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FTC Condemns Non-Competes: An Antitrust Perspective on Practical Next Steps for Companies

By Michael Murray, Michael L. Spafford, Michael S. Wise, & Noah B. Pinegar

The FTC recently concluded that many noncompete agreements between employers and employees violate federal antitrust law, announcing settlements of two significant antitrust investigations. These settlements were announced the day before the FTC proposed a regulation that, if adopted, would implement a near-universal ban on noncompete agreements. These actions represent a rejection of the centuries-old principle that noncompete provisions are enforceable so long as they are reasonable with respect to scope, duration, and geography. We discussed the FTC's proposed regulations in an alert last week. Here, we describe practical next steps that companies that currently rely on noncompete provisions should take in the short-term, medium-term, and long-term to account for the shift in antitrust law embodied in the settlements and proposed in the regulations.

Background

President Biden's administration continued and expanded the previous administration's focus on antitrust enforcement in the labor markets. In particular, in July of 2021, the President promulgated an Executive Order calling on the FTC to consider applying the antitrust laws to "curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

Over the course of the next eighteen months, the FTC (and DOJ) heeded this call in merger reviews, investigations, and advocacy. While much of this activity can be seen as increasing aggressiveness in enforcing existing laws and principles, the FTC is more recently pushing for new antitrust requirements that rewrite the existing playbook. It appears that one of the first areas where this will play out is in treatment of noncompete provisions between employers and employees.

Two FTC Settlements Involving Allegedly Problematic Noncompetes

On January 4, the FTC by a vote of three to one (with the Commission's sole Republican commissioner dissenting) announced settlements of two investigations into the use of noncompete agreements in employee contracts. These actions are the first FTC enforcement actions against employee noncompete agreements. Both proceeded under Section 5 of the FTC Act.

The first settlement involved two affiliated companies in the security guard industry and their individual owners. These companies, according to the FTC, exploited their superior bargaining power against security guards paid at or near the minimum wage to impose a 100-mile, two-year noncompete with a

penalty for violation of $100,000. Under the terms of the settlement, the security guard companies and their owners may not enforce, threaten to enforce, or impose noncompete restrictions on current or past workers, including in new business ventures.

The second settlement involves two large glass manufacturers of food and beverage containers. These companies, according to the FTC, imposed one or two-year noncompetes on approximately 1,700 employees to impede the entry of rivals. Under the terms of the settlement, the companies must eliminate the noncompete restrictions.

The FTC majority stated that "[t]oday's actions should put companies and the executives that run them on notice that using noncompetes to restrain workers and restrict competition invites legal scrutiny." Commissioner Wilson dissented in both actions, writing that the FTC majority did not properly interpret Section 5 of the FTC and proceeded without evidence of anticompetitive effects. She further highlighted the fact that noncompete provisions have been judged based on their reasonableness at common law and under various state laws for "several hundred years." The FTC's new use of federal law to rewrite the rules of noncompete enforcement thus indicates a clear intention by the Democratic Commissioners to answer President Biden's call for more aggressive antitrust enforcement.

The FTC's Broader Proposed Regulation Banning All Noncompete Requirements

The day after the announcement of the two settlements referenced above, on January 5, the FTC by a vote of three to one proposed regulations that would ban employers from imposing noncompete agreements on workers. The FTC again relied on Section 5 of the FTC Act, concluding preliminarily that noncompetes constitute an unfair method of competition. As with the settlements, the FTC took the view that proof of anticompetitive effects is not necessary for a Section 5 violation, and further that the long-standing case-by-case treatment of noncompete agreements should be discarded.

Under the proposed rule, it would be illegal for an employer to enter into or attempt to enter into a noncompete with a worker, maintain an existing noncompete with a worker, or represent to a worker, under certain circumstances, that the worker is subject to a noncompete. The proposed rule extends to both paid and unpaid employees and independent contractors. It also extends to non-disclosure agreements or agreements to repay training costs upon early termination of employment if such agreements amount de facto to a noncompete. Finally, the proposal extends to noncompetes related to the sale of a business unless they involve a person who owns at least 25% of the sold business.

