FOCUS: LABOR AND EMPLOYMENT LAW

If Non-competes Go the Way of the Dodo—What Is an Employer to Do to Protect the Company?

Paul F. Millus

The Federal Trade Commission's ("FTC") proposed ban on non-competition agreements (the "ban") was scheduled to go into effect on September 4, 2024. However, on July 3, 2024, the District Court in the Northern District of Texas issued a preliminary injunction staying the proposed rule.[1] On August 20, 2024, the District Court granted summary judgment to plaintiff on the issue, primarily based on a determination that the FTC had exceeded its statutory authority in promulgating the Non-Compete Rule.[2] The effect was to enjoin enforcement of the ban nationwide. The FTC has appealed to the 5th Circuit.

The District Court in the Middle District of Florida also granted a preliminary injunction enjoining the FTC from enforcing the ban, likewise based on a determination that Commission has exceeded its statutory authority.[3] The FTC has appealed that decision to the 11th Circuit as well. However, in a contrary ruling on July 23, 2024 in the Eastern District of Pennsylvania, the District Court denied the request for a preliminary injunction against the FTC's enforcement of the ban.[4] The court found no irreparable harm and that plaintiff had failed to establish a likelihood of success on the merits. The court held that the FTC did have statutory authority to promulgate substantive rules as to unfair methods of competition noting that nowhere in Section 6 of the FTC Act is the FTC's power limited only to procedural rules. Yet, these developments do not affect the Texas District Court's set-aside of the rule. At present, the FTC cannot enforce the rule.

As for the likelihood that the Trump administration will continue the FTC appeals or even allow the rule to stand with new additions to the FTC, one would think that is unlikely. As such, on a federal level (at least for now), non-competes will live on.

The momentum, nevertheless, to ban non-competes on the state level remains high. In December 2023, New York Gov. Kathy Hochul vetoed the legislation passed by the New York State Legislature in June 2023 that would have prohibited future use of non-compete agreements in New York State. Also, in February 2024, the New York City Council tried to pass a bill that would have prohibited employers from entering new non-compete agreements with employees as well as rescinding any non-compete agreements that predate the effective date of the bill. That bill was sent to committee and nothing has come out of committee since. Furthermore, over the past two years multiple states sought extensive bans of non-compete agreements. As of now, however, only five states have fully banned non-compete clauses: California, Colorado, Oklahoma, North Dakota, and Minnesota. Thirty-three states have restrictions in place for the use of non-compete agreements—primarily in the health care field. Time will tell if these states are simply waiting for the FTC ban to clear the field, or if they are serious about going it alone now that the federal government does not have their backs.

The optimists in support of non-compete agreements may breathe a sigh of relief and go about the business of including such clauses in their employment contracts. There is no question that, as a matter of law, non-competes are permitted in New York, at least for now. Nevertheless, even though non-competes remain perfectly legal in New York, we are seeing chinks in the armor.

First, a few words on "blue penciling" as employers may believe that the court will invariably correct their error if their non-compete clause is overbroad. "Blue penciling" occurs when a court engages in paring down restrictive covenants, such as non-compete agreements, in a manner that will revise a restrictive covenant while maintaining its viability, i.e., modifying the duration and geographical scope.[5] It can be a savior of an overly-broad restriction. However, that does not mean the court will engage in the wholesale redrafting of restrictive provisions.[6]

Blue-penciling is not available where an employer seeking partial enforcement cannot demonstrate an "absence of overreaching, coercive use of dominant bargaining power … [and that it] has in good faith sought to protect a legitimate business interest."[7] Thus, while a court has the discretion to pare or "blue pencil" a restrictive covenant as to its duration and geographic scope in the context of granting injunctive relief, the question of reasonableness is one of fact and remains in the sound discretion of the court.[8] So drafting an restrictive covenant that borders or exceeds what would normally be permissible is a dangerous game with no guaranty the court will come to the rescue and preserve some or all of it.[9]

For now, with the understanding that non-compete covenants are still alive and well enough, employers should reexamine the terms of those covenants to assess them in light of prevailing law (and possible future changes) to have a covenant that can withstand scrutiny. Common sense should come into play.

The employer should ask themselves: What is the business really trying to prevent and protect? Is this employee leaving really going to impact the business in any meaningful way? How much time on the shelf does the business need to impose on this employee that will allow the business to deal with the employer's departure and eventual hiring of by a competitor? What are the company's protectable interests? And how long does it really need to protect them? But to be forewarned is to be forearmed. While employers may count their blessings that they can still include their favorite non-compete clause, a Plan B is in order if the non-compete agreement it previously relied on is found unenforceable in the future.

