Protecting Employers Property From Harm by Former Employees: What Can Be Used if Non-Compete Are No Longer Valid?

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Non-competition agreements employers have relied on to prevent former employee competition are increasingly unenforceable in the courts and may be banned altogether. Concerns that they unduly limit an individual's ability to work have been joined by recent studies that show use is also causing several incidents of macroeconomic damage. Employers need to consider adopting alternative means to protect property interests that could be placed at risk by competing former employees. When doing so, care should be taken to use terms that comply with governing law and are made binding on employees only as necessary to protect employers' at-risk property interests.

Keywords: non-compete, alternative agreements, protecting employer property interests

INTRODUCTION

Although effective and enforced for years in state courts, the law has begun to turn away from supporting use of non-compete agreements against former employees. While employers risk loss of a variety of property interests when a former employee leaves and hires on with a competitor or sets up a new firm to directly compete, courts now restrict the reach and application of these agreements, noting the harm done to former employees' right to earn a living. Courts are also more adamant that employers show that there is a property interest at risk in each case.

Proposed federal law would restrict use much further. Federal regulation promulgated by the Federal Trade Commission (FTC) would generally forbid the use of non-competes in employment. (FTC, 2024). Alternative agreements to protect employer property rights would still be permitted so long as they do not act like non-competes to foreclose former employees' ability to compete meaningfully.

Section II of this article will review the legal status of non-compete agreements under state law and the reasons for declining enforcement, followed by an examination of the terms and status of the promulgated FTC rule banning them as instruments of unfair competition. The FTC rule's exceptions, it's forecasted benefits, and court challenges will be considered.

Section III will examine alternative agreements that allow former employees to compete and protect employers' property interests at risk from that competition. These include non-solicitation, non-disclosure, and non-disparagement agreements, which can be used to protect interests in established customers, employees, trade secrets, and reputation. Employers should also use binding agreements to reinforce protection for intellectual property rights. For each, corresponding law providing support will be discussed.

Use and application for each alternative agreement will be considered along with recommendations for best practices in Section IV, followed by concluding remarks in Section V.

NON-COMPETE AGREEMENTS-LEGAL STATUS UNCERTAIN

State Law Is Increasingly Critical

Non-compete agreements are creatures of state law. While generally enforceable throughout the country, the extent of enforcement varies by state. Lawful for centuries, they are now under increasing scrutiny. While agreements between firms not to violate antitrust law as an unlawful restraint of trade, employees have been allowed to "agree" in advance not to work for a competitor after their employment has ended. Non-competes are an exception to the laws against restraints on trade, viewed a necessary to protect an employer's property interest in its established customer base, valuable employees, trade secrets and confidential information, and other intellectual property interests.

Because non-competes adversely impact former employees' economic livelihood, they have has always been subject to a court's strict scrutiny and limitations. Enforcement requires a reasonably stated duration, geographic limits, and definition of what constitutes competition to be prevented. Failing those limitations, the agreement may be seen beyond that necessary to protect the employer's interests, unduly harsh to an employee's use of skills in the marketplace after employment and rendered unenforceable as a violation of public policy.

Some states now hold non-competes entirely unenforceable. Nearly half of the other states restrict use to high annual income employees, typically $100,000 or more. (Sahadi,2024). Courts have also denied enforcement when a non-compete is used in a blanket manner against all employees including low-income and low-skill workers. Employer property is not at risk with no exposure to customers, employees or confidences.

Given the reality of the private sector U.S. workplace, where many workers are "at will" and terminable at any time and generally without good cause or notice, some view such employment so illusory that it does not justify further claim by either party beyond termination. In those cases, courts have denied enforcement of non-competes, finding a lack of consideration when it was agreed to after employment begins. (N.L. Rev., 2015)

In addition, studies now show that non-competes have caused damage to the national economy by restricting labor mobility and innovation. Yet while increasingly unpopular, estimates show nearly 30 million employed Americans, or 1 in 5 employed, are subject to existing non-competes. (Hsu, 2024). The continued use and specter of macro-economic harm have made them a federal concern.

