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FTC Proposes Nationwide Ban on Non-Compete Agreements

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On January 5, 2023, the Federal Trade Commission announced a proposed rule that, if enacted, would amount to a near-total ban on the use of non-compete agreements and leave employers with fewer legal means of protecting their confidential and proprietary information.

Under current law, agreements containing non-compete clauses are governed by state restrictive covenant statutes or common law. They may also be subject to challenge under federal and state antitrust law, although historically those efforts have had minimal impact. Most states limit non-compete clauses, requiring that their geographic scope, duration, and restrictions on competitive activity be reasonable. This leaves most non-compete agreements subject to courts' interpretations about what constitutes a legitimate business interest. Three states—California, North Dakota, and Oklahoma—have adopted statutes rendering non-compete clauses void for nearly all employees with limited exceptions, such as California's exception for the sale of a business. In recent years, some states—including Washington, Colorado, Illinois, Arizona, and Nevada—have enacted restrictive covenant statutes rendering non-compete clauses void based on the worker's earnings, consideration, notice, and other factors.

As employers and their counsel have expanded the use of employee non-competes, some have called for federal regulation of non-compete agreements, with both Democratic and Republican senators introducing legislation to limit or prohibit the use of non-compete agreements except in certain circumstances. With congressional action looking unlikely, President Biden issued Executive Order 14036 in July 2021. Aimed at promoting competition in the economy, the Order, among other things, directed the Federal Trade Commission (FTC) to consider promulgating a rule "to curtail the unfair use of non-compete clauses and other clauses or agreements that

may unfairly limit worker mobility." In November 2021, the FTC released a draft strategic plan for FY 2022-2026, containing a goal to "[s]tudy and investigate…non-compete and other potentially unfair contractual terms resulting from power asymmetries between workers and employers." One month later, the FTC and U.S. Department of Justice Antitrust Division hosted a joint workshop on antitrust concerns in labor markets.

The FTC cites Section 5 of the FTC Act (15 U.S.C. § 45), which broadly prohibits unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce, to support its rule-making authority in this area. Historically, the FTC has not regulated non-compete agreements between employers and employees. Multiple legal commentators have called into question whether Section 5 provides the FTC with the authority to issue and enforce a nationwide rule prohibiting non-competes. Importantly, the FTC's jurisdiction under Section 5 is not unlimited—banks, federal credit unions, air carriers, common carriers, meatpackers and poultry dealers are exempt from its coverage. Also, Section 5 may only be enforced by the FTC (not by private plaintiffs) against "persons, partnerships, or corporations." The FTC Act defines the term "corporation" as an entity "organized to carry on business for its own profit or that of its members," which renders certain conduct engaged in by non-profit entities as beyond the FTC's reach.

The newly proposed FTC non-compete rule is broad

The FTC's newly proposed rule prohibits employers from imposing non-compete clauses on workers with only one narrow exception. It is based on an initial finding that non-compete agreements constitute an unfair method of competition and therefore violate Section 5 of the FTC Act.

It is difficult to underestimate the wide-ranging effect this proposed rule would have on standard executive and other forms of employment agreements. For example, the proposed rule would prohibit employers nationwide both from entering into new non-compete provisions and from maintaining its existing non-compete clauses with all workers—including not just employees, but also independent contractors, consultants, interns, and volunteers. Thousands (if not millions) of non-compete agreements in existence today will simply cease to have any legal effect under the FTC's proposal.

Under the current formulation of the rule, this broad definition of "worker" extends to even senior-level executives with access to a company's most sensitive and valuable information. Employers frequently condition executives' participation in equity plans and other incentive-based compensation, such as profits interest agreements, short and long-term bonus plans, and retention agreements, on an employee's commitment to abide by non-compete restrictions. The scope of the proposed rule also presumably goes beyond a traditional employer-employee relationship, extending to partnerships and membership agreements among individuals. As a result, standard noncompetition clauses within LLC and partnership agreements could also be impacted.

The proposed rule in its current form would also require employers to take active steps to rescind existing non-competes and inform workers that such clauses are no longer in effect. Specifically, employers would be required to rescind existing non-compete clauses with current and former workers within 180 days of the final rule going into effect. Those employers would also be required to inform their workers in an individualized communication that the non-compete clause is no longer in effect within 45 days of rescinding the non-compete clause.

Definition of "non-compete" touches other agreements too

While the proposed rule does not explicitly prohibit other popular forms of restrictive covenants, such as non-disclosure agreements or client or customer non-solicitation agreements, the rule also recognizes that those clauses can be broadly drafted to have the same effect as a non-compete and can functionally serve as de facto non-compete agreements. As such, the rule prohibits the use of any form of agreement that has the effect of prohibiting workers from seeking or accepting new employment. For example, the rule contemplates that employers would be prohibited from requiring workers to reimburse employers for training costs if workers leave before a certain period of time, where "the required payment is not reasonably related to the costs the employer incurred for training the worker."