A Future Without Non-compete Covenants—Where Can an Employer Get the Best Bang for Its Buck?

In such a future, an employer will hire an employee after a costly search in terms of time and money, train that employee, expose that employee to very significant aspects of the employer's operations, introduce that employee to clients and allow that employee to build relationships with other employees. Then, after all that, the employee decides to leave. While an employee can terminate his/her employment at any time, the employer not only has to rinse and repeat with a new hire, the employer might find its former employee has that competitive spirit, and will seek to use all that knowledge and training gained to the former employer's detriment. What, if anything, can an employer do (or what could have been done) to soften the blow from the loss of a trusted member of its staff?

It should be noted that the complete proposed elimination of non-compete agreements by the FTC is not applicable to non-compete agreements entered into by a person pursuant to a bona-fide sale of a business entity; it does not prohibit employers from enforcing non-compete clauses where the cause of action related to the non-compete clause accrued prior to the purported effective date of the final rule; and it does not explicitly ban non-disclosure agreements, customer non-solicitation agreements, or employee non-solicitation agreements. As for the bill vetoed in New York—which still lurks beneath the waves—New York's proposed law also included three exceptions. First, employers would be permitted to enter into agreements to protect their trade secrets or their confidential/proprietary information from disclosure. Second, employers could also execute contracts with an employee for a "fixed term of service" (while the proposed law did not define a "fixed term of service," it is understood that this exception would cover "garden leave" agreements[10]). And third, employers could enter into agreements to prevent the solicitation of clients that developed a relationship with the departing employee during their employment as long as competition is not restricted. The vetoed bill did not contain any express exception for covered individuals who are sellers of a business (which is probably one of the primary reasons the Governor would not sign it) and also was silent regarding the treatment of employee non-solicitation provisions.

An employer may start there. Indeed, what is worse than an employee with a lot of knowledge leaving for a competitor? Answer: An employee taking multiple members of an employer's key staff to join him/her. A well-crafted non-solicitation clause pertaining to other employees can help stop the bleeding while allowing a departing employee to pursue his/her goals. Next, keeping record of an employee's contact with the employer's clients will provide a valuable measure of protection for the former employer.

An employer also has the benefits afforded by confidentiality agreements. Keep in mind, however, that an employer's interests justifying a restrictive covenant are limited "to the protection against misappropriation of the employer's

trade secrets or of confidential customer lists, or protection from competition by a former employee whose services are unique or extraordinary."[11] Employers should understand—not everything is a "trade secret."[12]

To prevail on a claim for misappropriation of trade secrets, an employer must demonstrate "'(1) that it possessed a trade secret, and (2) that the [employee] used that trade secret in breach of an agreement, confidential relationship or duty, or as a result of discovery by improper means.'"[13] For example, if the employer's clients are large and well-known companies around the world and their identities and key contacts are available in the public domain, these names and contacts would not constitute protectable trade secrets.[14]

Finally, employers should never forget that, even without an agreement, there are protections stemming from the common-law duty of loyalty owed by an employee to his employer. Also known as the "faithless servant doctrine," the duty of loyalty, while not a complete replacement for the protections afforded by a non-compete agreement, can provide the former employer some comfort. "The employer-employee relationship is one of contract, express or implied and, in considering the obligations of one to the other, the relevant law is that of master-servant and principal-agent."[15]

Fundamental to that relationship is the proposition that an employee must be loyal to his employer and is "prohibited from acting in any manner inconsistent with his agency or trust and is at all times bound to exercise the utmost good faith and loyalty in the performance of his duties."[16] An example of such a breach is the diversion of the employer's corporate opportunities to the employee.[17] The penalty for this breach is powerful, including forfeiture to the salary paid during the time period of disloyalty as well as disgorgement.[18] Of course, not every act that would seem disloyal constitutes such a breach. Such that, "[t]aking preparatory steps, while still in the employer's employ, to enter into a competing business is not a breach of an employee's duty of loyalty as long as the employee does not use the employer's time or resources to do so,"[19] "never lessen[s] his [or her] work" on behalf of the former employer, and "never misappropriate[s] to his[or her] own use any business secrets or special knowledge."[20]

In sum, employers, even if non-competes do disappear, remain capable of pursuing their rights through a variety of means.

