FTC REGULATION OF NON-COMPETE PROVISIONS IN EMPLOYMENT AGREEMENTS

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SCOPE OF ARTICLE.

This article discusses recent considerations by the United States Federal Trade Commission (FTC) to utilize its power to promulgate a rule or issue guidance governing the use of non-compete agreements in the employment context. This piece offers a brief analysis of the established framework for governing non-compete agreements in several states, including Texas. The discussion will also cover the reasons for FTC's growing interest in issuing a universal rule to partly, or wholly, regulate the use of non-compete agreements by employers.

INTRODUCTION.

On January 9, 2020, the FTC held a public workshop at its office in Washington, DC.[1] The purpose of the workshop was to examine the legal basis and to provide data-supported justification for promulgating rules related to the use of non-compete agreements. Participants in the workshop included experts in the areas of administrative law, non-compete agreements, FTC processes, as well as economic researchers who study the aggregate economic impact of non-compete agreements.

The FTC organized the Workshop in response to economic research which shows that the nationwide prevalence of non-compete agreements has an adverse effect on wages, labor mobility and innovation. Additionally, several proposed bills before Congress within the last 5 years reflect a push from government officials for additional regulation of non-compete agreements, likely in response to conclusions from the aforementioned economic research. This article will explore the discussions at the January 9, 2020 Workshop and analyze the impact of any potential FTC regulation on the use of non-compete agreements.

A. Non-Compete Agreements: An Overview

Non-compete provisions are restrictive covenants typically used in four contexts: (1) employment agreements; (2) franchise agreements; (3) partnership agreements; and (4) business sales agreements. This article focuses on the use of non-compete agreements in the first category. Regarding employment relationships, a non-compete agreement or "covenant not to complete" is an agreement between an employer and employee that restricts the employee from performing, after the employment relationship terminates, any work for another employer for a specified period of time, any work in a specified geographical area, or any work for any other employer that is similar to the work performed for the employer who is a party to such agreement.

The purpose of a non-compete agreement is to protect various legitimate business interest of the employer by limiting subsequent employment of employees by competitors. Those interests include, but are not limited to, trade secrets, customer goodwill, confidential or proprietary information, and special training acquired by employees during employment. For employers, non-compete agreements are invaluable tools to protect against the loss of revenue and business. Understandably, these restrictions, on their face, hold few benefits to the employee.

1. Protection of Trade secrets

The protection of trade secrets as a legitimate business interest is perhaps the most-cited justification for the use of non-compete agreements. Trade secrets, being the intellectual foundation of a company, are of economic value and warrant protection from competing businesses. *Gonzales v. Zamora*, 791 S.W.2d 258, 265 (Tex. App.–Corpus Christi 1990, no writ). Trade secrets define the unique way in which a company provides its goods and services, and such information is not meant for public knowledge. Under Texas law, a trade secret may consist of any formula, pattern, device, or compilation of information that is used in one's business and which gives one an opportunity to obtain an advantage over competitors who do not know or use the same processes. *Id.* Without that exclusive "recipe," a company may lose its competitive edge and may very well find itself lost in the shuffle of the market. Thus, trade secrets are worth protecting.

Besides intellectual information and processes, employers may use non-compete agreements to restrict future employment opportunities of departing employees who possess other confidential and proprietary data. Items such as customer lists, pricing information, client information, customer preferences, buyer contacts, market strategies, blueprints, and drawings have all been shown to warrant protection. *Computer Assocs. Int'l v. Altai*, Inc., 918 S.W.2d 453, 455 (Tex. 1996); *See also Martin v. Credit Prot. Ass'n, Inc.*, 793 S.W.2d 667, 670 n.3 (Tex. 1990) (Customer

[1] Federal Trade Commission, "Non-Competes in the Workplace: Examining Antitrust and Consumer Protection Issues," January 9, 2020, https://www.ftc.gov/news-events/events-calendar/non-competes-workplace-examining-antitrust-consumer-protection-issues; For ease of reference, the FTC's January 9, 2020 Workshop may be referred to herein as "the Workshop".

information is a legitimate interest which may be protected in an otherwise enforceable covenant not to compete). Indeed, for certain companies dealing in subscriber businesses, a customer list may be the most important asset the company owns. It is understandable that, like trade secrets, though defined more broadly, confidential information like a company's customer list are considered uniquely valuable to the company and worth protecting. The rationale is that if an employee is barred from immediate employment by a competitor for a number of years, it will delay the immediate impact of the transfer of trade secrets and confidential information, or prevent it altogether.

2. Customer Goodwill

The Texas Covenants Not to Compete Act (the "Act"), Tex. Bus. & Com. Code Ann. §§ 15.50-.52, provides that "goodwill" is a protectable interest. Texas law has long recognized that goodwill, although intangible, is property and is an integral part of the business just as its physical assets are. *Alamo Lumber Co. v. Fahrenthold*, 58 S.W.2d 1085, 1088 (Tex. Civ. App.—Beaumont 1933, writ ref'd); *Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex. Civ. App.—El Paso 1962, writ ref'd n.r.e.). Goodwill is defined as:

> "the advantage or benefits which is acquired by an establishment beyond the mere value of the capital stock, funds or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant and habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices."

