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Federal Trade Commission Proposes Sweeping Ban on Non-Compete Clauses

Law and the Workplace on **January 6, 2023**

On January 5, 2023, the Federal Trade Commission ("FTC") proposed an expansive new rule which would impose a near-complete ban on the use of noncompetes (the "Proposed Rule") by employers. The Proposed Rule is the culmination of the FTC's recent efforts, following President Biden's July 9, 2021 Executive Order on promoting competition in the economy, to enhance its scrutiny of anticompetitive practices and policies in the workplace. As a further sign of its priorities, just one day before issuing the Proposed Rule, the FTC announced enforcement actions against three companies claimed to have illegally imposed non-compete restrictions on security guards and glass manufacturing workers in violation of Section 5 of the Federal Trade Commission Act.

The FTC's notice of the Proposed Rule is the first step in the rulemaking process. Stakeholders will have sixty days to comment on the Proposed Rule following its forthcoming publication in the Federal Register. The FTC will review the comments and may revise the Proposed Rule before publishing a final version. As currently drafted, the final rule would take effect 60 days after it is published in the Federal Register, and employers will have until 180 days after its publication to comply with its requirements (the "Compliance Date").

What's in the Proposed Rule?

The Proposed Rule would add a new subchapter to the Code of Federal Regulations providing that an employer may not (1) enter into or attempt to enter into new non-compete clauses as of the Compliance Date; (2) maintain pre-existing non-compete clauses as of the Compliance Date; and (3) represent to workers, under certain circumstances, that the worker is subject to a non-compete. (p. 4.)

Key Definitions

Under the Proposed Rule, a "non-compete clause" is defined as "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer." (p. 107.)

As defined, a "non-compete clause" would not include restraints *during* employment, nor would it include other types of common contractual restrictions such as non-disclosure or confidentiality agreements, agreements for the repayment of training costs, agreements providing for the forfeiture of deferred compensation or benefits by competing workers, or agreements restricting a worker from soliciting clients, customers, or other workers. (pp. 11, 108-09.) However, the Proposed Rule provides for a "functional test" under which such restrictions are prohibited if they act as *de facto* non-competes by being so broad as to have the *effect* of preventing workers from seeking or accepting other employment following separation from their employer. (pp. 109, 214.)

The Proposed Rule additionally defines other key terms, including "worker," "employer," and "employment." (pp. 112-13, 115-16.) Notably, the Proposed Rule provides that the FTC will apply these definitions regardless of how the terms are defined under other federal or state labor laws, which address, for example, whether an entity is an individual's legal "employer," or the existence of an "employment" relationship. In particular, the Proposed Rule's definition of "worker" would include interns, volunteers, apprentices, independent contractors, and gig economy workers, but not a franchisee in the context of a franchisee-franchisor relationship, regardless of how such individuals are classified under the Fair Labor Standards Act ("FLSA") or state analogues. (p. 116.)

Rescission of Existing Non-Compete Clauses

The Proposed Rule requires employers to rescind existing non-compete agreements with workers no later than the Compliance Date and provide notice to workers that their non-compete clauses are no longer in effect and may not be enforced. (pp. 125-26.) Individualized written notices must be provided to each currently employed worker, as well as former workers for whom the employer retains contact information, within 45 days after rescinding the non-compete clause. (pp. 125-27.) The Proposed Rule establishes a safe harbor for employers who use the model notice language provided in the Proposed Rule. (pp. 128, 215-16.)

Exception for Non-Competes in Sale of Businesses

The Proposed Rule acknowledges that non-competes arising in the sale-of-business context may implicate "unique interests and have unique effects" (p. 132) and may help "protect the value of the business acquired by the buyer." (p. 130.) Thus, the Proposed Rule establishes a narrow exception to its prohibitions for non-competes entered into by a person who is selling a business entity (or their ownership interest in the entity), or selling all or substantially all of a business entity's operating assets. However, the exception only applies to a "substantial owner, substantial member, or substantial partner" who holds at least a 25% ownership interest in the business entity to be sold. (pp. 132, 214-15.)