FTC Rule: Non-Competes as Unfair Competition

The Federal Trade Commission (FTC) was established by Congress in 1914 (FTC Act, 2024) and has continued as the nation's second-oldest continuous economic regulatory agency. From the beginning, its charge has been large in relation to its modest resources. It has the regulatory responsibility to prevent unfair and deceptive trade practices in interstate commerce throughout the United States. Unfair practices include all manner of business combinations in restraint of trade, from monopoly practices of the trusts in the early 20th century, to predatory pricing, price discrimination among others.

The FTC was assigned enforcement responsibility under the federal antitrust laws, along with the Justice Department, and jurisdiction includes review and approval of prospective mergers, and supervision of firm activities highly concentrated markets. Still, there's more to its responsibility. The FTC is also charged with prevention of deceptive business practices. Among many, these include bait and switch, false advertising, unwanted solicitation and other fraudulent marketing schemes and devices used on business and consumers.

Given its extensive obligations, there have been examples of regulatory challenges. When the agency promulgated its rule requiring marketers to voluntarily substantiate all advertising claims, enforcement was met with five years spent in adjudication and court proceedings to rein in false marketing claims of product effectiveness by a single producer for one product. (*Warner-Lambert v. F.T.C.*) (1977). However, the Commission successfully combats nationwide consumer fraud as demonstrated by its 2003 creation of the popular and effective National Do Not Call Registry to combat abusive telemarketing. (FTC, 2003)

According to President Biden's executive order, (E.O. 14036) the FTC ventured into the realm of employment law and undertook the heavy enforcement lift of a rule declaring the wide use of non-compete agreement, an unfair method of competition in violation of Section 5 of the FTC Act and a restraint on trade and business under its Act. Still, in a vote of 3 to 2, the board passed a rule to invalidate nearly all uses of non-competes by employers subject to FTC regulation. In the FTC press release chair Lina M. Khan announced "The FTC's final rule to ban Non-competes will ensure Americans have the freedom to pursue a new job, start a new business, or bring a new idea to market". (FTC, Press Release, 2024).

The Commission noted that the action was needed because non-competes trap workers and suppress wages, and have been used to excess, even against employees in low-paying service positions, such as fast food and retail, where employers have no property at risk by former employees taking a job or creating a new business in the same field.

Specifics of the FTC Rule

The proposed rule will be effective September 4, 2024, with wide application. If enforced, it will generally banish the use of non-competes in the for-profit U.S. employment against "workers" broadly defined as paid and unpaid employees, independent contractors, externs, interns, consultants, apprentices, and even volunteers. The ban will not affect non-competes under challenge in current litigation. However, employers will be required to give notice that non-competes will no longer be enforced, to remove any further effects of prior non-competes.

There are two major exclusions from the rule's application. Each protects property of a former business or employer but without undue impact on a former business affiliate or employee:

Sale of Business and Other Ownership Transfers

Non-competes are permitted beyond the employer-employee relationship such as use against the seller in the sale of a business. The exclusion reaches a sale of the entire business or the seller's interest in the business. For the same reason, franchise agreements can also contain non-competes against the franchisee, more like a relationship between two business entities than employment. In both cases, the non-compete is justified given the substantial risk to property interests posed by competition after the transaction occurs. Similarly, "garden leave" arrangements where the employee is semiretired but paid the same salary pro rata will not be covered because the employment relationship is still ongoing.

Senior Executive

In recognition that non-competes are frequently a matter of contract negotiations and exchange of value paid for between the firm and executive, consideration given justifies exclusion for top executives. Further, such former executives are likely to pose the greatest risk to the employer's property interests. The exclusion is narrowed by the requirements making the executive a "senior" with an earnings minimum ($151,164), a status of top executive or with significant policy making authority- affecting less than 1% of workers. In any case, the exclusion is grandfathered and will only apply to existing negotiated contracts prior to the rule's effective date.

The rule will not apply to entities exempt from FTC enforcement jurisdiction, including nonprofits, banks, savings and loans, federal credit unions, common carriers, etc. However, for industries, like healthcare, where a nonprofit model is the established mode for tax purposes, the Commission will reserve the right to require the non-compete ban to apply, if the entity is a profit-making enterprise for the profit of members.