Taormina, 355 S.W.2d at 573; *see also* BLACK'S LAW DICTIONARY 703 (7th ed. 1999) (defining "goodwill" as "[a] business's reputation, patronage, and other intangible assets that are considered when appraising the business . . ."). To employers engaged in sales and similar businesses which benefit from customer retention, there is value in protecting customer relationships and preventing employees who develop those relationships from immediate employment with competitors, where those previous relationships will benefit their new employer. Non-competes are useful tools in limiting the immediate transfer of customer goodwill to a competitor. Presumably, after the 12- or 24-month restrictive period, a replacement employee would have rebuilt the relationship which valued customers held with the departed employee. This allows a company to retain customer loyalty and business revenue.

3. Investment in Human Capital

On-the-job training provided by an employer comes at a cost to the employer in time and money. Particularly, specialized training for moderately to highly technical positions may require months, or even years of initial and continued education. Since the money and time invested in specialized training are valuable and protectable assets, employers use non-compete agreements to prevent a departing employee from taking the skills acquired and immediately using those skills to benefit a competitor.[2] The House Business and Commerce Committee echoed this purpose for the Act:

> "It is generally held that these covenants, in appropriate circumstances, encourage greater investment in the development of trade secrets and goodwill employee training, providing contracting parties with a means to effectively and efficiently allocate various risks, allow the freer transfer of property interests, and in certain circumstances, provide the only effective remedy for the protection of trade secrets and good will [sic]."

House Comm. on Bus. & Commerce, Bill Analysis, Tex. S.B. 946, 71st Leg., R.S. (1989).

B. Non-Competes Under Texas Law

Texas jurisprudence once held non-compete agreements were unenforceable because they were in restraint of trade and contrary to public policy. *See Chenault v. Otis Eng'g Corp*., 423 S.W.2d 377, 381-82 (Tex. Civ. App.—Corpus Christi 1967, writ ref'd n.r.e.). But, over time, the courts came to recognize "that it was in the interest of trade that certain covenants in restraint of trade should be enforced." *See Cline v. Frink Dairy Co*., 274 U.S. 445, 461 (1927); Thus, the rule became established in Texas that reasonable non-compete clauses in contracts pertaining to employment are not considered to be contrary to public policy as constituting an invalid restraint of trade. *Chenault*, 423 S.W.2d at 381. Texas courts have therefore enforced reasonable covenants not to compete dating back at least to 1899. *Patterson v. Crabb*, 51 S.W. 870, 871 (Tex. Civ. App. 1899, writ dism'd) (recognizing under the common law the inequity of

[2] *See generally* Greg T. Lembrick, *Garden Leave: A Possible Solution to the Uncertain Enforceability of Restrictive Employment Covenants*, 102 Colum. L. Rev. 2291, 2296 (2002) (noting the employers' high cost of developing human capital, including extensive training, revelation of confidential information and exposure to key customers).

allowing a former employee to compete against an employer by using that employer's goodwill against him when the employee had agreed not to compete with the employer).

Under Texas law, enforceable non-compete agreements must (1) be ancillary to an otherwise enforceable employment agreement, and (2) must be reasonably limited as to time, geographical area, and scope of work. TEX. BUS. & COM. CODE ANN. § 15.50 (a). The first requirement for enforcement is that the non-compete must be part of an otherwise valid employment agreement. *See Justin Belt Company v. Yost*, 502 S.W.2d 681, 683 (Tex. 1973). A non-compete cannot, on its own, form the consideration for an agreement. Instead, the non-compete must be connected, or supplementary to an already valid agreement. *Chenault*, at 381-82 ("The courts of this State have in numerous cases enforced negative restrictive covenants not to compete when ancillary to employment involving trade or professions….").

In addition to being ancillary to an enforceable employment agreement, Texas courts require non-compete agreements to be reasonably limited as to time, geographical area, and scope of work. *See Digital Generation, Inc. v. Boring*, 869 F.Supp.2d 761, 774 (N.D. Tex. 2012). Exactly what constitutes reasonable time, geographical and activity restraints is determined by the courts on a case-by-case basis.

1. Geographical Scope

While there is not a bright line rule as to what geographic limitations are reasonable, courts have often-but not always-upheld non-competes that limit competition within the geographic area where an employee worked. *See e.g., Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 794 (Tex. App.—Houston [1st. Dist.] 2001, no pet.) (upholding a reformed non-compete covenant that prohibited a former manager from working in those counties where he previously oversaw operations). It is important to note that the absence of geographic restrictions is not fatal to enforcement of a non-compete agreement. The factors are to be balanced to ensure the restriction is not more than what is necessary to protect the employer's legitimate business interest. *See Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644, 657 (Tex. 2006) (holding that a covenant not to compete was reasonable even though the covenant's restrictions applied regardless of geographic location)

2. Duration

Texas courts generally uphold non-compete periods ranging from two to five years as reasonable. *See e.g., Johnson Serv. Group, Inc. v. France*, 763 F.Supp. 2d 819, 826 (N.D. Tex. 2011) (noting that "two to five years has repeatedly been held as a reasonable time limitation") (citing *Gallagher Healthcare Ins. Services v. Vogelsang*, 312 S.W.3d 640, 655 (Tex. App.—Houston [1st. Dist.] 2009, pet. denied) (upholding a covenant not to compete as reasonable that imposed a two-year restriction that prohibited a former employee from working with former clients with whom she worked for two years preceding her termination); *See also, Salas v. Chris Christensen Systems Inc.*, 2011 Tex. App. LEXIS 7530 at *19 (Tex. App.—Waco Sept. 14, 2011, no pet.) ("we cannot say that the Agreement's five-year restraint is per se unreasonable").

