ALERT MEMORANDUM

FTC Proposes Rule to Ban Non-Competes

January 9, 2023

On January 5, 2023, the U.S. Federal Trade Commission ("FTC") proposed a rule that would prohibit employers from entering into non-compete agreements ("non-competes") with workers and require them to rescind all existing non-competes by written notice. The proposed ban is a notable departure from current practice, where non-competes are enforceable if "reasonable,"[1] with some state-by-state exceptions. However, the proposed rule is still subject to change through notice and comment[2] and, if adopted, affected parties will likely challenge the FTC's authority to issue such a rule.[3] Below is an overview of:

1. The background behind the proposal,
2. The key compliance implications of the proposal, and
3. Next steps with respect to potential changes and challenges.

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I. Background

Non-competes can serve several legitimate functions. Non-competes are agreements between employers and workers that restrict workers' ability to work for or launch a competing business, within certain time, industry, and geographic boundaries. These agreements have long been viewed as providing employers with the ability to share trade secrets with employees with the certainty that these employees will not share sensitive information with competitors as well as allowing employers to invest in training employees with non-employer-specific skills with the certainty that competitors will not appropriate the benefits of those investments.[4] Non-competes also are thought to facilitate mergers and acquisitions, by giving acquiring parties assurance that their ability to achieve the full-value of their investment will not be undermined by key employees defecting to competitors.[5] Such protections may be particularly important in start-up acquisitions, where company value can be tightly tied to the knowledge and goodwill associated with a few key individuals. Workers can arguably benefit from non-competes too if they accept them in return for a share of the value they create, e.g., better wages, benefits, equity incentives, or severance packages. Workers who are owners may well also benefit by agreeing to non-competes in order to induce buyers to be willing to purchase—and pay more for—their businesses in M&A transactions.

The FTC believes non-competes harm competition. The FTC is concerned that, rather than providing incentives for employers to invest more in innovation and in employee training, non-competes are regularly used as a tool to suppress competition and wages in labor markets.[6] The FTC is particularly concerned about the use of non-competes with respect to low and minimum wage workers, a practice it has targeted through individual enforcement actions that were recently settled.[7] The FTC asserts that non-competes with these lower-paid employees are less likely to produce the benefits discussed above. Further, the FTC also asserts that such employees may be less able to negotiate the non-competes they are subject to, or where they are subject to potentially illegal non-competes, less able to challenge them in court. The FTC has also expressed concerns that, apart from their impact on workers, non-competes may reduce competition between firms by making it difficult for disruptive competitors to attract the staff that they need to challenge incumbents.[8]

II. Compliance implications

The FTC's proposal is a ban on non-competes. While the FTC has expressed concern regarding the impact of non-competes on low and minimum wage workers in particular, its proposal would, with one exception, ban *all* non-competes between employers and workers, with worker defined broadly to include any "individual classified as an employee, independent contractor, extern, intern, volunteer, apprentice, or sole proprietor."[9] The ban would cover explicit non-competes as well as other agreements ("*de facto* non-competes") that "have the effect of prohibiting the worker from seeking or accepting employment."[10] The proposal would also require employers to notify any (current and former) workers subject to non-competes that those non-competes are no longer in effect. To that end, the main thrust of compliance would be that businesses (1) could not enter into any new non-competes (unless the narrow exception applies) and (2) would have to notify current and former workers that existing non-competes were no longer enforceable.[11]

The ban provides for one limited exception. The lone exception[12] allows for non-compete clauses between the seller and buyer of a business, where the worker restricted by the non-compete clause owned at least 25% of the business sold.[13] The notice of proposed rulemaking states that "limiting the exception to substantial owners, substantial members, and substantial partners would ensure that the exception is only available where the seller's stake in the business is large enough that a non-compete clause may be necessary to protect the value of the business acquired by the buyer." As a practical matter, the exception falls short of providing value protection

when key talent does not individually own such a significant stake in the company, as is frequently the case even in circumstances where workers receive significant proceeds from the sale of a company (including in the case of many start-up and biotech targets that are led by founding teams with significant stakes held by their venture capital partners). To that end, the FTC has requested comments on whether the "substantial ownership interest" should be set at a different percentage level (e.g., 10% instead of 25%). The FTC may also want to consider replacing the bright-line test with a facts-and-circumstances approach.