Forecasted Benefits vs. Legal Challenges

As an agency, rulemaking requires action within delegated jurisdiction and a rational basis for passage, to be tested in court by a record of substantial evidence, establishing the propriety of its action. During the period of public comment, the FTC received overwhelming support. (FTC, 2024). Forecasted macro-economic benefits from the rule include:

- 8,500/year more new business startups.

- $524/year improved average employee wages.
- $194 billion lower health care costs over the next decade.
- 17,000 to 29,0000 more patents/year for the next 10 years

While the FTC rule would preempt all inconsistent state laws, legal arguments have been made that the rule exceeds the Commission's statutory jurisdiction. The Commission admits it has never used its rulemaking power to regulate employment agreements. The challenge is particularly sharp in this case where state law has been settled in favor of enforcement for so many employees for so many years. Further, the broad sweep and impact of the rule seems more legislative than administrative, suggesting the issue would be the type normally reserved for Congress to address. One FTC board member who voted against passage explained his objection this way: "We are not a legislature….I do not believe we have the power to nullify tens of millions of existing contracts". (Wiessner, 2024).

Congress in fact has made several failed attempts at legislation to ban non-competes, most recently with the reintroduction in February of 2023 of the proposed Workplace Mobility Act, with findings of harm and provisions like those of the FTC rule but adding exception to permit non-competes in conjunction with partnership dissolutions. The legislation would authorize the Department of Labor to publicize its terms and the FTC to enforce it. However, the Bill has since sat in a Senate Committee. (Atlas, C. *et.al.* 2023)

Almost immediately after passage, actions challenging the FTC's authority on various grounds have been filed in federal courts around the country by business groups. One case asserts that the FTC act does not grant the Commission authority to pass the non-compete ban as a method of unfair competition. *Chamber of Commerce v FTC* (2024) The rule risks invalidation if a challenge reaches the current Supreme Court and its adopted "Major Questions" doctrine, used to strike down an agency finding jurisdiction when not clearly delegated by Congress, *West Virginia v E.P.A.* (2022) and its recent reversal of the "Chevron Doctrine" and precedent deferring to agency statutory interpretations. *Loper v Bright Ent. v Raimondo* (2024) Several legal commentators have expressed the view that the Commission may ultimately be enjoined from enforcing the rule. (Wiessner, 2024) However, the matter is far from resolution and will require monitoring.

Given the changing landscape of enforcement in state courts and the potential of a federal ban on nearly all uses, employers should be prepared to abandon non-competes and consider alternative agreements to protect employers' property rights. Several are commonly used.

ALTERNATIVE AGREEMENTS TO PROTECT EMPLOYERS PROPERTY RIGHTS

Employers are entitled to protect core property rights by alternative agreements that are considered less restrictive to former employees right to work as and for a competitor and therefore more likely enforceable. These can help to protect employers even while former employees are competing.

Non-Solicitation Agreements and Interference With Contract Actions

These agreements forbid a former employee from soliciting existing employer's customers or employees. The courts more favor them than non-competes as they may do less damage to the former employee's new employment opportunities and are justified because they are aimed to protect two of employers' specific property interests. Courts recognize that development of customers, clients, and patient accounts and recruitment, staffing and training of important employees, involves investments of time and effort to develop and therefore are entitled to protection. So, they are frequently used and enforced against employees where these property interests are obvious- in customer-based businesses focused on territory like banking, commercial sales, and professional practices.

Courts and the FTC rule both also require they not be written or applied more broadly than necessary to protect employer's property interest in current consumers. Duration should be no longer than necessary. Application to low-income employees without knowledge or exposure to key accounts may not be justified. Courts are less likely to enforce a non solicitation of future customers. Application to prevent a former employee from making a general advertisement or public notice of a new job or venture would be overbroad. One directed towards the former employer's current customers would not.