3. Scope of activity

A non-compete agreements "must bear some relation to the activities of the employee." *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381, 387 (Tex. 1991). The prohibited activity must be the same or substantially similar to that performed for the previous employer. Accordingly, an agreement "that contains an industry-wide exclusion from subsequent employment is unenforceable." *Wright v. Sport Supply Group, Inc.*, 137 S.W.3d 289, 298 (Tex.App.—Beaumont 2004, no pet.).

According to the Texas Supreme Court, "[t]he hallmark of enforcement is whether or not the covenant is reasonable." *Marsh USA Inc. v. Cook*, 354 S.W.3d 764, 777 (Tex. 2011). Determination of reasonableness is highly fact specific. Thus, geography, time and scope of activity will be weighed as a multi-factor test to determine the enforceability of a non-compete. Even if a non-compete agreement is overbroad, it may not be invalid. Instead, Texas courts may reform (re-write) the agreement to impose restraints no greater than necessary to protect the legitimate business interests of the employer, and then enforce the agreement as reformed. *Peat Marwick Main & Co.*, 818 S.W.2d at 388 (Tex. 1991); TEX. BUS. & COM. CODE § 15.51(c).

C. How Other States Enforce Non-Compete Agreements

Regulation of non-compete agreements is historically handled by state common law and statute. The requirement that non-compete agreements are drafted and applied reasonably exists in all states that enforce non-compete agreements. Beyond the general requirement of reasonableness, non-compete laws vary across the nation because states have developed unique frameworks for governing non-competes to fit the economic and industry demands of their workforce.

Three states - Oklahoma, North Dakota, and California - do not enforce non-compete agreements.[3] States which do enforce non-compete agreements carve out exemptions for various occupations:

- Broadcasters: Arizona, Connecticut, DC, Illinois, Massachusetts.
- Physicians: Arizona, Colorado, Delaware, Illinois, Massachusetts, New Mexico, Rohde Island, Tennessee and Texas.
- Employees in a technology business: Hawaii.
- Automobile salesmen: Louisiana.

Others states, including Alabama and Arkansas, more broadly exempt "professionals" such as medical, veterinary and social workers.

States also vary in which interests are considered protectable via non-compete agreements:

- In Alabama, employers may use non-compete agreement to protect trade secrets; confidential information; commercial relationships or contacts with specific prospective or existing customers, patients, vendors, or clients; customer, patient, vendor, or client goodwill; and specialized and unique training involving substantial business expenditure specifically directed to a particular agent, servant, or employee, if identified in writing as consideration for the restriction.
- In Florida, employers may use non-compete agreements to protect trade secrets, confidential business information, substantial customer relationships and goodwill, and extraordinary or specialized training.
- In Idaho, employers may use non-compete agreements to protect their trade secrets, technologies, intellectual property, business plans, business processes and methods of operation, goodwill, customers, customer lists, customer contacts and referral sources, vendors and vendor contacts, and financial and marketing information.

In addition to occupational exemptions and protectable interests, states also take different approaches to balancing interests to determine enforceability of non-competes. For example:

- Alaskan courts consider whether the non-compete eliminates unfair as opposed to ordinary competition; whether the covenant stifles the employee's inherent skill and experience; the proportionality of the benefit to employer in contrast with the detriment to the employee; whether the employee's sole means of support is barred; whether employee's talent was developed during employment; and whether the forbidden employment is incidental to the main employment.
- In Illinois, the non-compete must be ancillary to a valid employment relationship and no greater than required to protect a legitimate business interest. Additionally, non-compete agreements cannot impose undue hardship on the employee, and cannot be injurious to the public.
- In Michigan, a non-compete agreement must have an "honest and just purpose" and to protect legitimate business interests and must be reasonable in time (no more than one year), space, and scope or line of business. *See Hubbard v Miller*, 27 Mich 15, 19 (1873). Additionally, non-compete agreements cannot be injurious to the public.
- In Nevada, non-compete agreements are void unless (a) supported by valuable consideration; (b) the terms of the agreement are not greater than required to protect the employer; (c) there is no undue hardship on the employee; and (d) the agreement is appropriate in relation to the consideration.
- Ohio requires that non-competes are not too restrictive than necessary to protect the employer's legitimate business interests and result in no undue hardship to employee. Courts also consider whether the non-compete is injurious to public interest. Additional considerations include: the absence or presence of limitations as to time and space; whether employee is sole contact with customer; the employee's possession of trade secrets or confidential information; the purpose of the restriction (elimination of unfair competition vs. ordinary competition and whether the restriction seeks to stifle the employee's inherent skill and experience); proportionality of benefit to employer as compared to the detriment to the employee; other means of support for the employee; when the employee's talent was developed; and whether the forbidden employment is merely incidental to the main employment.

[3] All state-by-state survey data in this section is sourced, with permission, from *Employee Non-Competes: A State-by-State Survey*, BECK REED RIDEN, LLP, Russell Beck (June 27, 2020) available at https://www.faircompetitionlaw.com/wp-content/uploads/2020/06/Noncompetes-50-State-Survey-Chart-20200627.pdf.