1. *Ryan, LLC v. Fed. Trade Comm'n*, 3:24-CV-00986-E, 2024 WL 3879954 at *1 (N.D. Tex. Aug. 20, 2024).
2. *Id.*, 2024 WL 3879954 at *14.
3. *Properties of the Villages v. Fed. Trade Comm'n*, 5:24-CV-316-TJC-PR, 2024 WL 3870380 at *9 (M.D. Fla. Aug. 15, 2024).
4. *ATS Tree Services, LLC v. Fed. Trade Comm'n*, CV-24-1743, 2024 WL 3511630 (E.D. Pa. July 23, 2024).
5. See e.g., *Wrap-N-Pack, Inc. v. Eisenberg*, 04CV4887 (DRH)(JO), 2007 WL 952069 at *7 (E.D.N.Y. Mar. 29, 2007) *citing S. Nassau Control Corp. v. Innovative Control Mgmt. Corp.*, 95-CV-3724(DRH), 1996 WL 496610 at *5, n.2 (E.D.N.Y. June 20, 1996); *Webcraft Techs., Inc. v. McCaw*, 674 F. Supp. 1039, 1047 (S.D.N.Y. 1987).
6. *Denson v. Donald J. Trump for President, Inc.*, 530 F.Supp.3d 412, 436 (S.D.N.Y. 2021).
7. *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 394 (1999).
8. See, e.g., *Webcraft Techs*, 674 F.Supp. at 1047; BDO *Seidman v. Hirshberg*, 93 N.Y.2d at 390.
9. *ABH Nature's Product v. Supplemental Manufacturing Partner*, 19-CV-5637(LDH)(JRC), 2024 WL 1345228 at *7 (E.D.N.Y. 2024).
10. A garden leave clause, unlike a restrictive covenant, requires that the employee provide the employer with a specific, reasonably long period of notice before terminating the employment. During this time, the employer cannot force the employee to do any work, but the employee is paid his full salary and benefits. Since the employee remains an "employee," however, he cannot go to work for a competitor or do anything else to harm the employer.
11. *Power–Flo Technologies, Inc. v. Crisp*, 231 A.D.3d 1070 (2d Dep.t 2024) *citing R & G Brenner Income Tax Consultants v. Fonts*, 206 A.D.3d 943, 945 (2d Dep't 2022) *quoting BDO Seidman*, 93 N.Y.2d at 389; see *also Arthur J. Gallagher & Co. v. Marchese*, 96 A.D.3d 791, 792 (2d Dep't 2012).
12. *Poller v. BioScrip, Inc. Eyeglasses* 974 F.Supp.2d 204, 215 (S.D.N.Y. 2013) (A "trade secret" is any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.)
13. *Sentium, LLC v. Bloomberg Fin. L.P.*, 17-cv-7601(PKC), 2018 WL 6025864 at *3 (S.D.N.Y. Nov. 16, 2018) (*quoting Schroeder v. Pinterest Inc.*, 133 A.D.3d 12, 27 (1st Dep't 2015).
14. *Reed, Roberts Assocs., Inc. v. Strauman*, 40 N.Y.2d 303, 308 (1976).
15. *Western Elec. Co. v. Brenner*, 41 N.y.2d 291, 295 (1977), *citing 9 Williston, Contracts* [3d ed.], § 1012, p. 13; Restatement, Agency 2d, § 2, Comment a, subd. d).
16. *Lamdin v. Broadway Surface Adv. Corp.*, 272 N.Y. 133, 138 (1936); Western Elec. Co., 41 N.Y.2d at 295.
17. *Gomez v. Bicknell*, 302 A.D.2d 107, 112-13 (2d Dep't 2002).
18. *Design Strategies v. Davis*, 469 F.3d 284 (2d. Cir. 2006); see *also Diamond v. Oreamuno*, 24 N.Y.2d 494, 498 (1969) and *Gomez*, 302 A.D2d at 114 (internal citations omitted) ("As an alternative to an accounting of the disloyal employee's gain, a calculation of what the employer would have made of the diverted corporate opportunity is an available measure of damages. The choice of remedy belongs to the employer.")
19. *Jeremias v. Toms Capital LLC*, 204 A.D.3d 498, 499 (1st Dep't 2022).
20. *Feiger v. Iral Jewelry*, 41 N.Y.2d 928, 929 (1977).

Paul F. Millus is a Member at Meyer, Suozzi, English & Klein, P.C. and former chair of the NCBA Labor & Employment Law Committee. He can be reached at pmillus@msek.com.