Milbank

Insights

Antitrust and Executive Compensation and Employee Benefits Groups

UPDATE: Slow Down, You Move Too Fast: The FTC Non-Compete Ban May Not Last

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Key Takeaways

1. The Non-Compete Rule is set to take effect on September 4, 2024. On July 3, a US district court in Texas, however, preliminarily enjoined the Federal Trade Commission (the "FTC") from implementing or enforcing the Non-Compete Rule against the specific plaintiffs who challenged the Rule in that case. The court held that these challengers are likely to succeed on the merits because the FTC lacks the statutory authority to promulgate the non-compete rule and because the rule's overbreadth renders it "arbitrary and capricious."
2. The court intends to issue a final ruling on the merits on or before August 30, 2024. Given the court's preliminary ruling, it is likely to rule in plaintiffs' favor again. The open issue is whether the court will prevent the FTC from enforcing the Rule in any context or will limit the final relief to the specific plaintiffs. Either order will be subject to appeal to the Court of Appeals for the Fifth Circuit (likely an unfavorable forum for the FTC) and ultimately to the Supreme Court of the United States. Whether and when the rule might take effect thus remains an open question.
3. Use of non-compete agreements continues to carry risks. The FTC remains free to target non-competes but will have to adjudicate the merits of individual non-competes on a case-by-case basis. State law also remains a source of limitations.
4. Employers should evaluate existing and future non-competes and ask whether: (1) a non-compete agreement is necessary to protect legitimate business interests; and (2) if so, the agreement is sufficiently narrow in scope, time and geography. Employers also should continue monitoring compliance with the changing landscape of applicable state laws, including laws that prohibit non-compete restrictions on low-wage or non-executive earners.

As we advised in a prior alert, on April 23, 2024, the FTC issued the Non-Compete Clause Rule (the "Non-Compete Rule" or the "Rule") that bans non-compete agreements, with limited exceptions, commencing on September 4, 2024. Immediately following the Non-Compete Rule's publication, businesses in Texas and

Pennsylvania brought lawsuits. Both challenged the FTC's statutory authority to promulgate the Non-Compete Rule and the Rule's merits under the Administrative Procedures Act (the "APA") and sought preliminary injunctions, staying the effective date.[1]

Court Finds Plaintiffs Likely to Succeed in Challenge to FTC's Non-Compete Rule

On July 3, 2024, a district court in Texas held that the plaintiffs were likely to succeed on the merits of their challenges because (1) the FTC lacks substantive rulemaking authority with respect to unfair methods of competition; and (2) the Rule is unreasonably overbroad and, therefore, arbitrary and capricious under the APA. Although the court acknowledged that the FTC has authority to engage in rulemaking with respect to agency organization procedure or practice (*i.e.*, housekeeping rules), it rejected the FTC's argument that it has the authority to issue substantive rules regarding unfair method of competition. The court further noted that the Non-Compete Rule is broader than any state law, and that the FTC failed to provide evidence or a reasoned basis for imposing a sweeping prohibition rather than targeting specific, harmful non-competes.

Court Enjoins Implementation or Enforcement of Non-Compete Rule Against Certain Challengers

The court issued a preliminary injunction that stays enforcement of the Non-Compete Rule but only against the plaintiffs. The court limited its order in this way because (1) the plaintiffs did not request a nationwide injunction, and (2) a recent decision from the Court of Appeals for the Fifth Circuit counsels that preliminary injunctive relief should be no broader than necessary, and that the APA does not provide courts with authority to issue nationwide injunctive relief. The preliminary injunction will remain in place throughout the pendency of the litigation until the court issues a final ruling on the merits of plaintiffs' claim and awards final relief. If the litigation in the district court in Texas is ongoing on September 4, 2024, the order would allow the Rule to become effective against all others, *i.e.*, non-parties to the litigation.[2] Importantly, however, the court plans to issue a final ruling on the merits on or before August 30, 2024. At that time, the preliminary injunction will dissolve and be replaced with the final relief awarded by the court.

