# FTC non-compete rule “arbitrary and capricious”, court rules

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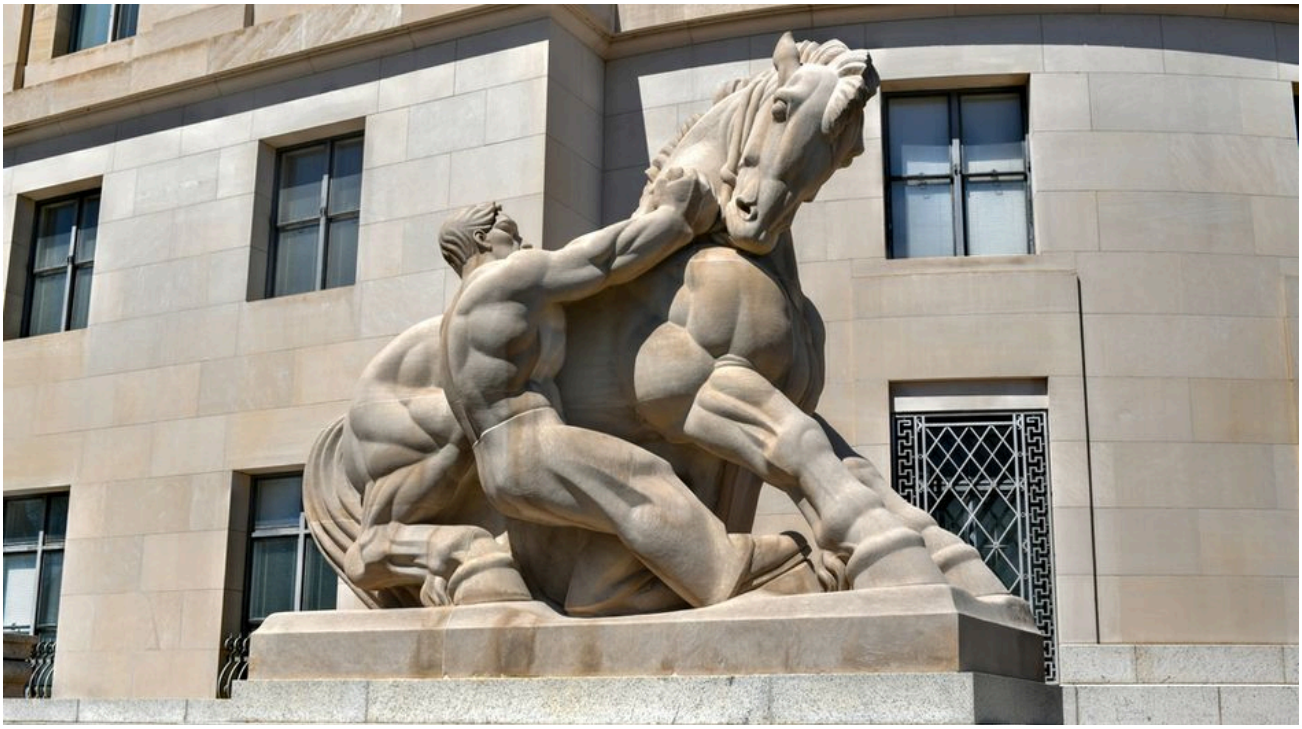

*Art Deco facade of the FTC building in Washington, DC. Shutterstock/Felix Lipov*

In reassuring news for IP-intensive US businesses, a Texas federal judge has temporarily partially blocked the Federal Trade Commission’s contentious ban on non-compete agreements from going into effect. The ruling is restricted to the plaintiffs and intervenors, such as the US Chamber of Commerce and several other business lobby associations.

A final ruling, including the potential application of an injunction nationwide, is due on or before 30 August, just couple of days before the rule is set to become effective – on 4 September.

Having determined that the FTC exceeded its statutory authority, the US District Court for the Northern District of Texas, Dallas Division, ruled on 3 July that FTC’s rule is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law”.

“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,” Judge Ada Brown of the Northern District of Texas said in the order. According to her, 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).

This development heightens the uncertainty around the FTC’s rulemaking authority over the enforceability of non-compete clauses in employment agreements.

The FTC’s determination to outlaw non-competes is related to the belief that around 30 million people, or 18% of the workforce, would find it easier to change jobs. It argues scrapping such restrictions will ultimately benefit the national economy, and increase the number of new business and patent applications in the country.

However, members of the business community and their advocate organisations have been fiercely critical of the move, **citing worries** that stripping companies of restrictions on employee mobility within competing industries would make innovative companies vulnerable to potential stealing or leaking of trade secrets.

Obtaining and maintaining competitive advantage and commercial success in high tech, pharma, and start-up businesses, for example, are said to be highly dependent on intangible assets as trade secrets. Non-compete agreements can help ringfence the high R&D investment that these companies make annually.

