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The Current Status of Non-Compete Agreements: It's Complicated

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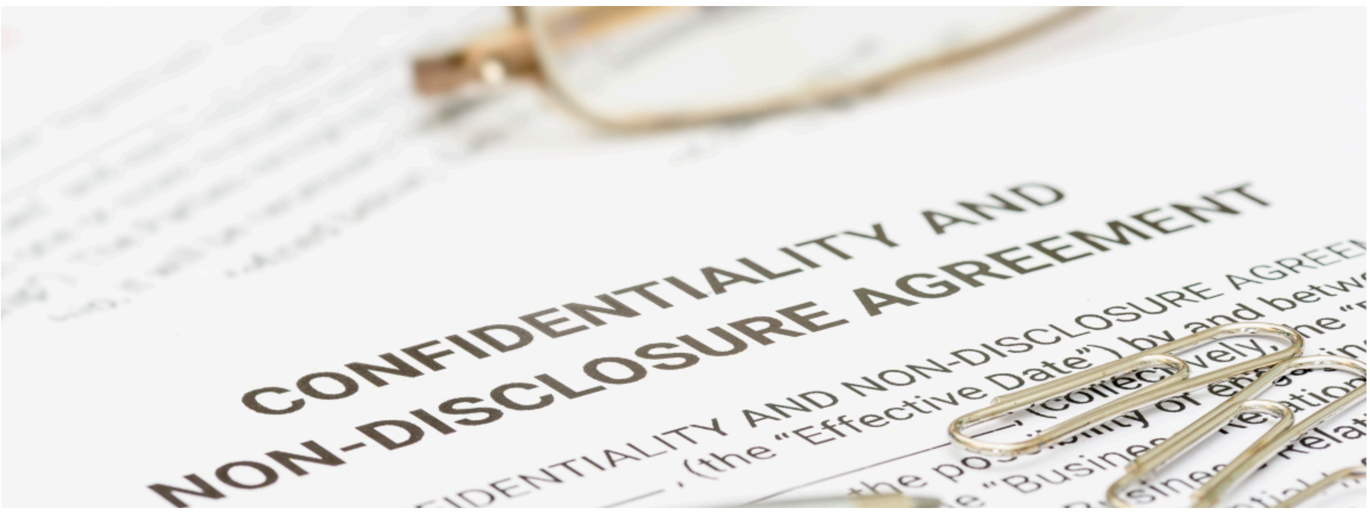

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It is estimated that one in five workers in the United States is subject to a non-compete agreement. Depending on how the employer has written the agreement, to varying degrees, the non-compete restricts an employee's ability to work for a competitor after their employment ends. These restrictions have long raised serious public policy concerns.

On the one hand, employers argue that they need to protect their business interests, which include investments made in training and developing employees and products, as well as retaining customers. On the other hand, non-compete agreements impede employee mobility and may flat-out prevent an employee from making a living for a period of time. There is also concern that employers often write the agreements in a way that overreaches in the scope and duration of the restrictions, and that the agreements are adhesive – meaning that most employees have no choice but to accept the terms if they want the job. There is also a healthy amount of skepticism about whether employers need the business protections they often cite in support of enforcing non-compete agreements, because there are other existing or available protections (for example, confidentiality and non-solicitation agreements, as well as trade secret laws).

In reality, most employees do not present a high level of competitive risk to the company when they depart employment. Nevertheless, these agreements have become so ubiquitous that the popular press has picked up stories at the extremes. Infamously, the hourly "sandwich artists" at Jimmy John's were subject to non-compete agreements. So were teenage counselors at a summer camp. Are these restrictions enforceable? Given the current landscape, it's complicated.

The Short-Lived Federal Trade Commission Rule

The regulation of non-competes has historically been left to either state statutory law or common law contract doctrine. Under the Biden administration, the Federal Trade Commission voted 3-2 to issue a final rule banning non-competes nationally, with very limited exceptions. The Commission cited concerns about "the tendency of non-competes to harm competitive conditions in labor, product, and service markets."