In announcing the proposal, the FTC majority stated that "noncompete clauses reduce competition in labor markets, suppressing earnings and opportunity even for workers who are not directly subject to a noncompete." The agency estimated that the proposed rule could increase wages by nearly $300 billion and expand opportunities for about 30 million Americans. Commissioner Wilson again dissented, stating that the FTC lacks authority to engage in rulemaking, especially of this magnitude, under Section 5 of the FTC Act and that the proposal "represents a radical departure from hundreds of years of legal precedent that employs a fact-specific inquiry into whether a non-compete clause is unreasonable in duration and scope, given the business justification for the restriction."

The proposed rule is now subject to notice and comment. The agency explicitly called for comment on whether the regulation should apply to all workers, including executives and highly paid workers and franchisees.

Antitrust Takeaways

The FTC's settlements and proposed regulations present new risks for the use of noncompete clauses. There are three notable features of the FTC's actions.

- First, the FTC's condemnation of noncompete clauses does not turn on an assessment of their reasonableness. In the settlements, the FTC did not rest its allegations on the unreasonableness of the clauses with respect to scope or duration. In the proposed regulation, the FTC proposes to ban all noncompetes regardless of reasonableness.
- Second, the FTC's condemnation of noncompete clauses does not turn on their enforcement. In the glass manufacturers' settlement, the FTC did not mention any history of enforcement of the noncompetes. In both the settlements and the proposed regulation, the FTC would require the rescission, with notice to employees, of existing noncompete clauses.
- Third, the FTC's condemnation of noncompete clauses does not soften when they are imposed on executives, highly-skilled workers, or in connection with the sale of a business (except for owners). The glass manufacturers' settlement involved skilled laborers, including trained workers, and the FTC's proposed regulation explicitly extends to executives and transactions.

More generally, the FTC's approach to noncompetes demonstrates a clear willingness to challenge existing norms for competition law enforcement. Indeed, if Section 5 no longer requires proof of an anticompetitive effect to demonstrate a violation, it would significantly expand the categories of conduct that the FTC might view as "unfair" and therefore subject to sanction.

Practical Next Steps

In light of the FTC's settlements and proposed regulations, companies should take the following three steps with respect to noncompetes in those local jurisdictions in which they are allowed:

A. Short-term—Re-evaluate the current risks.

The FTC's settlements concern noncompetes enforced against low-wage workers and noncompetes imposed on (even if not enforced against) skilled workers who are necessary for new companies to enter a market. Because those practices have drawn the ire of the FTC, companies should evaluate whether they use noncompetes in similar circumstances. While we await adoption of a final rule, companies can consider a mitigation plan that would identify employees who would be impacted and determine steps for complying with a potential ban on noncompetes. In addition, companies that rely heavily on noncompetes for the protection of their businesses may consider whether to join potential declaratory actions that are likely to materialize as a means to forestall the FTC's enforcement of this proposed ban.

B. Medium-term—Prepare for nationwide, retroactive ban.

The FTC is likely to finalize regulations similar to those that it proposed, with perhaps some tweaks for executives, high-wage workers, or franchisees. Preparing now for a future in which existing noncompetes are illegal likely involves considering existing protections in place for trade secrets and the dissemination and use of confidential information. It may also affect training plans and HR policies that can impact employee mobility.

C. *Long-term—Plan for transactions.*

After the FTC finalizes its regulations, companies will need to take into account the possibility that non-owner officials of targets for acquisition may not be bound by noncompetes. That could change valuations or inspire acquirers to negotiate other provisions to protect their investments.

The FTC’s settlements and proposed regulations represent a significant development in antitrust treatment of noncompetes. Companies should plan now to mitigate risk of enforcement later.

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

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FTC Proposes Rule Banning All Non-Competes

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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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