A retroactive ban would upend bargained-for arrangements. In a sale-of-business context, the retroactive nature of the proposed rule would upend for signed or consummated deals the value protection the business exception is intended to safeguard. Sale-of-business non-competes have been negotiated by sophisticated parties at arms-length, with buyers paying significant consideration in exchange for the value protection non-competes provide. Retroactively striking these non-competes deprives buyers of benefits they have already bargained and, in the case of consummated transactions, paid for.

Businesses need to consider alternative protections. Setting aside whether the exception should be broadened, if non-competes are banned as proposed, that will leave the practical question of what businesses could do to fill the gaps non-competes currently address. In short, businesses would have to rely on related contractual provisions that the proposal would not ban, e.g. non-disclosure agreements ("NDAs"), non-solicitation agreements, garden leave, and fixed-term contracts. Business often employ these types of provisions in California, where non-competes have long been illegal. Elsewhere, businesses frequently add non-competes on top of these provisions because non-competes provide a more objective standard, while proving that an employee has misappropriated sensitive information is considerably more fact intensive and often requires lengthy and expensive arbitration or court proceedings.

Businesses need to evaluate potential alternative protections. For workers that have access to sensitive information (e.g., trade secrets), businesses would need to ensure that they have NDAs or other IP protections in place to protect that information. Businesses would also need to ensure that these NDAs and IP protections do not run afoul of the proposed rule's prohibition on *de facto* non-competes, which explicitly references NDAs "written so broadly" as to "effectively preclude[] the worker from working in the same field."[14] Given the novel nature of this rule, such review would require businesses to use judgment (and to accept some degree of risk given inherent subjectivity). One option that businesses may consider would be adding provisions to NDAs that if a worker goes to work for a competitor who could use the sensitive information that the worker has, a violation is presumed unless the worker can affirmatively prove that he or she did not use the information. The FTC would likely challenge such burden-shifting provisions as *de facto* non-competes, so there would be considerable uncertainty until that issue is litigated.

Similarly for workers associated with key relationships, businesses will want to ensure that they have client or customer non-solicitation agreements in place. As with NDAs, businesses will need to review any such agreements to ensure they would not be categorized as *de facto* non-competes.

Where businesses provide valuable training to workers, they may want to sign those workers to longer-duration fixed-term contracts that make it less likely the worker will leave before the business is able to recoup its training investment. These provisions have been successfully employed in the entertainment industry, where there is often particular reliance on specific individuals with specialized talents and skills.[15] As noted in the FTC's release, these provisions also would not trigger the proposed rule,[16] which defines non-competes with respect to the effect of provisions "after the conclusion of [a] worker's employment."[17] Under this definition, the proposal would also appear to still allow for "garden leave" policies where employers continue to pay base salary

during the remaining term of a worker's contract. Of course, the ability to enforce both fixed-term contracts and garden leave provisions would still be subject to state common law.[18]

The FTC's ability to enforce the rule via penalties would be limited. Finally, the FTC may be limited in its ability to enforce the proposed rule via penalties. The FTC can only seek penalties for (1) violations of cease and desist orders and (2) under certain circumstances, violations related to "unfair or deceptive practices."[19] Since the proposed rule categorizes non-competes as "unfair methods of competition"[20] and not "unfair or deceptive practices," penalties would not be available absent specific "cease and desist orders." Still, the agency may attempt to issue such orders broadly, or may use other processes to penalize companies using non-competes. For example, the FTC could include specifications in second requests designed to identify non-competes, and then open up separate investigations or broaden reviews if non-competes are found. Further, there are a number of state laws, referred to as "little FTC Acts," which create a cause of action for practices that constitute "unfair methods of competition."[21] These laws would create potential financial liability for companies that continue to employ non-competes. Given the FTC's limited ability to directly levy penalties, it's possible these laws would result in a high-volume of civil class action litigation. It is also possible that, in light of some of the likely regulatory challenges detailed below, the FTC in adopting a final rule may choose to rely instead on "unfair and deceptive acts and practices" authority, though this would subject the proposal to additional procedural requirements.[22]

