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BLOG

FTC Proposes Rule Prohibiting Most Non-Compete Clauses for "Workers"

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On January 5, the Federal Trade Commission (FTC) released a Notice of Proposed Rulemaking (NPRM) to prohibit employers from imposing most non-compete clauses on workers. The proposed rule is the current FTC's most significant attempt yet at utilizing antitrust enforcement and administrative rulemaking to increase competition in labor markets. If finalized and upheld against likely court challenges, the rule would significantly impact businesses throughout the country.

The Proposed Rule

Non-compete restrictions are often used to protect a business's trade secrets, and have become increasingly common in employment contracts in recent years for employees of all stripes, from highly compensated white-collar executives to low-paid blue-collar workers. The FTC's research finds that non-compete clauses bind about 30 million people in the United States, or one in five American workers. FTC Chair Lina Khan stated that the present rule is being proposed because of "a raft of economic evidence" that now shows "the ways that non-compete clauses undermine competition." The FTC explained that non-competes harm workers and competition by significantly reducing wages and stifling new businesses and ideas.

The proposed rule deems non-compete clauses an unfair method of competition prohibited by Section 5 of the FTC Act. As a result, the rule would ban employers from entering non-compete clauses with their "workers." Notably, "workers" is defined broadly to include not just employees, but also independent contractors, externs, interns, volunteers, apprentices, and sole proprietors who provide a service to a client or customer. For existing non-compete agreements, employers would be required to rescind the non-compete clause within 180 days after publication of the final rule and to provide notice to workers regarding such a recension.

The proposed rule also applies to other types of employment restrictions when they constitute "de facto" non-competes by preventing workers from switching jobs. Examples of such "de facto" non-competes may include in certain circumstances non-disclosure agreements that prevent workers from working in the same field and requirements to repay training costs.

The proposed rule includes one narrow exception to its broad prohibition for non-competes imposed on persons who own at least 25% of a business and sells that business interest.

The FTC's aggressive approach to non-competes follows closely on the heels of a string of recent enforcement actions under Section 5 of the FTC Act against allegedly unfair non-competes. On January 4, 2023, the day before issuing the NPRM, the agency announced that it had "taken legal action against three companies and two individuals forcing them to drop noncompete restrictions that they imposed on thousands of workers," which the FTC alleged "constituted an unfair method of competition under Section 5 of the FTC Act." The three lawsuits—and simultaneous consent agreements—made good on the agency's November 2022 Policy Statement that it would "rigorously enforc[e] Section 5's prohibition on unfair competition, as a recent Competition Corner post predicted. The suits marked the first time that the FTC has sued to stop noncompete agreements and reiterated the Biden administration's focus on stamping out noncompete agreements—a priority announced via Executive Order in mid-July. (See here for a Competition Corner post regarding the Executive Order's focus on labor markets.) It also signaled the FTC's commitment to employing Section 5, which had been virtually unused on a standalone basis in nearly a decade. Chair Khan, joined by Commissioners Rebecca Kelly Slaughter and Alvaro M. Bedoya touted the actions as "put[ting] companies and the executives that run them on notice that using noncompetes to restrain workers and restrict competition invites legal scrutiny." Commissioner Christine S. Wilson—currently the sole Republican commissioner—voted against all three proceedings and issued two strong dissenting statements arguing that the orders were a stark departure from Section 5 precedent based on scant evidence and foreshadowed that, under the current FTC majority, "[p]ractices that three unelected bureaucrats find distasteful will be labeled with nefarious adjectives and summarily condemned, with little to no evidence of harm to competition."

Rulemaking Process

The FTC voted 3-1 to publish the NPRM, the first step in its rulemaking process. After the Federal Register publishes the proposed rule, the public will have 60 days to submit comments. The proposed rule seeks public comment on a number of topics, in particular, whether: (i) franchisees should be covered by the rule; (ii) senior executives should be exempted from the rule, or subject to a rebuttable presumption rather than a ban; or (iii) low- and high-wage workers should be treated differently under the rule.

After the public comment period, the FTC will have an opportunity to review the comments, potentially extend or re-open the comment period, and revise the proposed rule based on comments it has received, before finalizing the rule.

Given the uncertainty of whether or not the FTC will seek multiple rounds of comments, how long it will require to revise the proposed rule, or what legal challenges it will face, it is not clear when the rule would be finalized. However, a final rule will likely not be in place until at least 2024. The rule will take effect six months after a final version is published.

