rule created and revisit alternate ways to protect their legitimate interests. This article examines the FTC's rule, the legal challenges to it, and the opportunity businesses have to consider different ways to protect their competitive interests.

SCOPE OF THE FTC RULE ON NON-COMPETE CLAUSES (16 C.F.R. PART 910)

The FTC rule as written prohibits non-compete agreements with "workers," declares current non-competes unenforceable except in limited circumstances, and mandates notice to workers of that unenforceability. (16 C.F.R. § 910.2.) It does not apply to non-profit entities (which are not subject to FTC authority), banks and savings and loan institutions, certain common carriers, or non-competes in franchise agreements.

For businesses subject to the FTC's jurisdiction, the new rule was to take effect on September 4, 2024. It would have prohibited employers from entering into new non-compete agreements with "workers," which includes not only employees but also independent contractors, interns, externs, and volunteers. (*Id.*) Notably, the rule defines "non-compete clause" as "a term or condition of employment that prohibits a worker from, penalizes a worker for, *or functions to prevent a worker* from" working for another person or operating a business after conclusion of the employment. (*Id.* (emphasis added).) Thus, the rule could reach not only explicit non-compete clauses but also overly broad non-disclosure or non-solicitation agreements that operate as de facto non-competes.

In addition, the rule would have prevented employers of workers with existing non-compete agreements from enforcing them, except against "senior executives," and required employers to give notice to those workers that such agreements would not be enforced. The rule did not affect litigation regarding non-compete clauses in employment agreements pending prior to the effective date, or cases brought after that date alleging claims that arose before it.

The FTC carved out a few exceptions to the rule. First, the rule's retroactivity would not apply to senior executives, defined as those who earn at least $151,164 in annual compensation and hold a policy-making position. Policy-making positions include presidents, CEOs, and others with final authority to make policy decisions for the business. Second, the rule would not

apply to non-compete agreements relating to the bona fide sale of a business entity, a person's ownership interest therein, or of all or substantially all of a business entity's operating assets. Third, if an employer had a good faith basis for believing that the FTC's new rule does not apply, then that employer's enforcement, or attempted enforcement, of a non-compete clause would not violate the new rule. The circumstances under which the good faith basis exception would apply are unclear. The FTC's guidance, however, makes clear that an employer would not have a good faith basis for non-compliance simply due to the absence of a judicial ruling on the rule's validity. If the rule had taken effect, then, employers could not have relied on pending legal challenges to contend they had a good faith basis for non-compliance.

LEGAL CHALLENGES TO THE FTC'S NON-COMPETE RULE

Employers quickly challenged the FTC rule. The plaintiffs in *Ryan LLC, et al. v. FTC*, No. 3:24-CV-00986 (N.D. Tex.), *U.S. Chamber of Commerce v. FTC*, No. 6:24-CV-00148 (E.D. Tex.), *ATS Tree Services, LLC v. FTC*, No. 2:24-CV-01743 (E.D. Penn.), and *Properties of the Villages, Inc. v. FTC*, No. 5:24-CV-00316 (M.D. Fla.) all filed suit to strike the rule on multiple grounds, including that the FTC lacked authority to promulgate it and that the rule is arbitrary and capricious.[1] The plaintiffs in each case argued that the FTC does not have substantive rulemaking authority under 15 U.S.C. §§ 45, 46. The FTC, on the other hand, contended that the statutes confer the power not only to investigate and adjudicate specific cases of unfair competition but also to make substantive rules preventing such conduct.

The *Ryan* court enjoined enforcement against the plaintiffs in that case pending a decision on the merits, and recently issued a nationwide injunction barring the rule from taking effect.[2] The court held that "the FTC exceeded its statutory authority in implementing the Rule, and the Rule is arbitrary and capricious." (August 20, 2024 Memorandum Opinion and Order, p. 14.) While "the FTC has some authority to promulgate rules to preclude unfair methods of competition," the court concluded that "the FTC lacks the authority to create substantive rules through this method." (*Id.*, p. 17.) Based on its review of the history and structure of the enabling statute, the *Ryan* court held that "the text and the structure of the FTC Act reveal the FTC lacks substantive rulemaking authority with respect to unfair methods of competition" and, therefore, that the FTC "exceeded its statutory authority in promulgating the Non-Compete Rule." (*Id.* p. 22.)