III. What's Next?

There are many steps between the current proposal and an enforceable rule. This current proposal is just the first step in light of potential changes and challenges. A sixty day public comment process will start once the proposal is published tomorrow in the Federal Register. We expect many companies will push the FTC on rescinding the proposed rules or at least revising the rules to scale back their coverage. In particular, we would expect many companies and business organizations to push for distinctions in the rule for high versus low income workers. The FTC is already considering such a distinction and explicitly requested comments on specific alternative constructs for how such a distinction might be implemented.[23] This segmented approach would mirror the already existing law in eleven states, including Washington, Colorado, and Illinois.[24] It would also allow for the use of non-competes with respect to the workers for whom they provide the most value, but would restrict the use of non-competes against low and minimum wage workers, an area where the FTC has expressed particular concern.

The proposal will face credible challenges. The proposal will also face significant challenges based on whether (1) the FTC has the authority under the FTC Act to issue this rule, (2) the rule violates the "major questions doctrine," and (3) Congress could grant the FTC the authority to make such a rule without violating the non-delegation doctrine. Parties will likely also challenge whether the economic research supports the broad prohibition being sought.[25]

The FTC may lack the authority necessary under the FTC Act. There will likely be serious challenges that the FTC does not have the authority under the FTC Act to promulgate this rule. The FTC has only once before (over fifty years ago) issued a rule solely under its authority to regulate "unfair methods of competition."[26] That rule was not enforced and has since been withdrawn.[27] Since that time, Congress has implemented further constraints on the FTC's rulemaking authority. Following a slew of rulemaking concerning "deceptive or unfair" practices, in 1975, Congress passed the Magnuson-Moss Act, which imposed significant additional requirements for rulemaking.[28] There will be arguments that Magnuson-Moss clarified that the FTC only has rulemaking authority with respect to unfair and deceptive practices[29] and that by invoking "unfair methods of competition" the FTC has impermissibly avoided the requirements of Magnuson-Moss.

Notably, many of the rationales advanced for the proposed rule are consumer protection rationales, e.g., that non-competes are frequently inserted as boilerplate provisions in adhesion contracts with workers who lack the training and bargaining power necessary to avoid them. While such behavior appears to fall under the category of "deceptive or unfair" practices, the FTC is regulating it without meeting the requirements of Magnuson-Moss. The FTC justifies this end-run by noting that these behaviors also have effects on competition. It is hard to imagine many unfair or deceptive practices that in the aggregate would not also have effects on competition. To that end, the Commission's interpretation could be read to impermissibly evade Magnuson-Moss.

The proposal may violate the major questions doctrine. Given the significant impact of the proposed rule, it will likely face serious challenges under the "major questions doctrine." That doctrine requires that when an agency's claim of authority concerns an issue of "vast economic and political significance," Congress "speak clearly" in granting that authority.[30] As the FTC's own publicity around the proposed rule makes clear, this appears to be an area of vast economic significance. Notably, the notice of proposed rulemaking states that approximately one in five American workers are currently bound by a non-compete clause.[31] Further, as discussed in the prior paragraph, it is not necessarily "clear" that Congress authorized the FTC to create a rule banning non-compete clauses as "unfair methods of competition."