Legal Landscape of Non-Compete Clauses

The proposed rule is a major departure from how non-competes have been treated to date. As Commissioner Wilson noted in her dissenting statement, to date, courts have employed a fact-specific inquiry into whether a non-compete clause is unreasonable in duration and scope, given the business justification for the restriction. Although three states prohibit non-competes (California, Oklahoma, and North Dakota), most jurisdictions enforce non-compete agreements when necessary to protect a legitimate business interest, such as protecting trade secrets or other proprietary information. In such instances, the court will evaluate whether the temporal and geographical restrictions are reasonable and if the agreement does not unduly harm employees, public interests, or fair competition. Nonetheless, the FTC has consistently emphasized that such clauses must be narrowly tailored. (See here for a Competition Corner post regarding narrowly tailored non-competes in M&A transactions.) Notably, the proposed rule as currently written would supersede any state statute, regulation, or order that was contrary to the proposed rule's ban on non-compete provisions.

Potential Challenges to the Proposed Rule

The issuance of a final rule is unlikely to be the final say in the matter. The proposed rule will likely be subject to a variety of legal challenges. For example, Commissioner Wilson argued in her dissent that the rule is vulnerable to a number of legal challenges, including that (1) the FTC lacks authority to engage in "unfair methods of competition" rulemaking since it is not clear that the FTC Act provides authority for competition rulemaking, (2) the major questions doctrine addressed in *West Virginia v. EPA* applies, which would require the FTC to identify clear congressional authorization to impose a broad regulation banning non-compete clauses; and (3) assuming the FTC does possess the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the non-delegation doctrine.

The U.S. Chamber of Commerce has already criticized the NPRM, stating that it is "blatantly unlawful" and that "Congress has never delegated the FTC anything close to the authority it would need to promulgate such a competition rule." Previously, in September 2021, the Chamber of Commerce likewise wrote in a letter to the FTC that the agency "lacks legal authority" to enforce such a rule that "would harm consumers by banning the many pro-competitive aspects of non-competes." The Chamber of Commerce argued that the FTC lacks statutory authority to promulgate a rule banning or severely restricting non-competes since nothing in the FTC Act's text expressly gives the FTC rulemaking authority to prohibit business practices that the FTC deems an unfair method of competition.

What Employers Should Do Now

Employers can start taking several steps to prepare for adoption of a final rule that is likely to severely restrict use of non-compete clauses. Although the exact contours of the rule and timing for its implementation are not certain, once a final rule is adopted, employers can expect just 180 days to implement changes and notify affected workers. Litigation challenges to the rule will likely seek injunctions to delay its implementation, but employers cannot count on such court relief to delay their compliance obligations.

- **Review your use of non-competes in active contracts.** Given the widespread use of non-compete clauses, employers should not wait to review their active agreements to gauge any potential recensions or changes that would need to be made to standard or individualized employment agreements. For employers with varied employment agreements developed over time for various business units and functions, the process of reviewing all agreements for non-competes and considering modifications may be significantly time-consuming. Starting that review process now will ensure that businesses are well-prepared to act quickly when a final rule is adopted.
- **Develop NDAs, non-solicitation agreements, and other alternatives to non-competes.** The commentary around the proposed rulemaking notes that appropriately tailored non-disclosure agreements (NDAs) and customer non-solicitation agreements will generally not be prohibited by the proposed rule. Employers should review their current use of such agreements and consider requiring new or amended agreements from workers to protect their trade secrets, customer relationships, and other legitimate business interests.
- **Consider submitting comments in the rulemaking process.** Should employers or companies have significant concerns regarding the banning of non-competes, they are encouraged to submit such comments to the FTC before the comment period expires. Employers can consider working together with trade associations to submit joint comments. Providing concrete examples of specific procompetitive uses of non-competes may be impactful.
- **Consult with knowledgeable antitrust and employment counsel.** Experienced counsel can help guide employers through the uncertainty of the FTC's rulemaking and develop alternatives to existing use of non-competes. Involving counsel at an early stage will help ensure that employers are well-prepared to address whatever the future may hold.

On March 6, 2023, the FTC unanimously voted to extend the public comment period on the proposed rule from March 20 to April 19. Outgoing FTC Commissioner Christine S. Wilson issued a concurrence stating that she "would have supported extending the public comment by 60 days."

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