Further, the Court found the rule to be arbitrary and capricious because (1) it is overbroad, imposing "a one-size-fits-all approach with no end date" without adequate factual support; and (2) it fails to consider less disruptive alternatives. (*Id.*, pp. 23-25.) In particular, "[t]he Commission's lack of evidence as to why they chose to impose such a sweeping prohibition—that prohibits entering or enforcing virtually all non-competes—instead of targeting specific, harmful non-competes, renders the Rule arbitrary and capricious." (*Id.*, p. 24.) Because the FTC lacked authority to promulgate substantive rules regarding unfair methods of competition, and because the rule was arbitrary and capricious, the Court held that it "must 'hold unlawful' and 'set aside' the FTC's Rule as required under [5 U.S.C.] § 706(2)." (*Id.*, p. 26.) The Court rejected the FTC's argument that any relief should apply only to the Plaintiffs in the case. (*Id.*)

Thus, employers need not comply with the FTC rule now, and it seems unlikely that either the Court of Appeals for the Fifth Circuit or the United States Supreme Court will overturn the injunction if the FTC appeals.[3] However, the rule's issuance unquestionably raised awareness of issues implicated by non-competes and employers ignore those issues at their peril. The FTC's lengthy commentary explaining its view of non-competes and the competitive harms they create provides a roadmap for future challenges. Employees will surely use the information provided by the FTC about the alleged anticompetitive harms caused by non-competes to support claims that their particular non-compete clauses are overbroad, unreasonable, and, therefore, unlawful. State courts and legislatures may increase efforts to curb the use of non-competes, and the FTC still has authority to investigate and adjudicate their use on a case-by-case basis.

WHAT SHOULD EMPLOYERS DO?

Non-competes can protect businesses'interests in encouraging collaboration, promoting investment and innovation, and minimizing the risks associated with employees leaving to work for a competitor. While this tool remains available as a matter of federal law, challenges to non-competes will not disappear. States may become more active in policing, if not prohibiting, their use and enforcement. Employers have an opportunity to thoughtfully evaluate their businesses' risk management strategies and implement agreements reasonably tailored to accomplish their goals. For example, non-solicitation agreements, non-disclosure agreements, and confidentiality agreements all provide excellent protections and – provided they are not overbroad – can avoid the anticompetitive concerns raised by non-competes. Additionally, companies could implement incentives for workers to continue their employment, such as retention bonuses, training repayment policies, or deferred compensation agreements. The creation of a trade secret protection program will also go a long way to protect a company's innovations without relying on a non-compete clause.

CONCLUSION

Despite the injunction prohibiting enforcement of the FTC's non-compete rule, companies should review their employment agreements and determine whether tools other than non-competes can effectively protect the employers' legitimate competitive interests. They should also remember that the state laws surrounding non-competes and other employment agreements vary. Businesses with employees in multiple states need to chart their path carefully to ensure compliance across state lines.

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[1] The Chamber of Commerce ultimately joined the first-filed *Ryan, LLC* case, causing the court to dismiss the Chamber's separate action without prejudice.

[2] In *Properties of the Villages,* the court entered a preliminary injunction barring enforcement of the rule against the plaintiffs. No. 5:24-CV-00316, at *1 (M.D. Fla. Aug. 15, 2024). While the court in *ATS Tree Services* denied the plaintiffs' motion for preliminary injunction and to stay the effective date, that decision appears to have been mooted by the nationwide injunction entered by the *Ryan* court.

[3] The *Ryan* court notably (and unsurprisingly) relied on *Loper Bright Enterprises v. Raimondo,* 144 S. Ct. 2244 (2024), which overturned *Chevron U.S.A. v. Natural Res. Def. Council, Inc., et al.*, 467 U.S. 837 (1984) – making it unlikely that the U.S. Supreme Court would reverse the Ryan decision should the case get that far.