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FTC Enters Competition to Restrict Non-Compete Clauses

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January 11, 2023 - In his July 2021 Executive Order on Promoting Competition in the American Economy, President Joe Biden encouraged the Chair of the Federal Trade Commission (the "FTC") to "exercise the FTC's statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility." In response, the FTC last Thursday, January 5, released a proposed rule (the "Proposed Rule") that would ban post-employment non-compete clauses in agreements between employers and workers, other than in limited cases in connection with the sale of a business, labeling them "unfair methods of competition."

The day before it released the Proposed Rule, the FTC entered a consent order (the "Order") finding that three companies, Prudential Security, O-I Glass Inc. and Ardagh Group S.A., had violated Section 5 of the Federal Trade Commission Act (the "FTC Act") by requiring workers to agree to non-compete clauses in their employment agreements. Each of these three companies had imposed broad non-compete restrictions on hundreds of their respective employees across a variety of positions, including lower paid and/or hourly employees. The FTC found that the restrictions contained in the agreements of each company constituted an unlawful "unfair method of competition" under Section 5 of the FTC Act. The Order required each of the three companies to cease "enforcing, threatening to enforce, or imposing non-competes against any relevant employees," and required, among other things, the companies to void and nullify the non-competes in question without penalizing the affected employees. It also required the companies to notify former, current and new employees that they may "freely seek or accept a job with any company or person, run their own business, or compete with them at any time following their employment." These are the first such actions ever taken by the FTC.

The Order appears to have been issued in anticipation of the Proposed Rule the FTC released the very next day -- last Thursday -- that would ban most post-employment non-compete provisions in agreements between employers and workers. There are serious questions as to the FTC's authority to promulgate and enforce the Proposed Rule, if it (or some semblance of it) becomes final. We expect there to be significant litigation over the FTC's authority to impose and enforce the Proposed Rule. Whether or not the Proposed Rule is ultimately upheld or invalidated by the Supreme Court (which is where it will likely land), the proposal is the FTC's clarion call with which all companies will have to deal,

especially if (as proposed) the FTC intends to apply the Proposed Rule retroactively to all non-compete arrangements already in place.

In a nutshell, the Proposed Rule provides:

- "[I]t is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker; to maintain with a worker a non-compete clause; or, under certain circumstances, to represent to a worker that the worker is subject to a non-compete clause." The Proposed Rule defines "worker" broadly as "a natural person who works, whether paid or unpaid, for an employer," with no differentiation between employees, independent contractors, senior executives, highly paid professionals, or other worker categories. The Proposed Rule would apply not just to post-employment non-compete provisions but also to any so-called "de facto noncompete clause", which the FTC does not define but warns could include overly broad confidentiality agreements, "employee choice" clauses (where an employee may choose between abiding by a non-compete provision or forfeiting compensation), and provisions prohibiting solicitation of employees or customers.
- Employers must rescind any existing non-compete clause within 180 days of the date that the final rule is published in the Federal Register, and within 45 days of rescinding the clause, "provide notice to the worker that the worker's non-compete clause is no longer in effect." The FTC would provide model language for this notice and establish a safe harbor whereby employers that send a notice complying with the model language "would satisfy the rule's requirement to rescind existing noncompete clauses."
- There is a limited exception for non-compete clauses between a buyer and seller of a business. However, this exception is only available where the restricted party is "an owner, member or partner holding at least a 25% ownership interest in a business entity." Non-compete clauses under this exception would still be subject to judicial scrutiny, and would need to be reasonable in scope and duration.

The Proposed Rule would significantly restrict the common law non-compete rules and standards developed in almost every United States jurisdiction. In fact, the Proposed Rule is even more onerous than the non-compete rules that apply in California, North Dakota and Oklahoma, where non-competes are also prohibited as void against public policy except in limited circumstances, including in connection with the sale of a business, but which do not currently require an employer to notify employees that non-competes included in legacy agreements are not enforceable.

Companies should bear in mind, however, that whatever the outcome of the Proposed Rule, some states and courts that have long permitted non-competes (albeit subject to reasonableness standards) are imposing more stringent requirements. For example, in 2018, Massachusetts implemented more stringent rules governing non-competes, which include requiring non-competes to be separately supported by consideration and prohibiting the use of non-competes for employees classified as nonexempt under the Fair Labor Standards Act. As another example, a recent decision by the Delaware Chancery Court put employers on notice to narrowly tailor their non-competes in the sale of business context, holding that the "acquirer's valid concerns about monetizing its purchase do not support restricting the target's employees from competing in other industries in which the acquirer also happened to invest."

Key Takeaways from the Proposed Rule

- As always, companies should carefully tailor their non-compete provisions to be reasonable in geographic scope, temporal scope and restricted activity. They should also tailor them narrowly to protect the legitimate business interests of the employer. Additionally, employers should consider avoiding application of such provisions to rank-and-file employees.
- We encourage businesses to begin thinking about the non-compete clauses included in their contracts, how those provisions may need to be altered as these guidelines become clearer, and the ancillary impact those changes might have (such as on compensation arrangements). For new contracts, businesses should consider using other forms of restrictions that are less likely to be considered de facto non-compete clauses such as tailored confidentiality and non-solicitation provisions.

- Even though this is only a proposed rule, it is clear that this increased focus on non-compete clauses is a high priority for the FTC. The FTC is likely to scrutinize such provisions in agreements during merger reviews under the Hart-Scott-Rodino Act. Companies with deals under review or who expect to have deals under review should therefore consider whether it is appropriate to modify or eliminate their non-compete provisions in light of the Proposed Rule even before a final rule is promulgated.

Comments to the FTC

We think it is wise to heed the advice of Commissioner Christine Wilson, the lone dissenting FTC commissioner to the Proposed Rule. The FTC has established a 60-day comment period, until March 10, 2023, on both the Proposed Rule and on proposed alternatives that would make it slightly more flexible. Commissioner Wilson warns "I strongly encourage the submission of comments from all interested stakeholders. . . . this is likely the only opportunity for public input before the Commission issues a final rule. For this reason, it is important for commenters to address the proposed alternatives to the near complete ban on non-compete provisions." We encourage you to share your views with us as we navigate comments that we and others may submit to the FTC. Among the issues to consider are:

- Whether Section 5 of the FTC Act gives the FTC statutory authority to broadly prohibit noncomplete clauses in most agreements between workers and employers without any review of the reasonableness of those non-competes as has been required at common law for centuries.
- Whether the Proposed Rule should incorporate exceptions to the ban on non-compete clauses for senior executives, other highly paid or highly skilled workers and other categories of workers, and whether different standards should apply to the different categories of workers.
- Whether employers have reasonable alternatives to non-compete clauses for protecting their trade secrets, confidential information and other investments, such as confidentiality agreements and IP protections.
- Whether the exception for the sale of a business should be broader.
- Whether the FTC should adopt a rebuttable presumption that non-compete clauses are unenforceable, rather than a categorical prohibition.
- Rather than prohibiting non-compete clauses, whether the FTC should use a disclosure regime whereby workers are specifically notified of non-compete clauses.
- Whether the Proposed Rule should include an exemption for small entities or different requirements for small entities.
- Whether the proposed compliance period of 180 days following the date that the final rule is published in the Federal Register would afford businesses sufficient time to comply with the Proposed Rule, and whether there should be more flexible transition rules for currently existing arrangements.

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