Covenants not to Compete: The End of an Era

On January 5, 2023, Federal Trade Commission (FTC) Chair Lina Khan announced a proposed federal regulation that, if enacted, would invalidate non-competes and similar restrictive covenants that are routinely used by companies to limit a former employee’s professional activities post-employment. The proposed rule would not only ban the future use of non-compete clauses for workers and independent contractors, the rule would invalidate these clauses retroactively. Furthermore, the FTC signaled that it would also review non-solicitation clauses to see if they effectively function as non-competes. Although the FTC’s sweeping proposal is unprecedented at the federal level, the agency is in fact catching up with several states that have already curtailed the bounds of non-compete clauses.

Traditional Principles of Restrictive Covenants

The FTC is targeting restrictive covenants that routinely appear in employment contracts, such as:

1. Non-compete clauses, which prohibit an employee from working in the same business, industry and/or geographic area as their former employer;

2. Customer non-solicitation clauses, which prohibit an employee from seeking business from the former employer’s customers, including prospective clients; and

3. Employee non-solicitation clauses, which prohibit an employee from trying to hire their former co-workers to work at a competing business.

Traditionally, restrictive covenants have been governed by state law, which is usually stipulated in the employment contract. Although each state retains autonomy to set its own criteria, most courts have required that restrictive covenants be “reasonable.” The threshold of reasonableness is not a bright-line rule; it depends on the facts and circumstances of each case. Many courts, including Delaware, use a test that weighs: (i) the geographic scope and temporal duration of the clause; (ii) the employer’s legitimate economic interest in enforcing the provision; and (iii) a balancing of the equities. New York courts also consider whether the clause “harms the public,” i.e., underlying policy issues. If a restrictive covenant is deemed unenforceable, some courts will “blue pencil” or edit the clause to make it “reasonable” rather than completely striking it.
The Current “State” of Play

Recently state legislatures and courts have reconsidered the legality of restrictive covenants. Before 2007, only three states—California, North Dakota and Oklahoma—banned non-compete clauses. Since then, over 20 states have adopted measures that curb an employer’s ability to enforce these provisions. This watershed movement shows no signs of abating with approximately 66 bills pending in 25 states. Among the jurisdictions with the most significant changes are Colorado and the District of Columbia, which have limited non-competes to “high-compensated employees,” and Illinois, which has banned non-competes for workers earning below a certain threshold. However, most states still permit broad non-solicitation clauses to protect an employer’s confidential and proprietary information.

What’s Next?

The FTC’s proposed rule is the latest initiative to implement President Biden’s Executive Order on Promoting Competition in the American Economy [view related post]. If adopted, the new rule would make it illegal for an employer to: (i) enter or attempt to enter a non-compete with a worker or independent contractor, whether paid or unpaid; (ii) maintain a non-compete with a worker; and (iii) represent to a worker that they are bound by a non-compete. The FTC will look at the contract holistically to see if an employer has effectively implemented a non-compete through overly-restrictive non-solicitation clauses. The requirements would apply retroactively.

The proposed rule will be open to public comment for a 60-day window before it is published. The FTC has specifically asked for statements on

1. Whether franchisees should be covered by the rule;

2. Whether senior executives should be exempted from the rule, or subject to a rebuttable presumption rather than a ban; and

3. Whether low- and high-wage workers should be treated differently under the rule.

The new rule would take effect 60 days after final publication in the Federal Registry, and employers would be given 180-days to comply.

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