A non-delegation challenge is also likely. Given the broad scope of rulemaking authority being claimed by the FTC, the FTC's authority to promulgate the rule will likely also be challenged under "the non-delegation doctrine." That doctrine prevents Congress from delegating its "legislative power" to other branches without sufficient guidance.[32] However, the doctrine only requires that Congress provide an "intelligible principle" to guide the executive branch in its decision-making.[33] While there are some indications of renewed judicial interest in the doctrine,[34] it has not been used successfully since 1935.[35]

Businesses should take action now to address the proposed rule. In sum, the FTC's proposal faces serious challenges. However, if enacted, it would have a major effect on how companies conduct business. Companies that would be affected should consider using the sixty-day comment period to push for the changes that will be most important to them. Companies should also start preparing for what they will do if the proposal does pass, e.g., by cataloguing their current agreements to determine where amendments or notices may be needed and to better understand whether existing NDAs, non-solicits, and other protections are necessary or sufficient to protect the company moving forward.

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[1] *Vencor, Inc. v. Webb*, 33 F.3d 840, 845 (7th Cir. 1994) (Non-competes in employment contracts "are valid and enforceable if the terms are reasonable in light of the surrounding circumstances."); Starr, Prescott, and Bishara, *Noncompete Agreements in the U.S. Labor Force*, 64 J. L. & ECON. 55 (2021) ("Most states employ a three-pronged test, commonly referred to as the "reasonableness criterion," in which the court balances the protection needed by the employer and the harm done to the employee and society."). Antitrust scrutiny of non-competes in employment contracts has similarly been under the "rule of reason," which evaluates them via a fact-specific inquiry. Antitrust Law Developments, Vol. I, 1C 5(b).

[2] *Statement of Chair Lina M. Khan Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 5 ("This proposal is the first step in the FTC's rulemaking process. It identifies several potential alternative rules, including those that would cover only a subset of workers or that would apply different legal standards to different categories of workers.").

[3] David Michaels, *FTC Proposes Banning Noncompete Clauses for Workers*, WSJ (Jan. 5, 2022) ("The U.S.

Chamber of Commerce said Thursday it is weighing a lawsuit over the proposal if it is adopted. 'We don't believe they have the statutory authority . . .'").

[4] Eric Posner et al, *Investing in Human Capital: The Efficiency of Covenants Not to Compete* (January 2004).

[5] *Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 265 (7th Cir. 1981) ("The recognized benefits of reasonably enforced noncompetition covenants are by now beyond question. In the case at bar, Robert Wagstaff's testimony underscores the recognized necessity for such a covenant: 'We certainly felt that we didn't want to buy Stoner Manufacturing Company and then find out that he had set up shop someplace else and had the benefit of his name and equipment and whatnot.'").

[6] *Statement of Chair Lina M. Khan Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023) ("First, noncompete clauses reduce competition in labor markets, suppressing earnings and opportunity even for workers who are not directly subject to a noncompete.").

[7] Lina Khan, *Noncompetes Depress Wages and Kill Innovation*, NYT (Jan. 9, 2023) ("Noncompetes were long assumed to apply mainly to high-level executives with access to sensitive corporate information. But their use has exploded in the past few decades, extending far beyond the boardroom… Studies and media reports have found noncompetes routinely invoked against fast-food workers, arborists and manual laborers, to name a few examples."); *Statement of Commissioner Slaughter Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023) ("They are often imposed on workers with no ability to bargain as a condition of employment. Even when noncompetes have been ruled unenforceable by courts or outlawed by legislation, firms continue to use them, as was alleged in a recent case the FTC settled over noncompetes imposed on minimum wage–earning security guards.").

[8] Lina Khan, *Noncompetes Depress Wages and Kill Innovation*, NYT (Jan. 9, 2023) ("How can a new business break into the market if all of the qualified workers are locked in?"); *Statement of Chair Lina M. Khan Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 5 ("A recent Commission action shows how depriving new businesses of access to skilled workers can thwart competition.").

[9] §910.1 (b),(f).

[10] §910.1 (b)(2).

[11] §910.2(b).

[12] While not framed as an exception, the proposed rule also explicitly does not cover franchisor-franchisee agreements. §910.1 (f). However, the FTC is seeking comment on whether to broaden the rule to cover such arrangements. *Statement of Chair Lina M. Khan Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 5 ("The current proposal does not cover noncompetes used by franchisors to restrict franchisees, but we recognize that in some cases they may raise concerns that are analogous to those raised by noncompetes between employers and workers.").

