FTC RULE BANNING NON-COMPETES PRELIMINARILY ENJOINED BUT NOT DEAD YET: POTENTIAL IMPACT ON CONFIDENTIALITY AND TRADE SECRET PROTECTION

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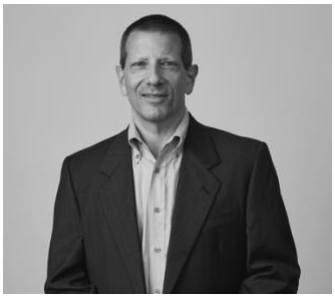

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On May 7, the *Federal Register* published the FTC's final rule banning most non-compete clauses with workers in the United States after the FTC concluded that such non-complete clauses constitute methods of unfair competition. By its own terms, the final rule is scheduled to become effective September 4, 2024. On July 3, 2024, however, the United States District Court for the Northern District of Texas preliminarily enjoined the FTC from enforcing the rules against the parties in that case, and the court promised a ruling on the merits by August 30, 2024. It seems likely that the court will hold that the final rule is invalid. If the final rule ultimately survives, and assuming a nationwide injunction against the FTC barring enforcement is not put in place through other litigation, then with limited exceptions the final rule would ban all non-compete agreements with workers (a term broadly defined) for post-employment opportunities in the United States.

The final rule is very similar to the proposed rule banning non-compete clauses that the FTC initially published in January 2023, which resulted in over 26,000 public comments, including comments submitted by IPO. IPO's interest in this issue arises in part from the final rule's potential impact on innovation and on the protection of intellectual property, both through impact on the use of confidentiality and non-disclosure/non-use agreements and on the ability to protect trade secrets.

At least three lawsuits were immediately filed challenging the FTC's final rule. In the leading case, *Ryan LLC v. FTC* (N.D. Tex., No. 3:24-cv-00986-E) ("*Ryan*"), the plaintiff argues, among other things, that the FTC does not have the regulatory power to issue rules, such as this non-compete ban, to address unfair methods of competition. After the plaintiff moved for a preliminary injunction to prevent the final rule from becoming effective, which motion was joined by some intervening plaintiffs, on July 3 the court held it was likely that "the text, structure, and history of the FTC Act reveal that the FTC lacks substantive rulemaking authority with respect to unfair methods of competition under Section 6(g)" and granted "the motion for preliminary injunction and postpones the effective date of the Rule as applied to Plaintiffs." (*Ryan* Dkt. 153 (Memorandum Opinion and Order)) at 1-2. The *Ryan* court considered, but refused to enter, an injunction against nationwide enforcement.

Section 1 below discusses the court's decision in the *Ryan* case. Sections 2-4 discuss the final rules promulgated by the FTC. Even with the recent decision in *Ryan,* it is important to understand the FTC's final rule because it may ultimately withstand these challenges, either in the district courts or on appeal, and because the FTC's final rule will inform the debate on this issue in the U.S. Congress and in states across the country who are considering non-compete bans.

1. SUMMARY OF THE RYAN COURT'S DECISION.

Judge Ada Brown of the Northern District of Texas issued her decision after briefing and oral argument. Plaintiffs' motion challenged the FTC's rulemaking authority concerning the enforceability of

employer/employee non-compete agreements, arguing that the FTC lacks statutory authority, the rules are the product of an unconstitutional exercise of power, the FTC's findings and conclusions were arbitrary and capricious, and the rules are unlawful. *Ryan* Dkt. 153 at 7. The Court characterized the FTC's position as:

> (i) because non-compete clauses are "unfair methods of competition" under Section 5 of the FTC Act, and (ii) pursuant to the authority granted them in Section 6(g), the Commission has the authority to issue the Rule. See 15 U.S.C. §§ 45(a)(2), 46(g); see generally 16 C.F.R. § 910.1-6. Subject to the limitations and distinctions above, the Rule essentially provides that it is an unfair method of competition—and therefore a violation of Section 5—for persons to enter or enforce non-compete agreements.