The FTC rule was challenged by employers in three federal courts, with mixed results. The U.S. District Court for the Eastern District of

Pennsylvania refused to preliminarily enjoin the rule from going into effect, and the employer (a tree removal service) voluntarily withdrew the challenge. Conversely, in a case brought by the Villages (yes, the retirement community) in Florida, the U.S. District Court for the Middle District of Florida granted a preliminary injunction preventing the law from taking effect, but limited the scope of its ruling to the parties in that case. Most significantly, just weeks before the rule was to go into effect, in *Ryan v. Federal Trade Commission*, the U.S. District Court for the Northern District of Texas permanently enjoined the rule nationwide. The court found that the FTC lacked statutory authority to promulgate the rule, and that the rule was arbitrary and capricious.

The FTC appealed to the Fifth Circuit, but following the change in administration, and President Donald Trump's appointment of a new Chairman of the FTC, the appeal was effectively abandoned. With this shift in power, there no longer appears to be any political desire to address non-compete enforceability at the federal level. The net result is that there is no effective federal law or regulation that addresses the enforceability of non-compete agreements with employees, and the issue is again left to the states.

State Statutory Approaches

As of this writing, a handful of states have addressed non-compete enforceability by statute. Until Florida passed the Contracts Honoring Opportunity, Investment, Confidentiality, and Economic Growth Act (the CHOICE Act) this summer, the two main statutory approaches were either outright bans or bans with income thresholds.

California, North Dakota, and Oklahoma have long effectively banned non-competes for all employees. Minnesota recently followed suit. Other states have passed statutes that allow enforcement of non-compete clauses only if the employee makes more than a stated annual salary threshold. For example, in Illinois, a statute that went into effect this year allows for enforcement of a non-compete agreement if the employee makes more than $75,000 annually. In Washington, the salary threshold is just over $123,000; in Colorado it is about $127,000. For employees over the income threshold, most statutes enforce the non-compete agreement so long as it is reasonable in its scope, duration, and geographical limits. That is to say, even if an employee in Illinois makes more than $75,000 annually, their non-compete agreement will not be enforceable if it is not reasonable. So, these statutes only provide outright bans for those employees with salaries under the threshold amount.

Just last year, the Senate and Assembly of the New York State legislature passed a bill banning non-compete clauses, basically following the small minority of states that have enacted outright bans. But Governor Kathy Hochul refused to sign it. She signaled that she believed that non-compete clauses should be enforced only for highly compensated employees, though it is unclear where the salary threshold would land in New York.

This summer, Florida took a different policy position with the CHOICE Act, which Governor Ron DeSantis just signed into law in July. The Act significantly shifts Florida policy towards enforcement of non-compete agreements. Rather than work as some form of a ban on non-compete agreements, which has been the dominant statutory approach, the CHOICE Act is intended to make enforcement of non-compete clauses *easier* for employers. Among other things, the Act provides for a presumption that non-compete agreements are enforceable and provides that courts must issue a preliminary injunction to prevent an employee from breaching the agreement by working for a competitor. The employee faces a heightened burden of proof (clear and convincing evidence) to dissolve the injunction.

The CHOICE Act also uses a salary threshold to determine which employees are within its scope. The statute does not provide a concrete salary number. Rather, it states that an employee is within the Act if they earn a salary twice the annual mean wage of the county in Florida in which the employer's principal place of business is located or the employee resides. Even with this murky salary threshold, the stated purpose of this Act is to be "employer-friendly" by making non-compete agreements easier to enforce.