Somewhat ironically, the FTC cites employers' use of trade secret laws, including the doctrine of inevitable disclosure, as acceptable alternatives to enforcement of non-compete agreements, when the enforcement of those same laws is frequently criticized as the functional equivalent of a non-compete agreement.

Sale of business exception is narrow

The proposed rule recognizes the traditional state law exception to non-compete agreements or provisions that are entered into in the sale of a business. However, the exception is narrow, and applies only to those who own at least 25% of a company. Even California's exception to its general ban on non-competes does not limit its exception to such a substantial ownership stake, creating the unexpected outcome that even California's notoriously strict non-compete laws will be pre-empted at least in some respects by the FTC rule.

Legal authority and likely challenges

The proposed rule, as a matter of federal preemption, would supersede any state statute, regulation, order, or interpretation that is inconsistent with the provisions of the final rule except to the extent that they provide workers with greater protections.

The FTC voted 3-1 to publish the Notice of Proposed Rulemaking (NPRM), which will be subject to a 60-day period of public comment once it is published in the Federal Register. The FTC will review all

public comments received and must consider such comments when drafting and publishing any final rule. The rule would go into effect 180 days after the final rule is published.

This proposed rule rests on questionable legal authority. The substantial impact of the implementation of this proposed rule on an area of the law that has long been under the authority of state legislatures and courts is vulnerable to accusations of regulatory overreach. This rule will face a legal challenge under the Administrative Procedure Act in federal court by affected businesses and trade associations. The dissenting member of the FTC already identified at least three grounds for possible legal challenge including (1) the FTC lacks authority to engage in "unfair methods of competition" rulemaking; (2) the "major questions doctrine" explained in a recent 2022 U.S. Supreme Court opinion could be applied to argue that the FTC lacks clear Congressional authorization to issue the proposed rules; and (3) the FTC's action here constitutes an impermissible delegation of legislative authority under the non-delegation doctrine. In other words, even if the FTC reviews all the comments it receives and issues a final rule, such final rule will likely be tied up in the federal courts for years to come before it could become effective. The current composition of the U.S. Supreme Court will likely scrutinize this rule, its broad impact, and the FTC's purported authority with a level of skepticism that calls into question whether employers should respond to the rule before the courts issue definitive rulings.

For now, all "employers" and all other businesses and trade associations whose members have an interest in the enforcement of non-compete agreements under the current patchwork of state law should review the FTC's proposed rule and consider submitting comments to the FTC before the 60-day comment period ends. The more viewpoints and arguments raised questioning the legal and policy justifications for the FTC's proposed rule, the more the FTC will need to analyze when considering whether to publish a final rule and what such final rule would cover.

Recent FTC non-compete enforcement actions

The day before announcing the new rule, the FTC announced three enforcement actions against companies who allegedly imposed non-compete agreements on lower-wage workers. The actions were brought under Section 5 of the FTC Act with the FTC stating that "each of the companies and individuals illegally imposed noncompete restrictions on workers in positions ranging from low-wage security guards to manufacturing workers to engineers" that prohibited them from seeking or accepting work with another employer or operating a competing business after they left the companies.

In each case, the FTC ordered the company to cease enforcing, threatening to enforce, or imposing a non-compete agreement on the affected workers. The companies are also required to notify all affected employees that they are no longer bound by the non-compete agreements.

Next steps in the rulemaking process

This proposed rule is the first step in the FTC's rulemaking process. We anticipate the FTC will receive thousands of comments on the proposed rule, each of which the agency must consider. We also anticipate changes to this preliminary version in the final rule based on the FTC's review of comments received. It is possible, depending on the number and quality of comments received, that it could take the FTC until 2024 to publish a final rule. After a proposed final rule is published, it is likely to be subject to legal challenge further delaying its effective date assuming the FTC rule survives legal challenge.

Currently, non-compete agreements and related provisions remain subject to challenge under state law regarding restrictive covenants, as well as state and federal antitrust law. Going forward, employers should still look to applicable state laws to determine the enforceability of non-compete agreements, keeping an eye on FTC's rule making process. While employers do not necessarily need to take immediate steps in response to the proposed rule, this proposed rule, even if not likely to be enforced in its current form, is a good reminder that employers need to be judicious when entering into restrictive covenants or when seeking to enforce them. The ill-considered attempt by employers to enforce these clauses against former employees absent a legitimate business interest, such as enforcement actions against low-level or modestly compensated employees, has led to the political scrutiny that has resulted in the current proposed rule.

What this means to you

Employers who rely on non-competes should not hit the panic button, at least not yet. Most commentators agree that the proposed rule is unlikely to go into effect in its current form, if at all. However, this effort by the FTC should serve as a wake-up call to employers who have traditionally relied upon non-competes that their overuse has generated political controversy that is prompting regulatory and statutory responses. Many states have already taken or are considering efforts to limit or ban the use of non-competes, and that trend is almost certain to continue over next few years.

Contact us

Companies that would like outside legal counsel to review their existing non-compete agreements or submit a public comment in response to the FTC's proposed rule can contact Husch Blackwell's labor and employment and antitrust teams, including the authors of this alert.