States appear to have a competent framework of enforcement standards with appropriate state-specific exemptions that reflect the culture of the industries operating within each state. Notwithstanding the complex state framework employed in the 47 states which enforce non-compete agreements, the FTC is considering issuing a rule to regulate use of non-competes nationwide. Why would the FTC deem it necessary to apply any sort of one-size-fits all rule to the current state-determined framework?

D. Potential FTC Regulation of Non-Compete Agreements

1. Why does the FTC Want to Regulate Non-Compete Agreements

During the January 9, 2020 Workshop, there was extensive discussion regarding studies about the widespread use of non-competes and the detrimental effects to the economy caused by their prevalence (overuse). These studies did not focus only on the effect of the non-compete on the employee, i.e. limiting the employee's ability to work for a competitor, but they analyzed the market effect of non-compete use in the aggregate. Results of those studies likely form the basis of the FTC's recent interest in regulating the use of non-competes.

Regarding non-compete prevalence, a survey performed by the Economic Policy Institute shows 27.8% of private-sector workforce is required to enter into non-compete agreements.[4] More than a quarter (29.0%) of responding establishments with an average hourly wage below $13.00 require non-competes for *all* their workers. Additionally, 40% of establishments in each of the 12 largest states have at least some employees covered by non-competes. This includes 45.1% of establishments in California, despite non-competes being unenforceable under California state law.[5] More than half (53.7%) of responding establishments that have mandatory arbitration procedures, which bar employees from going to court to resolve workplace disputes, also require at least some of their employees to enter into non-compete agreements.[6] Researchers believe and have presented to the FTC that the prevalence of the use of non-competes has an adverse effect on labor mobility and causes wage stagnation.[7]

Those in favor of FTC regulation see the effects of non-competes not just as a labor issue, but also as market, competition and regional economic development issues.[8] Studies find that the increase in non-compete use depresses wages. Wage stagnation results because employees who usually increase their pay by finding better employment opportunities, have limited options for subsequent employment.[9] When that mobility is limited by non-competes, wages are also limited because employees change jobs with less frequency.[10] In fact, a study on the application of non-competes to low-wage workers found an increase in wages when non-competes are not utilized among the workforce.[11] According to Damon Silvers, Policy Director and Special Counsel to the AFL-CIO, wage stagnation is "the fundamental economic and social problem that the United States faces today…." [Wage stagnation] is persistent in our economy and the prevalence of non-competes "is completely intertwined with that phenomenon."[12] Proponents of FTC

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[4] Alexander J.S. Colvin & Heidi Shierholz, *Noncompete agreements: Ubiquitous, harmful to wages and to competition, and part of a growing trend of employers requiring workers to sign away their rights*, ECONOMIC POLICY INST., at 1 (Dec. 10, 2019).

[5] U.S. Department of the Treasury, Office of Economic Policy, *Non-compete Contracts: Economic Effects and Policy Implications*, March 2016, p. 16 available at: https://www.treasury.gov/resource-center/economic-policy/Documents/UST%20Non-competes%20Report.pdf (last visited March 1, 2018)

[6] *Id.*

[7] *See* Starr, Evan, The Use, *Abuse and Enforceability of Non-Compete and No-Poach Agreements: A Brief Review of the Theory, Evidence and Recent Reform Efforts*, February 2019 Issue Brief, p. 10, available at: https://eig.org/wp-content/uploads/2019/02/Non-Competes-Brief.pdf. See also, Krueger, Alan and Posner, Eric, *A proposal for protecting low-income workers from monopsony and collusion, Brookings Institute*, February 27, 2018.

[8] *See* Final Transcript of the FTC January 9, 2020 Workshop, "Non-Competes in the Workplace: Examining Antitrust and Consumer Protection issues" ("Workshop Tr."), p. 19.

[9] Marshall Steinbaum, *Employer Power in the High-Profit, Low-Wage Economy* ROOSEVELT INSTITUTE (April 2018) ("these agreements simply discourage workers from searching for new jobs, allowing their employers to pay less and demand more.") available at https://goo.gl/QAUGud.

[10] *See* Johnson, Matthew and Lavetti, Kurt and Lipsitz, Michael, *The Labor Market Effects of Legal Restrictions on Worker Mobility* (September 17, 2019) ("Using a newly-constructed state-year panel of Noncompete Agreement (NCA) enforceability spanning 1991 to 2014, we find that increasing the enforceability of NCAs leads to a decline in workers' earnings and job mobility. An increase from the 10th to 90th percentile of enforceability is associated with three to four percent lower annual earnings among employed workers.") available at https://ssrn.com/abstract=3455381.

[11] See Michael Lipsitz and Evan Starr, *Low-Wage Workers and the Enforceability of Non-Compete Agreements* (September 10, 2019) ("We find that the Oregon low-wage NCA ban increased hourly wages by 2.2-3.1% on average, with the effect as great as 6% over a seven-year period. Scaling this population-wide effect by NCA use in the hourly-paid population (14%) implies that the increase may be as large as 14-21% on those workers who actually sign NCAs...") available at https://ssrn.com/abstract=3452240.