Likewise, the blanket use of a "no hire" agreement might be questioned, however strategic poaching of valuable employees can be avoided. Further, the law recognizes a basis for suit separately from the no solicitation agreement, when the solicited employee had employment with a defined term of duration, terminable only for cause as is more likely with key employees. In such case, the employer can sue the solicited employee who departs early for breach of contract and sue the soliciting former employee for the tort of interference with contract. The interference action is a serious matter as it may support a judgment of punitive damages and can even lead to criminal sanctions in some jurisdictions. The action is more difficult to maintain when the solicited employee is an employee at will because evidence of a concurrent intentional wrong, such as a defamation of the employer or fraud on the solicited employee is necessary. (Rest. (2d) of Torts Sec 766) In either case, the contract interference suit aids employer's property rights in its established customers and employees free from solicitation.

Non-Disclosure Agreements and Trade Secrets Misappropriation Actions

Employers' property interests in trade secrets and confidential information unique to the employer's operations should be recognized and protected as a contract right by a non-disclosure agreement. Studies show employers use a non-disclosure agreement in 95% of cases where a non-compete is also used. But non-disclosure agreements are more favorably treated in court cases if properly drafted and applied. Overly broad or vague non-disclosure are not enforced nor effective. So, it is key to specifically define what information is considered confidential and cannot be disclosed. An agreement not to disclose publicly available information, any information obtained during employment, or related to the industry of the former employee would be overly broad and a de facto non-compete. (Lobel, 2024)

The Federal Defend Trade Secrets Act (18 USC 1836 et.sec.) and uniform state laws governing trade secret (UTA) provide a right of action for misappropriation. To qualify, the information must provide the employer with a competitive economic advantage, not be generally known, and protected as a secret. Common examples of trade secrets include such things as confidential customer lists, recipes, formulas, patterns, compilations, programs, devises, methods, or processes. Evidence of the employer's reasonable efforts to prevent misappropriation or exposure is critical to preserving the status of the information as a secret, and prerequisite to enforcement remedies. If that is done, remedies are available to resecure the information and recover damages for misappropriation.

Non-Disparagement Agreements and Defamation Actions

An agreement promising to refrain from disparagement will provide a contract action if breached. Employers can also rely on the law of defamation and disparagement. (Rest. (2d) of Torts Sec. 558 et sec.) False statements of fact that cause damage to reputation of an individual, firm or its products and services allows a tort action for damages. Some statements falsely accusing of criminal or fraudulent activity are considered per se where damages are presumed. However, there are several privileges that protect a false statement because a public policy is furthered. So, statements made by a former employee in error but in good faith of criminal activity, fraud, and conduct protected by whistle blowing provisions, may qualify because of a public policy.

Similarly, the employer of a former employee will frequently decline to provide a reference when requested by a prospective employer, for fear of a defamation suit. However, employers usually enjoy a qualified privilege to give one. If the reference is defamatory, no action against the employer will lie if the statement was made in good faith at the time it was made.

Use has a caveat from another federal source: In the context of labor law, the National Labor Relations Board has ruled employer use of confidentiality and non-disparagement agreements can constitute an unfair labor practice because they have been used to suppress discussion needed to share information in conjunction with labors right to organize under Section 7 of the National Labor Relations Act. (cite) A statement that preserves labor rights as part of a non-disparagement agreement might be considered.

No-Infringement of Intellectual Property

Employers frequently own intellectual property under U.S. laws governing patent, copyright, and trademark, as well as trade secrets, protected by federal and state law. Employees need to understand the employer's rights to all these intangible properties before becoming former employees, and possibly infringe or assert frivolous ownership claims. An agreement stating that employees on the job and thereafter acknowledge employer's ownership and will refrain from infringement puts employees on notice of employer's interests, may help to dissuade an infringement and can be used to provide evidence of both willful infringement and breach of contract.

Patent

Patents (35 USC) require application and government award then grants a virtual monopoly on the exploitation of a novel invention for 14 to 18 years. Patent actions by employers can involve disputes of ownership with and subsequent infringement by former employees. Patent law favors the employer over the employee by granting the firm ownership via the first-to-file rule (usually done by the employer) rather than first-to-invent (sometimes by a former employee). In addition, "shop rights" allows the employer equal rights to any patent created by the employee arising from employment. Waiver of patent claims is permitted, and notice of ownership likewise useful.