Common Law Contract Doctrine

In the vast majority of states without statutes addressing non-competes, common law contract doctrine, ostensibly through the lens of public policy, is used to assess the enforceability of the clause based on its reasonableness. Reasonableness is determined based on the scope, geographic and durational limits, and considered in the context of both the employer's legitimate business interests and other countervailing public policies (for example, a non-compete restriction should not prevent a patient from seeing the doctor of their choice). Thus, the common law leaves the decision whether to enforce a non-compete agreement within the discretion of the courts. There are many agreements that will fall in a grey area, with uncertainty about their enforceability. Coincidentally, the same is true for the statues that use salary thresholds but then apply a reasonableness standard where an employee's income exceeds the threshold.

Further, in some of the jurisdictions that apply a reasonableness standard, the courts follow what is frequently described as the "blue pencil rule." This rule essentially allows the courts to re-write non-compete restrictions that are held to be unreasonable. For example, if the employer restricted the employee from working for a competitor for two years within a 10-mile radius, and the court found these restrictions to be unreasonable, the blue pencil rule allows the court to revise the restrictions to, say, one year within a five-mile radius. This compounds the concern about employers overreaching because, if the employer knows that an overly restrictive clause will not be thrown out entirely but, rather, re-written, why not write it as broadly as possible? From the employer's perspective, the worst that happens is that the restrictions are narrowed by the court.

A Well-Worn Debate: Rules v. Standards

On its face, the landscape of current legal approaches to non-compete agreements appears baldly political. But it also follows the contours of a well-worn debate over how to structure and apply legal policy: namely, the differences between rules and standards. A rule is precise and clearly defined and there is no question as to what is allowed or prohibited by the rule. By contrast, a standard is stated as a general principle, and has more flexibility in its interpretation and application to specific situations.

For a common example, consider speed limits. A rule states that it is illegal to drive over 50 miles per hour. It is clear and simple to apply: if someone drives faster than 50 miles per hour, they have violated the rule. A standard would, instead, require drivers to drive at safe speeds. Unlike the rule, the outcome of applying the standard to any one case is not certain or predictable. It lends to flexibility and it allows itself to be tailored to specific context – that is, it allows for situations where it is safe to drive over 50 miles per hour. The standard requires an exercise of judgment in its application: what is a safe speed given the specific circumstances?

With non-compete agreements, the outright bans function as a rule. For example, in California, we have long been able to predict with certainty that an employee's non-compete restrictions will not be enforced. This is not so in the jurisdictions that apply a reasonableness standard. In those jurisdictions, application of the standard to any particular non-compete agreement is not certain or predictable. It will depend on the specific circumstances and the judgment of the court.

One apparent benefit of the reasonableness standard is that it takes into account the employer's interests, where the outright bans do not. The reasonableness standard balances the competing interests of employer and employee. However, this balancing of interests lends to a considerable amount of uncertainty and unpredictability. The unpredictability and uncertainty are not necessarily good for employers, who risk a loss in attempting to enforce an agreement they have with all of their employees. But it is worse for employees, who, whether or not the agreement would ultimately be enforced, are frightened to leave their companies and face a lawsuit they cannot afford to defend against. Indeed, the real value of non-compete agreements to the employer may be just that – what is known as an *in terrorem* effect. That is, the agreement scares the employee from quitting. And the uncertainty of the enforceability of the non-compete agreement only compounds that fear for the employee. The employer gets that benefit whether or not they actually expend resources to enforce the agreement.

Conclusion

In sum, the approach to policing non-competes has shifted with the political sands and, since the FTC rule has been abandoned, we are left with a state-by-state patchwork and very little certainty for most employers and employees. The approach taken by the FTC and the small handful of states that have enacted outright bans of non-compete agreements is the favorable approach. It eliminates uncertainty and unpredictability in enforcement, and employers may still use other avenues like confidentiality and non-solicitation provisions, as well as trade secret laws, to protect their interests. Moreover, it eliminates potential overreaching by employers who flex their bargaining advantage to unjustifiably subject employees to non-competes and, with that, prevent (or, at least frighten) employees from pursuing better opportunities.

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