Ryan LLC filed its lawsuit in Texas federal court just hours after the Commission announced the final rule with a 3-2 vote along party lines in April. The US Chamber of Commerce, the **staunchest critic** of the rule, filed its own lawsuit the next day but the Dallas federal court later had the Chamber join Ryan’s complaint as a plaintiff-intervenor.

In the complaint, Ryan asserted that the rule would result in “irreparable harm” by increasing the risk that departing employees may take Ryan’s intellectual property and proprietary methods to its competitors which “could not be effectively mitigated by trade secret laws and non-disclosure agreements”. Moreover, the global tax services company contended that the rule would “announce

open season for poaching of clients and workers" and claimed it would take "significant time and resources" to counteract the rule and update all existing agreements.

Contemplating the message that the injunction sends to trade secret holders, Amy Pearl, a New Jersey-based member of Archer & Greiner's Business Litigation and Trade Secret Protection and Restrictive Covenants groups, tells IAM that the court's decision "reinforces the need of employers to protect their trade secrets through all possible means". This, according to her, goes beyond non-compete agreements, including several of the "tried-and-true methods" of trade secret protection, including taking stock of their existing trade secrets and auditing who has access to that information.

In Pearl's opinion, while the fate of the FTC's rule plays out in the courts, businesses should be discerning in their use of restrictive covenants and take "great care" to ensure their contracts are narrowly tailored to cover only their most sensitive trade secrets. Her point is that the FTC rule would prohibit not only actual non-compete clauses, but also any other covenants that might be interpreted as functioning like non-competes.

David Pardue, partner at Parker Poe, agrees, saying it is important for companies to make sure restrictive covenants comply with state law and to use more than one kind of covenant to keep information and customers protected. This is because "a wait and see approach may be myopic in the end", he thinks.

**IAM's recent piece** detailed full recommendations and tips from lawyers on how companies should prepare in the event the controversial rule survives the legal challenges.

### The Commission's rulemaking authority under scrutiny

The Commission, according to its own arguments, is "empowered and directed" to prevent unfair competition under the FTC Act's Section 5. It describes the FTC's enforcement powers through administrative proceedings, including the authority to issue cease-and-desist orders against infringers — subject to penalties if the order is violated.

Section 6 of the Act explains the FTC's "additional powers". The FTC argues that in favour of its standing is one provision, which refers to "classification of corporations; regulations", granting it the power "to make rules and regulations for the purpose of carrying out the provisions of this subchapter".

But the court disagreed. The FTC rule, according to Judge Brown, "imposes a one-size-fits-all approach with no end date", which fails to establish a "rational connection between the facts found and the choice made". Also, she questioned the Commission's reliance on a "handful of studies" that examined the economic effects of various state policies towards non-competes.

"However, no state has ever enacted a non-compete rule as broad as the FTC's Non-compete Rule," the order stresses. It also points out that the Commission's position lacked evidence as to why they chose to impose "such a sweeping prohibition" that bans inking or enforcing virtually all non-competes instead of targeting "specific, harmful non-competes".

The court therefore concluded that the plaintiffs are likely to succeed on the merits that the FTC lacks statutory authority to promulgate such a rule. While the arguments and wording of the opinion suggest the direction the court is likely to follow, supporters of the FTC rule may yet find it reassuring that the injunction is temporary, partial and that the final outcome is still unclear.

As the lawsuits proceeds, what is certain is that the FTC's ban is likely to face increased scrutiny after the US Supreme Court's **overturning** of a longstanding precedent, known as the *Chevron* doctrine. In *Loper Bright Enterprises v Raimondo*, the Supreme Court has held recently that courts "must exercise their independent judgment in deciding whether an agency has acted within its statutory authority".

This killed the 1984 *Chevron USA Inc v Natural Resources Defense Council* ruling, which has allowed the federal agencies to enjoy the right to interpret ambiguous language in their applicable laws, rules and regulations since then. The Supreme Court's ruling is projected to **deeply impact** the rulemaking authority of federal agencies.

In light of these developments, Archer & Greiner attorneys Thomas Muccifori, who chairs the firm's Trade Secret Protection and Restrictive Covenants Group, stresses that businesses need to stay abreast of the "ever-changing" state law in determining the scope and enforceability of non-compete agreements and other restrictive covenants such as non-solicitation agreements and non-disclosure agreements.

While the Texas court's preliminary injunction gives US companies the reason for optimism about the future of the FTC's ban, "uncertainty still looms for businesses outside the scope of the court's ruling", Muccifori notes. In particular, businesses should keep watching what happens with similar lawsuits against the FTC rule that are pending in federal courts in Florida and Pennsylvania, with the letter expected to issue a decision by 23 July.

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