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FTC Proposes Rule Banning All Non-Competes

By Jennifer S. Baldocchi, Marc E. Bernstein, Kenneth W. Gage, Carson H. Sullivan, Matthew S. Aibel, Rakhi Kumar, Jessica E. Mendelson & Aja Nunn

On January 5, 2023, the Federal Trade Commission ("FTC") announced a proposed regulation that would ban non-compete agreements between workers and employers, with some limited exceptions (the "Proposed Rule"). The Proposed Rule also would invalidate prior agreements between workers and employers and require employers to inform their workers they are no longer bound by existing agreements. It is now subject to comment and possible revision. The Proposed Rule potentially will become final later in 2023. It is critical for employers to watch, wait, and prepare as this situation develops.

The topic has been in the federal government's crosshairs for some time:

- In 2018 and 2019, the FTC held hearings on competition, inviting comments on a wide-range of topics, including the use of non-compete agreements.
- Then, in 2020, the FTC held a public workshop on non-competes, and in 2021 solicited comments on contract terms that may harm competition, including non-compete provisions.
- On July 9, 2021, President Biden signed an Executive Order encouraging the FTC to ban or limit non-compete agreements.

More recently, the FTC brought enforcement actions against three companies and two individuals, resulting in settlements prohibiting the companies from using the challenged non-competes.

With the Notice of Proposed Rule-Making ("the Notice"), the FTC suggested these actions are necessary because "non[-]compete clauses reduce competition in labor markets" resulting in the suppression of "earnings and opportunity even for workers who are not directly subject to a non-compete." Commissioner Christine S. Wilson, however, issued a strongly-worded dissent, stating that the Proposed Rule was a "radical departure from hundreds of years of legal precedent" and that there was a lack of clear evidence to support the Proposed Rule.

Who does the Proposed Rule protect?

The Proposed Rule applies to agreements between employers and workers. A "worker" is broadly defined to include independent contractors, interns, volunteers, apprentices, and sole proprietors who provide services to a client. Proposed Rule § 910.1(f). "Employer" is defined as any natural person, partnership, corporation, association, or other legal entity, including any person acting under the color or authority of state law. Proposed Rule § 910.1(c); 15 U.S.C. 57b-1(a)(6).

The Proposed Rule contains a limited exception for the sale of business context, so long as the party restricted by the non-compete clause is an owner, member, or partner holding at least a 25% ownership interest in a business entity. Proposed Rule § 910.3; § 910.1(b)(2)(ii)(e).

What employers are covered?

The Proposed Rule would have extremely broad coverage, but the Federal Trade Commission Act does not give the FTC jurisdiction over all employers. Entities that are not subject to the FTC Act include certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers and foreign air carriers, and persons subject to the Packers and Stockyards Act of 1921, as well as an entity that is not "organized to carry on business for its own profit or that of its members," which likely applies to 501(c)(3)s and other not-for-profit corporations.

What does the Proposed Rule Cover?

The Proposed Rule defines a "non-compete clause" 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. Proposed Rule § 910.1(b)(1). The Proposed Rule would prohibit all non-compete agreements, including those that are styled or titled as something else but functionally prohibit competition. The Notice provides examples of such functional or de facto non-competes, including a non-disclosure agreement that is so broad that it would effectively preclude competition.

On the other hand, the Proposed Rule would permit employers to use restrictive covenants, including non-disclosure agreements and non-solicitation provisions, as long as the covenants are not so overly broad as to become "de facto non-compete clauses." The Notice explains, "the definition of non-compete clause would generally not include other types of restrictive employment covenants—such as non-disclosure agreements ('NDAs') and client or customer non-solicitation agreements—because these covenants generally do not prevent a worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer. However, under the proposed definition of 'non-compete clause,' such covenants would be considered non-compete clauses where they are so unusually broad in scope that they function as such."

The Proposed Rule also would require that companies affirmatively rescind all non-compete agreements that predate the compliance date. There is no grandfathering of existing agreements. Instead, employers would need to provide notice to current and former employees, "provided that the employer has the worker's contact information readily available." That notice can be in many different forms, including text message, and must be provided within 45 days of the rescission of the non-compete. Further, the FTC has suggested how to effectively communicate the notice of rescission, i.e. "You may run your own business—even if it competes with [EMPLOYER NAME]." Whatever the manner of communication, employers must rescind any active non-compete clause no later than the required compliance date. Proposed § 910.2(b)(1); § 910.2(b)(2)(C).

