

Recent federal and state laws restrict use of employee non-competition agreements by government contractors and other employers

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The employee non-competition agreement landscape continues to evolve rapidly, with several states enacting new limits on the use of non-competition agreements between employers and employees. Once a valuable tool for employers to protect their businesses from unfair competition, loss of customers, or misuse of company confidential information, many states have increasingly limited the enforceability of such agreements.

The federal government is now weighing in on the appropriate use of non-competition agreements between employers and employees. President Biden's July 9, 2021 Executive Order asks the Federal Trade Commission ("FTC") to limit such agreements — signaling a potential expansion of federal regulation of agreements between employers and workers. And a pending Senate bill would ban most non-competition agreements.

Given these developments, government contractors and other employers should assess whether their use of these agreements with employees is consistent with recent state developments and aligned with the broader trend toward limiting the enforceability of these agreements.

The state judicial and legislative treatment of non-competition agreements

Typically found in employment or separation agreements, non-competition agreements between employers and employees prohibit the employee from performing work that competes with their employer's business. This prohibition typically begins upon employment, and lasts for a specified period of time after the employee no longer works for the employer.

Non-competition provisions generally describe the duration of the non-compete period, the geographic limitation of the non-compete, and the types of work that the employee may not perform during the non-compete period.

Traditionally, the enforceability of these agreements has largely been a matter of common law and subject to state contract law principles, though a few states, most notably California,

long ago enacted statutes to limit enforceability to very narrow circumstances.

In the vast majority of states, courts have tended to evaluate restrictions using flexible, multi-factor tests and, in some jurisdictions, courts may exercise their discretion to partially enforce or even rewrite overbroad non-competes (known as "blue-penciling"). However, the past few years saw an increasing number of states implement more bright-line statutory rules that specifically limit non-competes.

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This trend has continued over the past year. In May 2021, Oregon amended its non-compete statute to expressly provide that overbroad non-competes are void and unenforceable, which may limit a court's ability to enforce a narrower version of that non-compete. See Oregon Senate Bill 169¹ (changing the relevant statutory language from "voidable" to "void and unenforceable").

Also in May 2021, Nevada amended its laws to provide penalties for employers that attempt to enforce non-competition agreements prohibited by law. See Nevada Assembly Bill 47 § 22.5(7)² (requiring courts to award attorneys' fees and costs where an employer improperly attempts to (i) enforce a covenant not to compete against an hourly wage employee or (ii) restrict employees from dealing with former customers whom the employee did not solicit).

Many states have recently banned non-competes for low-wage or hourly workers. Last year, Virginia banned most covenants not to compete for low-wage employees (Va. Code Ann. § 40.1-28.7:8),³ less than two years after Maryland had done the same (Md. Code Ann., Lab. & Empl. § 3-716).⁴

Nevada followed suit this year by prohibiting non-competition agreements for employees who are paid solely on an hourly wage, effective October 1, 2021. See Nevada Assembly Bill 47 § 22.5(3).⁵

Some states have enacted even broader restrictions on non-competition agreements. Later this year, the District of Columbia will join California, North Dakota, and Oklahoma as the only states that ban the use of employer/employee non-competition agreements in most circumstances. See D.C. Act 23-563.⁶

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As the patchwork of restrictions on covenants not to compete continues to grow, employers will need to keep track of the relevant state laws as well as potential federal laws and regulations that may be on the horizon.

Federal efforts to limit employee non-competition agreements

On July 9, 2021, President Biden signed the Executive Order on Promoting Competition in the American Economy (“Order”). As Covington previously reported,⁷ the Order covers a number of competition issues.

Most relevant to employer/employee non-competition agreements, the Order encourages the FTC to use its statutory rulemaking authority “to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility.” Executive Order, Section 5(g).⁸

Although the FTC has not yet released any such rules, the Order follows a workshop the FTC held in 2020⁹ regarding employer/employee non-competition agreements. It also comes shortly after the FTC’s announcement of a new rulemaking group¹⁰ and updated rulemaking procedures,¹¹ intended to “reinvigorate rulemaking authority” under 15 U.S.C. § 57a,¹² and “aid the planning, development, and execution of rulemaking — especially new rulemakings[.]”

Separate from the Order, four U.S. Senators recently introduced the Workforce Mobility Act of 2021¹³ (“WMA”) with bipartisan support. If it becomes law, the WMA would

- (1) largely limit the use of non-competes to agreements signed as part of a sale of a business or a partnership dissolution or disassociation,
- (2) give the FTC and U.S. Department of Labor dual enforcement authority, and
- (3) give workers a private right of action to sue for violations of the WMA.

These recent developments indicate that the federal government will restrict the use of employer/employee non-competition agreements. While a universal ban seems unlikely, the federal government may follow the state trend and prohibit non-competition agreements with low-wage employees or employees who have no access to the employer’s trade secrets.

Contractors and other employers whose employees have access only to customer relationships and confidential (but not trade secret) information may be particularly impacted by such restrictions.

Legislative or regulatory limits on the enforceability of existing non-competition agreements with employees also may have adverse tax consequences for some employees. For example, taxation of restricted stock is sometimes delayed after an employee leaves when the restricted stock is subject to a non-competition requirement.

Additionally, the excise tax for golden parachute payments is sometimes reduced or eliminated when a non-competition agreement is imposed following a termination of employment in connection with a corporate transaction. Banning the enforcement of these existing non-competition agreements could result in accelerating taxes or increasing excise taxes for some employees.

Practical guidance for government contractors and other employers

In addition to monitoring state and federal developments regarding employee non-competition agreements, employers should bear in mind the existing enforcement parameters. As a general matter, non-competition provisions must be no broader than necessary to protect the employer’s legitimate business interests.

An employee non-competition provision should clearly state that its purpose is to protect an employer’s trade secrets and other confidential business information from being improperly used or disclosed.

Employers should not assume that a court will blue-pencil overbroad provisions and enforce them in part, because a court may not have the power to do so or may simply decline to enforce an overbroad non-compete.

To increase the likelihood that a non-competition provision is enforceable as written, the agreement should be narrowly tailored with respect to duration and geography as well as the type of competitive activities prohibited. For example, a provision prohibiting work in any capacity for a competitor may be subject to attack.

An employee non-competition provision should clearly state that its purpose is to protect an employer's trade secrets and other confidential business information from being improperly used or disclosed. Companies employing low-wage workers should exercise additional caution in drafting covenants not to compete, and consider the extent to which such covenants are necessary, if at all.

Even with significant restrictions on the use of these agreements, employers can still protect their assets in other ways. For example, narrow customer non-solicitation agreements may be enforceable where broader non-competition agreements are not, and employee non-disclosure agreements are generally enforceable if appropriately tailored.

Aside from contractual restrictions on competition or solicitation, employers should maximize protection of their trade secrets and other confidential information through practical safeguards such as enhanced data security protection measures, employee training on how to protect company information, and consistent enforcement of security and confidentiality policies.

Notes

¹ <https://bit.ly/3ywdVSB>

² <https://bit.ly/36EG4M5>

³ <https://bit.ly/3gSmtNA>

⁴ <https://bit.ly/3zBVvRX>

⁵ <https://bit.ly/36EG4M5>

⁶ <https://bit.ly/3jAurwF>

⁷ <https://bit.ly/3gOEFRR>

⁸ <https://bit.ly/3CVtg2J>

⁹ <https://bit.ly/2V6CQiI>

¹⁰ <https://bit.ly/3BrC5iY>

¹¹ <https://bit.ly/3mP820R>

¹² <https://bit.ly/2WD9S9Y>

¹³ <https://bit.ly/3t5QpuB>

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