[12] *See* Workshop Tr. P. 53.

intervention believe there is a negative relationship between both the existence and the enforcement of non-compete agreements and the wage levels.[13]

One of the consistently addressed issues by the panelists at the Workshop, was the broad use of non-compete agreements among a company's entire workforce regardless of wage, skill level, access to trade secrets or amount of training provided. Jacob Hamburger, attorney in the offices of Policy and Planning at the Federal Trade Commission led a panel at the Workshop on the FTC's authority to address non-compete clauses. Hamburger criticized the prevalent use of non-compete agreements for low to middle-income workers and low-skilled workers like restaurant workers, nurses, hairstylists, massage therapists, salespeople, receptionists, customer service personnel and childcare providers. He recounted observations made while interviewing employees of businesses such as a high-end steakhouse which prohibited employees from working at any restaurant that featured steaks, chops, seafood or derived more than 25 percent of their revenue from the sale of beef. [14] Likewise, he recalled broad geographical restrictions on a nurse who was prohibited from working within 25 miles of her former employer. She lived in a small city in a relatively rural area of Illinois, which meant she could not work for any hospital or medical facility in the town.[15]

On a grander scale, in 2018, Illinois Attorney General Lisa Madigan issued a press release announcing a settlement with WeWork. The settlement agreement released over 1,400 employees nationwide from non-competes & eased restrictions in existing non-competes for another 1,800 employees nationwide.[16] According to the release, "WeWork used non-compete agreements that prohibited all employees from working for competitors after leaving the company. The non-compete agreements not only applied to executive and senior staff, but to all levels of employees, including cleaners, mail associates, executive assistants, and baristas, some of whom are paid as little as $15 an hour."[17] These examples of employers abusing non-compete agreements, and many similar episodes, are why the FTC believes it must intervene.

The panel also discussed the *in terrorem*[18] effect of non-compete use. Meaning, even in jurisdictions which do not enforce non-compete agreements, employers still require employees to sign non-compete agreements. The use of non-competes, even when unenforceable, still results in employees unwilling the change jobs due to fear of being sued for breach of contract.[19] In addition to chilling the movement of employees, researchers believe there is an equally chilling effect on employers extending offers for employment due to the cost of potential non-compete litigation. As Federal Trade Commissioner Rebecca Kelly Slaughter stated at the Workshop, "workers suffer when competition for their labor is chilled and employers are insulated from competition. Job opportunities become more limited, and workers are less able to negotiate better pay, benefits, or working conditions."[20]

In addition the economic research, and likely in response to that research, since 2015, a number of bills have been introduced by government officials urging federal regulation of non-compete agreements.

- 2015: Mobility and Opportunity for Vulnerable Employees Act[21] ("MOVE Act"): the act sought to (1) prohibit employers from entering into not to compete covenants with low-wage employees engaged in commerce or in the production of goods for commerce, and (2) require an employer of such employees to post notice of such

[13] *Id.* at 54.
[14] *See* Workshop Tr. P. 47-48.
[15] *Id.*
[16] Press Release, Illinois Attorney General, Attorney General Madigan Reaches Settlement With WeWork to End Use of Overly Broad Non-Competes, (September 18, 2020),
[17] *Id.*; See, also, Samantha Bomkamp, *Illinois AG Sues Jimmy John's Over Noncompete Pacts; Chain 'Disappointed,'* CHI. TRIB. (June 9, 2016), https://www.chicagotribune.com/business/ct-jimmy-johns-illinois-lawsuit-0609-biz-20160608-story.html [http://perma.cc/LMY4-544S] (detailing a lawsuit against Jimmy John's for its use of non-competes). Employment contracts at Jimmy John's restricted employees from working in any business that earned more than 10% of its revenue from "selling submarine, hero-type, deli-style, pita and/or wrapped or rolled sandwiches" and was within three miles of any Jimmy John's location.
[18] *See, e.g.*, Matt Marx & Ryan Nunn, *The Chilling Effect of Non-Compete Agreements*, ECONOFACT (May 20, 2018) ("[E]ven the possibility of legal action by one's ex-employer produces a 'chilling effect' on job mobility. Rather than risk a lawsuit, workers might stay with their current employer or switch industries entirely to comply with the contract.").
[19] Petition for Rulemaking to Prohibit Worker Non-Compete Clauses, OPEN MARKETS INSTITUTE (March 20, 2019) citing Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 682 (1960) ("For every covenant that finds its way to court, there are thousands which exercise an in terrorem effect on employees who respect their contractual obligations and on competitors who fear legal complications if they employ a covenantor, or who are anxious to maintain gentlemanly relations with their competitors.").

[20] *See* Workshop Tr. P. 108.
[21] S. 1504, 114th Cong. (2015-2016)

prohibition in a conspicuous place on the employer's premises. The bill empowers the Secretary of Labor to (1) enforce a complaint of a violation in the same manner as a complaint of a violation of the Fair Labor Standards Act of 1938, and (2) impose a civil fine on any employer who violates this Act.[22]