Id. at 6. Considering the traditional four-factor test for preliminary injunctive relief, Judge Brown found that plaintiffs met their burden of proof on all factors. Regarding likelihood of success, Judge Brown concluded that the plaintiffs were likely to prevail on their argument that the FTC does not have substantive rulemaking authority to regulate unfair methods of competition. *Id.* At 13-17. She also found the plaintiffs likely to prevail on the arbitrary and capricious ground, because of the FTC's "lack of evidence as to why they chose to impose such a sweeping prohibition—that prohibits entering or enforcing virtually all non-competes—instead of targeting specific, harmful non-competes," and failed to sufficiently consider alternatives to the expansive ban. *Id.* at 20-22. Some may view this part of the court's holding that the FTC failed to provide substantial evidence to support the final rule as surprising given that the final rule weighed in at 165 pages of small font in the *Federal Register*. However, Judge Brown elucidated her reasoning, including how the proposed broad federal rule appeared to conflict with existing state laws that permit non-compete clauses under a variety of circumstances, and a limited amount of research supporting the government's conclusions. She also indicated that because she found two reasons why plaintiffs were likely to prevail, she did not need to consider the other two arguments asserted in the motion.

With respect to the irreparable harm factor, Ryan argued:

> the Rule would result in irreparable harm as this will "increase the risk that departing workers may take Ryan's intellectual property and proprietary methods to its competitors"—which cannot be effectively mitigated by trade secret laws and non-disclosure agreements. (ECF No. 24 at 34). Ryan contends the Rule would "announce open season for poaching of clients and workers." (ECF No. 23 at 35). Ryan claims it would have to expend significant time and resources to counteract the Rule and update all existing agreements. (ECF No. 23 at 35–36).

Id. at 25. Judge Brown found that the plaintiffs' compliance with the rules, which mandate notice to current and former workers of the ban on non-competes, require nonrecoverable costs of complying with a putatively invalid regulation and, under Fifth Circuit law, constitutes irreparable harm. *Id.* at 26-27. Regarding the balance of equities and public interest factors, Judge Brown found that plaintiffs had shown "the injury to both Plaintiffs and the public interest would be great. Granting the preliminary injunction serves the public interest by maintaining the status quo and preventing the substantial economic impact of the Rule, while simultaneously inflicting no harm on the FTC." *Id.* as 28.

With respect to the scope of the preliminary injunction, the Court considered plaintiffs' request for nationwide relief, but was not persuaded on the little evidence proffered on the need for nationwide relief. Instead, the Court only enjoined the FTC from enforcing its rules against the named plaintiffs. *Id.* 30-32 (noting the injunction would not prevent the FTC from enforcing its rules against the non-party

members of the intervening plaintiffs Chamber of Commerce of the United States of America; Business Roundtable; Texas Association of Business; and Longview Chamber of Commerce).

Importantly, Judge Brown's opinion notes that she intends to enter a merits disposition on the action by August 30, 2024. This is just 4 business days before the deadline by which employers must provide current and former workers with notice that an existing non-compete clause is no longer enforceable under the rules. As a result, if Judge Brown does not strike down the rules as unenforceable nationwide, the FTC would NOT be enjoined from seeking to enforce its rules against any non-party who failed to provide the required notice to, or entered into a non-compete clause with, a worker after September 4, 2024.

As of the date of this article, we are not aware of any effort to seek a nationwide injunction against the FTC's enforcement of its rules pending a merits decision.

2. IMPORTANT ASPECTS OF THE FINAL RULE THAT WERE UNCHANGED FROM THE PROPOSED RULE.

- Under the final rule, any attempt to enter into a non-compete clause after the effective date of the proposed rule, or to enforce such a non-compete clause, with any worker for a job in the United States will be deemed a violation of the FTC Act prohibiting unfair methods of competition period, full stop.
- "Worker" is broadly defined to include, among others, employees, interns, independent contractors, paid and unpaid.
- The Rules do not apply to business-to-business contracts (franchisor-franchisee agreements remain excluded, but the Rules do apply to workers at franchisees).
- No private right of action for workers and no state attorneys general right of action.
- The FTC final rules will supersede any inconsistent state law, but not any state law that is more protective.

3. ASPECTS OF THE FINAL RULE THAT WERE SIGNIFICANT CHANGES FROM THE PROPOSED RULE.

- The FTC made clear that the final rules only apply to post-employment activities in the United States. It eliminated the potential that rules might impact workers seeking employment outside the United States.
- While the FTC rejected the notion that there should be different treatment for different workers (e.g., based on skill, role, experience, training, education, compensation, or any other meaningful criteria), and while the final rules ban all non-compete clauses for workers entered into after the effective date, the FTC provided a carve out for certain Senior Executives who entered into non-compete agreements before the effective date. It acknowledged that this limited class of workers could be treated differently because they had negotiating power to make a fair deal in exchange for the non-compete obligation. The final rule narrowly defines the category of Senior Executives as limited to those who (i) earn above $151,164 a year and (ii) make policy decisions that are operative for the entire enterprise (but not just a division or a subsidiary). The FTC does not give much clarity about what it means by making "policy decisions" that would qualify one as a Senior

Executive. For agreements entered into after the effective date, even Senior Executive non-competes are banned.