[13] §910.3.

[14] §910.1 (b)(2).

[15] *Twentieth Century Fox Film Corp. v. Netflix, Inc.*, 2021 WL 5711822, at *8 (Cal. Ct. App. Dec. 2, 2021). ("As our Supreme Court recently observed, there are public policy benefits to fixed-term contracts: 'When parties enter a contract not terminable at will, they cement their bargained-for intentions in accordance with the terms of that contract into the future.' . . . Thus, there is nothing about the fixed-term provisions themselves that would have rendered the Waltenberg and Flynn agreements unenforceable.").

[16] NPRM Part IVI.B(2)(c) ("If an employer wants to prevent a worker from leaving right after receiving valuable training, the employer can sign the worker to an employment contract with a fixed duration. An employer can establish a term of employment that is long enough for the employer to recoup its training investment, without restricting a worker's ability to compete with the employer after the worker's employment ends.").

[17] §910.1 (b).

[18] §910.4 ("A State statute, regulation, order, or interpretation is not inconsistent with the provisions of this Part 910 if the protection such statute, regulation, order, or interpretation affords any worker is greater than the protection provided under this Part 910.").

[19] Antitrust Law Developments, Vol. I, 8A. 4.(b).

[20] §910.2 (a).

[21] *See e.g.*, 815 Ill. Comp. Stat. Ann. 505/2 ("Unfair methods of competition . . . are hereby declared unlawful . . . In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5 (a) of the Federal Trade Commission Act.").

[22] *Dissenting Statement of Commissioner Wilson Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 11 ("[T]he Magnuson-Moss Act . . . require[s] substantive consumer protection rules to be promulgated with heightened procedural safeguards . . .").

[23] NPRM Part VI.B.

[24] NPRM Part II.C.1 ("11 states and the District of Columbia have enacted statutes making non-compete clauses void or unenforceable—or have banned employers from entering into non-compete clauses—based on the worker's earnings or a similar factor.); *See e.g.*, Wash. Rev. Code Ann. sec. 49.62.020(1)(b) and 49.62.030(1) (non-competes void and unenforceable unless inflation-adjusted

annualized earnings exceed $100,000 for employees and $250,000 for independent contractors).

[25] *Dissenting Statement of Commissioner Wilson Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 8 ("Similarly, the NPRM often bases its conclusions about the effects of non-compete clauses on limited support.").

[26] Antitrust Law Developments, Vol. I 8A. 6(a).

[27] Notice of Rule Repeal, 59 Fed. Reg. 8527 (1994).

[28] Magnuson-Moss, Pub. L. No. 93-637, 88 Stat. 2183 (1975); Antitrust Law Developments, Vol. I 8A. 6(a).

[29] *Dissenting Statement of Commissioner Wilson Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses*, FTC (Jan, 5, 2023), pg. 11 (It's not "clear whether Congress in the Magnuson-Moss Act sought to clarify existing rulemaking authority or to grant substantive rulemaking authority to the FTC for the first time. If the latter, then the FTC only has substantive consumer protection rulemaking power, and lacks the authority to engage in substantive competition rulemaking.").

[30] *Util. Air Regul. Grp. (UARG) v. EPA*, 573 U.S. 302, 324 (2014).

[31] NPRM Part II.B.1.a.

[32] *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 537, 55 S. Ct. 837, 846, 79 L. Ed. 1570 (1935) ("But Congress cannot delegate legislative power to the President to exercise an unfettered discretion to make whatever laws he thinks may be needed or advisable . . .").

[33] *Mistretta v. United States*, 276 U.S. 394, 406 (1989).

[34] *See Gundy v. United States*, 139 S. Ct. 2116, 2131 (2019) (Alito, concurring) ("If a majority of this Court were willing to reconsider the approach we have taken for the past 84 years, I would support that effort.").

[35] Nicholas Bagley, *A Warning From Michigan* ("But the doctrine has never done meaningful work in U.S. constitutional law. It has not been used to strike down an act of Congress since 1935.").