Preemption of State Law

The Proposed Rule contains an express preemption provision providing that it shall supersede "any state statute, regulation, order, or interpretation to the extent that such statute, regulation, order, or interpretation is inconsistent with the [Proposed] Rule." (p. 133, 217.) The FTC's intent is for the Proposed Rule to be a "regulatory floor, not a ceiling," which would not conflict with any state or local law that affords workers greater protections than those provided under the Proposed Rule. (p. 134.)

Key Takeaways

As foreshadowed by the FTC's issuance of a Policy Statement in November 2022 outlining new principles to expand its enforcement authority under Section 5 of the FTC Act, the Proposed Rule now invokes that authority to find non-competition clauses to be an "unfair method of competition" under Section 5. (p. 70.) As support for its conclusion, the FTC draws on a number of studies purporting to establish the proliferation and detrimental impact of non-competes to the economy (pp. 12-48, 74-78), as well as the unequal bargaining power in negotiating non-competes between employers and workers who may fail to understand their terms or impact. (pp. 81-86.)

Notably, the Proposed Rule does not cite these same justifications for senior executives, who are likely to negotiate the terms of their employment, often with the assistance of counsel. (pp. 72, 86.) Instead, the Proposed Rule maintains that consumers may, in fact, obtain "greater benefits" from the elimination of non-competes for senior executives than for other workers, which would encourage new business formation, enhance development of innovative products and services, and eliminate the need for new employers to buy-out executives from their existing non-competes. (p. 81.) Nonetheless, the Proposed Rule expressly seeks comment on the application of a categorical non-compete ban to senior executives, as well as other "highly paid or highly skilled" workers (pp. 73, 81, 86, 89), and acknowledges that "several alternatives to a categorical ban may also accomplish the objectives of the proposed rule to some degree, including different standards" for different categories of workers. (p. 124.) It remains to be seen whether the FTC will adopt different standards in the final Rule, but such changes seem likely, particularly given the Proposed Rule's efforts to distinguish its (less-convincing) rationale for senior executives as compared to other workers, as well as FTC Chairwoman Lina Khan's past comments to the Wall Street Journal emphasizing the harms of non-competes in the context of lower wage workers.

Moreover, legal challenges to the FTC's authority to issue the Proposed Rule are inevitable. The Proposed Rule was passed 3-1 over the opposition of Commissioner Christine Wilson—the sole remaining Republican appointee on the Commission—who issued a dissenting statement. As noted therein, the Proposed Rule relies on the FTC's authority to redress "unfair methods of competition" under Section 5 of the FTC Act, and does not assert the illegality of noncompetes under other antitrust laws, such as the Sherman or Clayton Acts. Business groups and stakeholders opposed to the Proposed Rule are thus likely to challenge the FTC's authority to issue it under Section 5, particularly given the recent expansion to this authority in the FTC's November 2022 Policy Statement. Separately, it is uncertain whether the Proposed Rule would survive judicial scrutiny under the major questions doctrine. Justice Gorsuch's concurrence in the Supreme Court's recent decision, *West Virginia v. EPA*, 142 S. Ct. 2587 (2022), observes that this doctrine is invoked when an administrative agency takes an action that: 1) resolves matters of great "political significance"; 2) seeks to regulate "a significant portion of the American economy"; or 3) intrudes in the an area that is the "particular domain of state law." *Id.* at 2620-21. Arguably, the Proposed Rule does all three, and accordingly, the FTC would be pressed to point to a "clear congressional statement authorizing [its] actions." *Id.* at 2622.

Prior to the Proposed Rule becoming final, employers are advised to fortify their other restrictive covenants intended to protect trade secrets and other valuable business assets, such as non-disclosure agreements and non-solicitation agreements, which the FTC does not propose to ban. Though the future of the Proposed Rule is uncertain, employers should ensure they are complying with existing state laws and best practices for the use of non-competes.

We will keep you apprised of future developments.

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Related Professionals

- **Steven D. Hurd**
  Partner
- **Scott S. Tan**
  Associate