What penalties are associated with violating the Proposed Rule?

Employers that fail to comply could face a range of sanctions through FTC enforcement actions, including: (1) injunctions; (2) compliance reporting requirements; (3) forced compliance with the notice obligations, with respect to impacted employees and voiding and nullifying existing non-compete agreements; (4) requiring FTC access to employer's premises for inspection and interviews;

(5) monetary penalties; and (6) notice obligations to the FTC regarding any changes in respondent's structure (i.e., dissolution, acquisition, merger, consolidation, etc.).

Is the Proposed Rule subject to change?

Yes. The FTC is soliciting comments for a 60-day period, which will commence after the date of publication in the Federal Register. After the comment period closes, the FTC will consider the input it receives and whether revisions are warranted. A final rule would go into effect 180 days after it is published. In the Notice, the FTC welcomes input for softer alternatives, noting at least two other possibilities in lieu of a categorical ban. One possibility is to replace the categorical ban on non-compete agreements with a rebuttable presumption of unlawfulness. The second possibility raised by the FTC would create exemptions for certain categories of workers based on a variety of factors, including a worker's job functions or earnings.

In her dissent, Commissioner Christine S. Wilson specifically points to the FTC's invitation for commentary on these alternatives, noting that "this solicitation for public comment is likely the only opportunity [stakeholders] will have to provide input not just on the proposed ban, but also on the proposed alternatives."

Proposed rules can change in response to comment, and we expect there to be substantial opposition from various stakeholders. In the end, the FTC may be convinced that a narrower rule should be adopted, but the outcome is uncertain.

Are legal challenges to the Proposed Rule Expected?

Yes. Given the broad scope of the Proposed Rule, we can expect a myriad of legal challenges, including whether it falls outside the FTC's authority. The Supreme Court has recently endorsed the "major questions" doctrine, which requires Congress to speak clearly when authorizing agency action in certain extraordinary cases. *West Virginia v. EPA*, 142 S. Ct. 2587 (2022); *Util. Air Regul. Grp. (UARG) v. EPA*, 573 U.S. 302, 324 (2014) (rejecting claim of regulatory authority when (1) the underlying claim of authority concerns an issue of "vast 'economic and political significance,'" and (2) Congress has not clearly empowered the agency with authority over the issue) (citation omitted). Such issues could be triggered in this scenario, because the FTC's mandate has typically focused on markets that impact consumer prices, i.e., antitrust scrutiny of mergers and price-fixing schemes among competitors. Delving into the non-compete arena through Section 5 of the FTC Act presumes an expansive view of the agency's mandate. Courts will likely be asked to weigh in on whether Congress intended the FTC to regulate non-compete agreements. By its own estimation in the commentary supporting the Rule, the FTC believes the monetary impact of banning non-competes on employee wages could be approximately $300 billion.

What are the next steps? Watch, Wait, Prepare

If adopted in its present form, the Proposed Rule would have significant implications for employers. It cannot be ignored. Interested parties should respond to the solicitation of public comments. Further, many states have already passed laws applying some of the measures discussed by the FTC in the Notice, and many employers have already begun to carefully scrutinize the use of, and enforceability of, non-competes. States such as California, Oklahoma, and North Dakota have banned most non-compete agreements, while others have banned these agreements for low-wage workers.

Regardless of the outcome of the Proposed Rule, employers should be prepared to use other tools beyond non-compete provisions to protect their legitimate business interests and intellectual property.

Paul Hastings has a leading practice in this area and our attorneys know how to work with companies to craft creative solutions to protect their confidential information and legitimate business interests.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Jennifer S. Baldocchi
1.213.683.6133
jenniferbaldocchi@paulhastings.com

New York

Marc E. Bernstein
1.212.318.6907
marcbernstein@paulhastings.com

Kenneth W. Gage
1.212.318.6046
kennethgage@paulhastings.com

Washington, D.C.

Carson H. Sullivan
1.202.551.1809
carsonsullivan@paulhastings.com