- 2015: Limiting the Ability to Demand Detrimental Employment Restrictions Act.[23] The bill, sponsored by Joseph Crowley, former US Representative from New York's 14th Congressional District, sought to prohibit employers from requiring low-wage employees to enter into non-compete agreements, to require employers to notify potential employees of any requirement to enter into a covenant not to compete, and for other purposes.
- 2015: Freedom for Workers to Seek Opportunity Act.[24] Sponsored by Derek Kilmer, Representative for Washington's 6th Congressional District, the bill sought to prohibit employers from requiring grocery store employees to enter into non-compete agreements.
- 2018: Workforce Mobility Act of 2018.[25] This bill, introduced by Senator Chris Murphy (Conn.), sought to prohibit employers from entering into, enforcing, or threatening to enforce non-compete agreements with any employee of such employer. The bill authorized the Department of Labor to enforce and impose a fine upon violators. It also provided a private right of action for aggrieved parties for actual and punitive damages, and for reasonable attorney's fees and costs if the action is successful.
- 2019: Freedom to Compete Act.[26] Introduced by Florida Senator Marco Rubio, this bill proposed to amend the Fair Labor Standards Act (FLSA) of 1938 to ban non-competes for most non-exempt workers. If passed, the Freedom to Compete Act would have applied retroactively to agreements entered into before its enactment.
- 2019: Workforce Mobility Act of 2019.[27] Introduced by Senators Chris Murphy (Conn.) and Todd Young (Ind.), this bill sought to ban non-compete agreements outside of the sale of a business or dissolution of a partnership. The bill sought to grant the FTC and the Department of Labor the power to enforce the ban through fines on employers.

While the bills listed above have not passed, the FTC still faces persistent pressure from government officials to regulate non-compete agreements. In July 2020, Senators Elizabeth Warren and Chris Murphy sent a letter urging the FTC to regulate non-compete agreements and requested a response from the FTC by August 4, 2020 to the following questions:[28]

> "1. What actions has the FTC taken since March 11, 2020 to pursue a potential Commission Rule restricting the use and enforcement of non-compete agreements in contracts between employers and employees?
> 2. Has the FTC considered any rulemaking pertaining to the use or enforcement of non-compete agreements during and after the COVID-19 public health emergency?
> 3. Has the FTC brought any enforcement actions against employers for using or enforcing non-compete agreements since issuing a joint statement with the DOJ in April 2020 regarding the use of these and other agreements that suppress competition in the labor market?
> 4. Has the FTC considered issuing a rule that would allow a defense of undue hardship during and after the COVID-19 public health emergency in response to employer lawsuits for a violation of non-compete agreements?"

As of the date of this article, the FTC has not issued a response to Senators' Warren and Murphy's question. Ostensibly, the January 9, 2020 Workshop was in response to this type of unrelenting pressure from government officials and is just the beginning of the FTC's preliminary inquiry into how it might regulate the use of non-compete agreements.

2. How Might the FTC Regulate Non-Compete Agreements?

Whether FTC has the authority to regulate non-compete agreements and the intricate administrative rule-making process by which it may do so are beyond the scope of this article. However, it is worth examining how, if it does choose to proceed, the FTC might restrict the use of non-compete agreements. Ryan Nunn, Policy Director at the

[22] *Id.* § 5.
[23] H.R. 2873, 114th Cong. (2015)
[24] H.R. 4254, 114th Cong. (2015)
[25] H.R. 5631, 115th Cong. (2017-2018)
[26] S. 124, 116th Cong. (2019-2020)
[27] S. 2614, 116th Cong. (2019-2020)
[28] Letter from Senator Elizabeth Warren and Senator Chris Murphy (July 22, 2020), available at https://www.warren.senate.gov/download/20200722-letter-to-ftc-on-non-competes-1&download=1

Hamilton Project and former labor economist in the Office of Economic Policy, spoke at the January 9, 2020 Workshop and suggested the following six ways in which the FTC may address the use of non-competes.[29]

a. Ban non-compete or render them unenforceable

Oklahoma, North Dakota and California are the only states that do not enforce non-compete agreements. However, research shows that lack of formal enforcement does not curb the use of non-compete agreements and does not prevent the chilling effects of informal enforcement. Additionally, without non-compete agreements, employers will still need to protect their trade secrets, which will undoubtedly cause a spike in trade secret litigation. A ban on non-competes may also act as a disincentive to employers who may otherwise offer higher wages and more training in exchange for contractual protection.[30]

b. Ban non-compete for certain groups of workers

As discussed above, a majority of states which enforce non-competition agreements also exempt their use for employees in certain professions. Additionally, certain states, including Rhode Island (low-wage employees, i.e. , employees earning no more than two and a half times the federal poverty level), Virginia (employees earning less than $52,000 annually), Maine (earning less than or equal to 400% of the federal individual poverty level - $49,960 as of 2019), Maryland (employees earning less than $15 per hour or $31,200 annually) and Illinois exempt low-wage employees from non-compete agreements. A potential FTC wage-based rule may adopt a similar framework as Rhode Island, Virginia, Maine, Maryland and Illinois. A wage-based rule is likely the least disruptive option to address the FTC's concerns. Low-wage and low-skilled employees are less likely to possess trade secrets, thus, employers are arguably less justified in restricting their future employment.

c. Limit non-competes to jobs that have trade secrets

Protection of Trade secrets is often the primary justification for the use of non-competes. However, they are certainly not the only protectable and legitimate interest. Thus, limiting non-competes only to jobs which have trade secrets will leave employers unable to use non-competes to protect other legitimate business interests.

d. Adjust enforcement of the non-compete.