- The final rule still includes an exception for sellers of a business, but this exception was expanded considerably. The final rule permits non-compete agreements entered into in connection with the sale of a business with any worker who is selling their ownership interest in the business, not just a worker who had at least a 25% ownership in the business, as had been required in the proposed rule. The final rule also expanded the availability of using non-competes with workers selling their ownership interest. Thus, it would appear that partners, members of a limited liability company, and stockholders in a corporation who sell their ownership interest may be subject to an enforceable non-compete clause. It remains to be seen whether the FTC will consider or adopt a "nominal" ownership value exception to protect certain workers from a non-compete restraint in the case of a sale.
- Regarding the proposed requirement that employers provide formal written notice to their current and former workers who are subject to a non-compete clause, the final rule requires that notice be given that the clause is now unenforceable, but the final rule does not require the employer rescind the existing clause, as was required by the proposed rule. Preapproved notice language is provided.
- The FTC changed the language of the proposed rule that had banned "de facto" non-compete clauses and deleted the two examples set forth in the proposed rules. Even so, the final rule still bans any clause that "functions to prevent a worker," after they leave your employment, from working for another or starting a business in the United States.

4. THE FINAL RULE'S IMPACT ON PROTECTION OF TRADE SECRETS AND CONFIDENTIAL INFORMATION.

As to the last item above, the final rule provides some explanatory comments that give two points on the spectrum of whether a confidentiality non-disclosure agreement might "function to prevent." In one example, the FTC advises that a non-disclosure agreement would not be a functional non-compete if it does not apply to information that (1) arises from worker's general training, knowledge, skill or experience; or (2) is readily ascertainable to other employers or the general public. On the other hand, the FTC advises that a non-disclosure agreement would be a functional non-compete if it bars a worker from disclosing any information "usable in" or that "relates to" the industry, or if it bars a worker from disclosing any information or knowledge the worker may obtain during their employment whatsoever. It thus remains likely that the parameters of what is acceptable and not acceptable would have to be defined by the FTC's enforcement of the final rules, and that it would take some time to develop a body of case law to enable employers and workers to understand with reasonable predictability what is and is not acceptable restraints.

The FTC's comments in the final rule confirm that it clearly heard the concerns commentators raised about the risks and costs of IP owners relying on trade secret protection in the absence of an enforceable non-compete agreement. These concerns include the loss of any prophylactic protection that a non-compete clause can provide, ability to deter former employees from using/disclosing trade secrets, and ability to file a lawsuit based on a non-compete promise before too much damage is done. The difficulties IP owners have relying on "the horse is out of the barn" trade secret litigation filed after a misappropriation occurred could be compounded if a non-disclosure agreement was considered a functional non-compete. The FTC dismissed these comments, however, because in the agency's view (i) trade secret law provides employers with a viable, well-established means of protecting investments in trade secrets, without the need to resort to the use of non-competes with their attendant harms to

competition, and (ii) trade secret protection can reasonably accomplish the same purpose as a non-compete (acknowledging that it may not be as effective) while burdening competition to a less significant degree. Regarding the expressed concerns about an increase in the occurrence, cost and burden of trade secret litigation, the FTC's responses can be summarized as determining that there was no empirical evidence to support the anecdotal concerns expressed. While an individual trade secret litigation may be very expensive, in the agency's view the overall cost of litigation given the absence of litigation over non-compete clause enforcement, will, in the FTC's judgment, be considerably less. The FTC also noted that in at least some states, the IP owner could pursue a trade secret claim prophylactically under the inevitable disclosure of trade secrets doctrine.

5. CONCLUSION.

The FTC's final rules are not currently enjoined by the pending litigation. Assuming that the final rules are not struck down in the *Ryan* Court's ruling on the merits anticipated on August 30, 2024, employers may want to assess, and perhaps modify, their agreements, protocols and procedures regarding identifying and protecting confidential information and trade secrets, to facilitate enforcing such obligations in light of the FTC final rules. It will be important to find the balance to protect innovation and important and especially valuable confidential information, and not burden workers with obligations that might functionally prevent them from seeking or obtaining employment with another employer, or starting a new company, in the United States.