Although the final ruling likely will be in plaintiffs' favor, for the reasons discussed above, the scope of relief to be awarded remains an open question: will it be nationwide or limited to the plaintiffs? If limited to the plaintiffs (and absent a contrary ruling from the district court in the parallel Pennsylvania action), this would allow the Rule to take effect on September 4, 2024. We think it more likely that the court will grant nationwide relief by invalidating and vacating the Rule (precluding the Rule from taking effect and the FTC from enforcing it) for two reasons. First, the plaintiffs have expressly requested this relief in their complaints, and second, the court has authority under the APA to set the Rule aside upon a finding that the FTC lacked statutory authority, or that the Rule is arbitrary and capricious.

Litigation is unlikely to end in the district courts, however. The FTC can appeal adverse rulings from the district court in Texas (to the Court of Appeals for the Fifth Circuit) and from the district court in Pennsylvania (to the Third Circuit Court of Appeals). Regardless of which side prevails at the district-court and appellate-court levels, the losing party can appeal to the US Supreme Court.

We will continue to monitor the cases in Texas and Pennsylvania and update you with relevant developments.

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[1] Both courts have allowed numerous third parties to file amicus briefs, some supporting the plaintiffs and others supporting the FTC (with the latter in Texas including briefs from academic scholars, Texas elected officials, and federal congresspersons).

[2] The district court in the parallel Pennsylvania action plans to issue a ruling on that plaintiff's motion for a preliminary injunction on or before July 23, 2024, and conceivably could issue a nationwide injunction, staying the effective date for all. We do not believe this is a likely outcome for at least two reasons. First, it is unclear whether the court will agree that the plaintiff is likely to succeed on the merits, meaning that the court may not award any preliminary relief. Second, the court has modeled the briefing schedule after that adopted by the district court in Texas. We think it more likely that, if the Pennsylvania court concludes the plaintiff is likely to succeed on the merits, it will issue a preliminary injunction that mirrors the July 3rd order from the Texas court.

The Future for Non-Competes in Employment Agreements

Although the fate of the Non-Compete Rule remains uncertain, the use of non-compete agreements will continue to carry risks. The FTC has authority to target unfair methods of competition through adjudication and can target their use on a case-by-case basis. State law also will continue to be a source of potential limitations. State laws that might be preempted by the Non-Compete Rule remain in full force and effect. Moreover, some jurisdictions, including California, North Dakota, Oklahoma and Minnesota have enacted near complete bans. Other states, including Colorado, Illinois, Maryland, and Massachusetts, prohibit the use of non-competes for certain categories of employees (*e.g.*, where the employee is under 18, earns wages below a certain threshold, or is paid hourly). Some jurisdictions also impose notice and/or consideration periods and limit the duration of post-employment restrictions. Employers executing or seeking to enforce non-compete agreements in these jurisdictions should keep apprised of the changing legal landscape.

Best Practices Moving Forward

Given the above, we recommend the following:

- Employers should still be mindful that they may face individual enforcement actions from the FTC and be forced to litigate the reasonableness of non-compete agreements.
- Employers must continue to comply with limitations imposed by applicable state statutes and decisional law.
- In that context, employers should review existing or new non-compete agreements and consider:
    a. Whether a non-compete is necessary to protect a legitimate business interest (*e.g.*, because the employee has access to confidential information that would pose a threat if in the hands of a competitor);
    b. Whether legitimate interests can be protected through less restrictive means (*e.g.*, via a non-disclosure agreement, or confidentiality or non-solicitation provisions) and/or through the use of garden leave (where the departing employee is paid not to compete for the restricted period);
    c. If a non-compete agreement is necessary, whether the agreement is narrowly tailored as to substantive scope, time and geography; and
    d. Whether the non-compete agreement is consistent with the laws of the jurisdictions in which the employer operates or may seek to enforce a non-compete agreement.
- While non-compete agreements generally are permitted in the context of a sale of business, the FTC's Non-Compete Rule and a number of state laws define what constitutes a sale of business, suggesting careful drafting is required.

Employers should consult with Milbank if they have questions about the legal challenges to the FTC's Non-Compete Rule or if they would like advice regarding non-compete agreements and applicable law. Milbank will continue to closely monitor developments in this area and Milbank attorneys are available to assist in navigating the changing law in this area.

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