The FTC may choose to tighten the scope, limit the protectable legitimate interest, and or mandate a shortened duration for all agreements. It may also choose to eliminate the ability to reform non-compete agreements and clauses in courts such that failure by employers to draft narrowly-tailored, reasonable agreements would result in the agreement being held wholly unenforceable.

e. Requirements on Compensation

This proposal would require the employer to increase the wages of an employee who agrees to sign a non-compete agreement. The FTC may also require the use of a "garden leave" agreement, whereby an employer must pay the former employee a fraction of the employee's salary during the period of restricted employment. This option may address the wage suppression issue as well as incentivize employers to draft non-compete agreements with shorter time restrictions.

f. Require enhanced transparency and notification

The FTC may require employers to provide notice to employees prior to entering into a non-compete agreement. Transparency allows both parties to the agreement to make an informed decision as to whether to proceed with the employment relationship. Massachusetts law on non-competes, reformed in 2018, provides a framework for enhanced transparency and notification:[31]

- the agreement must be in writing, signed by both the employer and employee, and state the employee has the right to consult counsel prior to signing. The employer must also provide notice of the agreement to the employee, the form and timing of which depends on when the employee is asked to sign the agreement.

[29] *See* Workshop Tr. P. 134-135.

[30] Non-competes in the U.S. Labor Force, by Evan Starr, J.J. Prescott, and Norman Bishara (August 30, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625714 (emphasis added).

[31] Russell Beck, *Massachusetts Noncompete and Trade Secret Reform Has Arrived: What You Need to Know.*, Fair Competition L. (Aug. 1, 2018), available at https://www.faircompetitionlaw.com/2018/08/01/massachusetts-noncompete-and-trade-secret-reform-has-arrived-what-you-need-to-know/ (explaining progress in Massachusetts's non-compete reform).

- Employers who require employees to sign a non-compete at the beginning of employment must provide a copy of the agreement to the employee either before making a formal offer, or 10 days before the employee starts, whichever comes first.
- Employers who require employees to sign a non-compete mid-employment must provide notice of the agreement not less than 10 business days before the agreement becomes effective.
- Further, non-competes entered during employment must be supported by independent consideration beyond continued employment.

CONCLUSION

It is unclear if or when the FTC may move beyond its preliminary data-gathering stage to more advanced stages of its rule-making process. Before it does so, additional data will be required to further establish the causation between non-compete use and wage stagnation and labor immobility. There will also likely need to be additional research on the impact of non-compete on employers in the market, as well as any effects on stifling startups and entrepreneurship.

What is clear is that states have an established framework for governing non-compete agreements. Because these statutes of governance are tailored to each state's unique workforce and industries, any action by the FTC to regulate non-compete agreements with a one-size-fits all rule will need to avoid disrupting this established structure.

Advanced Consumer & Commercial Law CLE: Potential FTC Regulation of Non-Compete Clauses in Employment Agreements

Dennis Siaw-Lattey
Munsch Hardt Kopf & Harr, PC
Dallas, Texas
August 12, 2020

January 9, 2020 Federal Trade Commission (FTC) workshop examined the legal basis and economic support to promulgate a Commission Rule restricting the use of non-compete clauses in employer-employee employment contracts

Key considerations:

- What impact do non-compete clauses have on labor market participants?
- What are the business justifications for non-compete clauses
- Is State law insufficient to address the harms associated with non-compete clauses
- Do employers enforce non-compete agreements contained in standard employment contracts? How routine is such enforcement?
- Are there situations in which non-compete clauses constitute an unfair method of competition (UMC) or an unfair or deceptive act or practice (UDAP)? How prevalent are these situations?
- Should the FTC consider using its rulemaking authority to address the potential harms of non-compete clauses, applying either UMC or UDAP principles? What "gap" in existing state or federal law or regulation might such a rule fill? What should be the scope and terms of such a rule? What is the statutory authority for the Commission to promulgate a rule?
- Should the FTC consider using other tools besides rulemaking to address the potential harms of non-compete clauses, such as law enforcement, advocacy, or consumer/industry guidance?
- What additional economic research should be undertaken to evaluate the net effect of non-compete agreements? Should additional economic research on the empirical effects of non-compete agreements focus on a subject of the employee population? If so, which subset?

Non-compete Agreements: The Basics

Employment provisions that ban workers at one company from going to work for, or starting, a competing business within a certain period of time after leaving a job.

Non-compete provisions typically used in the context of four agreements:

- Employment Agreements
- Franchise Agreements
- Partnership Agreements
- Business Sales Agreements

What do they protect?

- Trade Secrets
- Customer Goodwill
- Investment in Human Capital
- Other Legitimate Interests

Non-compete Agreements: The Basics

What do they protect?

- Trade Secrets
  - Protectable **AND** protected Intellectual property of the Company
  - Innovation
- Customer Goodwill
  - Relationships between Employees and Customers – prospective and existing
  - Developed by employees over time (e.g. sales industry)
- Investment in Human Capital
  - Cost and time invested to train employees
  - Sometimes required that the training be unique and involve substantial business expenditure (Alabama)
- Other Legitimate Interests
  - Confidential information; customer lists (Idaho), referral sources, vendors contacts, financial and marketing information

Trade secrets are protected in 40 of 50 states by non-compete agreements

Why?