Copyright

Copyrights (17 USC) give the creator the exclusive right to control the copying, distribution, display, and performance of creative works of authorship. Aside from works of art, music, and literature, the great diversity of protectable creative works includes business plans, forms, data bases, drawings and blueprints, and computer software. Copyright arises when the work is placed in a fixed medium. Registration is not required but beneficial. Employers are frequently in dispute with former employees over copyrights. The law favors the employer. Employers' ownership does not apply to works made for the employer by independent contractors or consultants but can be modified by agreement. However, works created by an employee on the job are the sole property of the employer by the court created "work for hire" doctrine. Notice of copyright ownership could be evidence of willful infringement in court.

Trademark

Trademarks (15 USC 1051 et.sec.) protect any symbol use in commerce that distinguish a business and its products or services in the marketplace. Continued use and development of a secondary association is sufficient to provide the right though again registration provides additional protections. Infringement occurs by a competitor's use of the trademark or a symbol sufficiently similar to cause confusion about its origin in the marketplace. And the competitor may be a former employee or new employer against whom an action can be brought for trademark infringement or related suits for unfair competition by former employees.

DISCUSSION OF BEST PRACTICES

Use of both non-compete and alternative agreements pose several concerns to employers. Legal counsel should be consulted in either case.

Non-compete agreements are generally enforced and may even be seen as necessary to protect the business. They still enjoy robust use and enforcement in certain sectors such as financial and entertainment industries, and professional services. Violation is simply shown by employment with a competitor or creation of one. However, enforcement will vary by state so law must be monitored in each state of use. In addition, given trends throughout the country they will also be increasingly difficult to use. The legal status of the FTC rule should also be watched, as it bans most non-competes and if upheld in litigation, would subject employers' use to fines, penalties and injunctive relief.

Alternative agreements are more likely enforceable but must also be reasonable at their limits. Overbroad non-solicitation and non-disclosure agreements can limit former employees' ability to compete and serve as de facto non-competes. Description of interests protected, and agreements duration and

geography must be reasonable about employer's possible risk. If broadly written to make all former employees' future employment unnecessarily difficult or overstate employer's risk, their enforcement could also be challenged under the FTC rule or other consistent state laws.

Violating non-solicitation and non-disclosure agreements will likely be more difficult and costly to detect and prove. Language defining what constitutes breach of each must be drafted with care. For example, solicitation and non-disclosure are frequently defined to include actions enabling others to solicit or use. That may not be necessary in all cases. Employers should develop protocols for monitoring and a policy to determine when and how legal action will be initiated when a violation is discovered. Especially for breaches of non-disclosure of trade secrets and confidential information, there may be need for immediate legal action to preserve them from loss to competitors and the public domain.

Breach of non-disparagement and non-infringement agreements will require specific evidence under separate governing laws. While breach may also be difficult to prove, these agreements do not pose the same concerns for breadth limitations as former employee reemployment opportunities would not normally be affected by those agreements.

With these considerations in mind, employers should:

- Use these agreements selectively and tailored to the former employee. Do not require them from low income or unskilled positions with no exposure to key customer accounts or current employees.
- Describe, to the extent reasonable, the customers and employees who cannot be solicited and the information that cannot be disclosed. Tighter descriptions improve enforceability.
- Limit non-disclosure agreements to trade secrets and confidential information beyond publicly available information.
- Try to use the agreements only to the extent needed to protect the employer's property interests at risk.
- Rely on legal counsel to evaluate governing law, draft enforceable language, and advise on use.

CONCLUDING REMARKS

Employers' use of non-compete agreements needs to be reexamined. Given the trends in state law increasingly refusing enforcement and the possibility of an outright federal ban, continued use will require monitoring of the changing legal landscape that is increasingly critical. Alternative agreements have been used and are available to protect employers' property from the effects of a former employee's competition without suppressing the right to compete and earn a living. They can be used in supplements, but the better course would be to use them as the more enforceable substitute means of protection.

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