Client Alert: The Ongoing Uncertainty of Federal Non-Compete Regulation

By Ben Clements

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After a rollercoaster year, non-compete agreements remain what they traditionally have been in the United States: contracts governed primarily by state law. Earlier this year, the Federal Trade Commission ("FTC") adopted a new federal rule banning employers nationwide from entering into non-competes with their workers. But within a few months, a federal court issued an injunction preventing the FTC's rule from taking effect. As least for now, the FTC's role in regulating non-competes is likely limited to case-by-case enforcement actions.

First, some table setting. Much of the debate about non-competes arises in the context of employment. Non-competes can be a useful tool for employers to retain their workers and protect their businesses. To that end, it is common for employers to attempt to restrict employees from engaging in certain work upon leaving the company. A generic example of such a restriction might be: "Employee agrees not to compete with Employer for 12 months after leaving her job." Concerns about employee mobility, employee compensation, and marketplace competition animate opposition to these kinds of contractual restrictions.

In the United States, the enforceability of these provisions has depended primarily on state law. Each state has its own objectives and laws. And states have balanced employer and employee interests in different ways. This means that the enforceability of a particular non-compete will likely vary from state to state.

In California, for example, non-competes are, with a few exceptions, unlawful. By statute, every contract that purports to restrain anyone from "engaging in a lawful profession, trade, or business of any kind is to that extent void." As the California Supreme Court has explained, this rule reflects a state "legislative policy in favor of open competition and employee mobility." It "protects Californians and ensures that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice."

In New York, by contrast, non-competes are lawful if they are "reasonable." A non-compete is reasonable if it: "(1) is no greater than is required for the protection of the legitimate interest of the employer, (2) does not impose undue hardship on the employee, and (3) is not injurious to the public." Legitimate employer interests include the protection of trade secrets, the protection against competition by a former employee whose services are unique or extraordinary, and preventing a former employee from exploiting a customer's goodwill.

In January 2023, against a patchwork of different state laws, the FTC proposed a new federal rule prohibiting employers nationwide from entering into non-competes with their workers. The FTC argued that the multi-state nature of many labor and product markets, coupled with attempts by employers to circumvent state laws that prohibit or restrict non-competes, warranted a uniform federal rule banning non-competes. For the rest of 2023 and early 2024, there was considerable debate about the legality and wisdom of such a rule and the impact it may have on the economy and labor markets. During this period, the FTC solicited and reviewed tens of thousands of public comments as part of the rulemaking process.

On April 23, 2024, the FTC issued its final rule banning non-competes. It published a lengthy discussion of its conclusions, which included that "State law alone is insufficient to address the negative effects of non-competes on competition." The FTC determined that a uniform national standard would help address problems created by the fact that "States are interconnected with respect to non-competes" and that "States are forced to balance the benefit to their residents of laws regulating non-competes against the fear that some employers may shift jobs to States where non-competes are more enforceable."

Shortly after issuing its final rule, the FTC was sued in the U.S. District Court for the Northern District of Texas. Less than four months later, the court in that lawsuit issued an injunction preventing the FTC's rule from taking effect. The court found that the FTC lacked authority to make the rule. The court also found that the rule was "arbitrary and capricious" because it was unreasonably overbroad, it was based on "flawed" empirical evidence, and it failed to adequately consider the positive benefits of non-competes. The FTC has appealed that ruling to the U.S. Court of Appeals for the Fifth Circuit. A similar appeal is pending in a different case in the U.S. Court of Appeals for the Eleventh Circuit.

So, after a rollercoaster year, the enforceability of non-compete agreements continues to depend primarily on state law. For now, employers may continue using non-competes in compliance with applicable state laws. Employers should, however, continue to monitor the status of the appeals pending in the Fifth and Eleventh Circuits, which may be decided in 2025.

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