- Creating trade secrets are costly and difficult to protect and conceal
- Non-compete provisions can provide substantial protection from competitor access

Other tools used to protect trade secrets may be insufficient

- Trade Secret Laws
  - Federal and state laws address detection and redress while non-compete agreements are preventative at the individual level (“prevention is better than cure”)
    - Right to private action for the theft of trade secrets by competition, but the laws do not prevent employee with information from going to work for the competition
  - Expensive to enforce (protracted litigation)
- Nondisclosure Agreements
  - Promise not to disclose learned information

47 states enforce non-compete agreements

Excluded States: North Dakota - California (Potential Trade Secret Exemption) - Oklahoma

Non-compete agreements, as a restraint of trade, are generally disfavored but will enforce if intended to:

1. Protect legitimate business interests, and are
2. Not more restrictive than necessary to protect those interests

The analysis requires balancing the interest of employer v. interest of employee

Legitimate business interests protected by non-compete provisions will vary by state

- Alabama – trade secrets; confidential information; commercial relationships or contacts with specific prospective or existing customers, patients, vendors, or clients; customer, patient, vendor, or client goodwill; specialized and unique training involving substantial business expenditure specifically directed to a particular agent, servant, or employee (if identified in writing as consideration for the restriction)

- Florida - trade secrets; confidential business information; substantial customer relationships and goodwill; extraordinary or specialized training

- Idaho - trade secrets; technologies; intellectual property; business plans; business processes and methods of operation; goodwill; customers; customer lists; customer contacts and referral sources; vendors and vendor contacts; financial and marketing information

- New Mexico - limitation of competition by employee with employer

*EMPLOYEE NON-COMPETES: A STATE-BY-STATE SURVEY, BECK REED RIDEN, LLP, RUSSELL BECK (JUNE 27, 2020) AVAILABLE AT HTTPS://WWW.FAIRCOMPETITIONLAW.COM/WP-CONTENT/UPLOADS/2020/06/NONCOMPETES-50-STATE-SURVEY-CHART-20200627.PDF

Balance of Interest Analysis

- **Alaska:** whether the covenant, stifles employee's inherent skill and experience; proportionality of benefit to employer and detriment to employee;
- **Illinois:** not injurious to the public; and reasonable in time, space, and scope. [May require two years of employment before any noncompete can be enforced.]
- **Michigan:** a noncompete agreement must have "an honest and just purpose" and to protect legitimate business interests. *Hubbard v Miller*, 27 Mich 15, 19 (1873).
- **Nevada:** no undue hardship on employee and appropriate in relation to the consideration.
- **Ohio:** whether employee is sole contact with customer, purpose of restriction (elimination of unfair competition vs. ordinary competition and whether seeks to stifle employee's inherent skill and experience)

Each state has a unique framework to enforce non-compete provisions

States that enforce non-compete agreements may still carve out exemptions for certain types of employees

- Physicians – at least 8 states specifically exempt physicians
- Broadcasters – 7 states
- Security guards (Connecticut)
- Automobile salesmen (Louisiana)
- Secretaries and clerks (Missouri)
- Low-wage workers:
  - Virginia: Low-wage employees, i.e., employees earning less than approximately $52,000
  - Rhode Island: low-wage employees, i.e., employees earning no more than two 2.5x the federal poverty level (currently $31,225, plus another $11,050 for each additional person in the household – based on the employee's "regular," i.e., non-overtime, nonweekend, nonholiday hours)

Texas Non-compete Agreements: General Overview

- Non-competes are required to be ancillary to an otherwise enforceable Employment Contract. Tex. Business and Commerce Code § 15.50 (a)
- Reasonably limited as to time, geographical area, and scope of work
  - Geography: within the geographic area where an employee worked
  - Time: more likely to find reasonable non-competes which are anywhere from two to five years in length
  - Scope of work: related to the type of activities the employee performed for the employer
- Reasonable time, geographical and activity restraints are determined by the courts, and each case needs to be considered individually

Why FTC interest in regulating non-compete agreement?

Per research studies and surveys, non-compete agreements tend to have negative market effects

- Suppress wages – employees increase their wages by changing jobs
- Limits mobility - reduction in job offer rates due to threat of litigation
- In terrorem effect – the existence of the noncompete compels employees to refrain from changing jobs even though the agreement may not be enforceable
- Limits innovation and invention - limit flow of ideas because the work force is stagnant

Why FTC interest in regulating non-compete agreement?

National Employment Law Project wrote to the FTC and cited the following prevalence statistics:

- In 2016, researchers estimated that 18% of workers are covered by non-competes, which amounts to 30 Million people
- 40% of workers had been covered by a non-compete at one time during their careers
- Even in California, 19% of workers had signed non-competes, and non-competes have not been enforceable in California since the 1800's

Why FTC interest in regulating non-compete agreement?

In response to legislation proposed by government officials

- 2015 – "MOVE Act" – Mobility and Opportunity for Vulnerable Employees Act – prohibit use of non-competes for low wage employees
- 2015 – Limiting the Ability to Demand Detrimental Employment Restrictions Act
- 2015 – Freedom for Workers to Seek Opportunity Act – ban use of non-competes for grocery store workers
- 2018 – Workforce Mobility Act of 2018 – federal ban on use of employee non-competes
- 2019 – Freedom to Compete Act- ban non-competes for most non-exempt workers
- 2019 – Workforce Mobility Act of 2019
- July 2020, Letter from Senators Elizabeth Warren and Chris Murphy urging the FTC to act and requesting a response by August 4, 2020

Possible FTC Rule Options

Although states have promulgated specific policies on non-compete agreement, the FTC may propose other alternatives that address the concerns highlighted

- Complete Ban on non-compete agreements
- Unenforceable against Low Wage employees
- Unenforceable against Low Skilled Workers

FTC rule-making process is an arduous task and discussions are still in the preliminary phase

- Long rule-making process
- More Research and surveys necessary
- Show causation