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Expert Q&A on the FTC's Proposed Rule Banning Employee Non-Competes

by Practical Law Labor & Employment

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An Expert Q&A with Peter A. Steinmeyer and Erik W. Weibust of Epstein Becker & Green, P.C. regarding the Federal Trade Commission's (FTC) proposed rule banning employee non-competes.

On January 5, 2023, the Federal Trade Commission (FTC) announced and released a notice of proposed rulemaking (NPRM) to prohibit employers from entering into, enforcing, or attempting to enforce non-compete clauses with workers, including independent contractors. The FTC's proposal would create a new subchapter J, Part 910 of the rules promulgated under Section 5 of the Federal Trade Commission Act premised on the assumption that it "is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker" and therefore falls within the FTC's domain. The proposed rule broadly prohibits traditional post-employment non-competes and, if finalized and it ever becomes effective, would be a sea change for employers that routinely use non-competes to protect their valuable assets, including trade secrets and goodwill. The NPRM was published in the Federal Register on January 19, 2023 and is subject to a public comment period before it becomes final (Non-Compete Clause Rule (NPRM), 88 Fed. Reg. 3482 (Jan. 19, 2023), to be codified at 16 C.F.R. pt. 910). The FTC has received thousands of comments and most experts anticipate that the proposed rule will be challenged on multiple grounds.

Practical Law Labor & Employment reached out to Peter A. Steinmeyer and Erik W. Weibust of Epstein Becker & Green, P.C. for their insights about the proposed rule and what employers should be doing now to protect their trade secrets and other valuable assets amidst this uncertain legal landscape.

Pete and Erik are Members of Epstein Becker & Green. They both focus on trade secrets and employee mobility issues and are two of the co-hosts of EBG's *Spilling Secrets* podcast on trade secrets and non-compete law. Pete also was recently appointed to the Practical Law Labor & Employment Advisory Board.

What Are the Key Provisions of the Proposed Rule?

The proposed rule prohibits employers from entering into, enforcing, or attempting to enforce post-employment non-compete agreements with workers. 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" (NPRM, 88 Fed. Reg. 3482, 3535, to be codified at 16 C.F.R. § 910.1(b)(1)). The proposed rule is notable in that it:
  - is not limited to non-competes with employees, but includes all workers, including independent contractors; and
  - also bans "de facto" non-competes, without clearly defining what they are. The FTC states that it will apply a "functional test" when determining whether a contractual provision has the de facto effect of prohibiting the worker from seeking or obtaining other employment or operating a business, regardless of what the term is called (NPRM, 88 Fed. Reg. 3482, 3509, 3535, to be codified at 16 C.F.R. § 910.1(b)(2).)
- If and when effective, requires employers to:
  - rescind existing non-compete agreements within 180 days of publication of a final rule in the Federal Register (see Is the Rule Retroactive?); and
  - provide individualized notice to current and former workers who were previously covered by a non-compete that the non-compete is no longer in effect.

  (NPRM, 88 Fed. Reg. 3482, 3535, to be codified at 16 C.F.R. § 910.2(b).)

- Includes a narrow exception for non-competes entered into in connection with the sale of a business (NPRM, 88 Fed. Reg. 3482, 3536, to be codified at 16 C.F.R. § 910.3; see also Are There Any Exceptions to the Non-Compete Ban?).
- Supersedes any state law contrary to the non-compete ban, but not any law providing greater protections for workers (NPRM, 88 Fed. Reg. 3482, 3536, to be codified at 16 C.F.R. § 910.4).

Are There Any Exceptions to the Non-Compete Ban?

As drafted, the proposed rule is very broad, but does have certain limitations. For example, it does not purport to ban:

- **Restrictive covenants other than "pure" non-competes**. The non-compete ban is limited to traditional "pure" non-competes. It does not per se prohibit other restrictive covenants, such as customer or employee non-solicits, unless they are so broad that they function as a "de facto non-compete."
- **Confidentiality agreements**. The proposed non-compete ban similarly does not per se prohibit confidentiality agreements, unless they are so broad that they functionally prevent a worker from working in the same field for another employer or in business for themselves.
- **Fixed-term employment contracts**. In supplementary information regarding the proposed rule, the FTC clarifies that the non-compete ban does not apply to contracts of employment with a fixed duration and specifically states that they are permissible (NPRM, 88 Fed. Reg. 3482, 3507). This is consistent with California law, where employment contracts for fixed durations are permitted, even though post-employment non-competes are not. If an employee with a fixed-term employment agreement leaves for a competitor before the contract term ends, the former employer can sue the departing employee for damages arising from the contract breach, but cannot bar them from taking the new job.
- **Concurrent employment restraints.** The FTC's supplementary information regarding the proposed rule specifically states that the non-compete ban "would apply only to post-employment restraints" but not to "concurrent-employment restraints," namely "restrictions on what the worker may do during the worker's employment" (NPRM, 88 Fed. Reg. 3482, 3509). It therefore appears that certain routine "garden leave" clauses (where the employee must give advance notice of their resignation, but remains an employee and is paid during the notice period) are permissible, unless they could somehow be deemed a de facto non-compete.
- **Sale of business non-competes.** The proposed rule includes an express carve-out for non-competes entered into in connection with a person:
  - selling a business entity;
  - otherwise disposing of all of the person's ownership interest in the business entity; or
  - selling all or substantially all of a business entity's operating assets.

  (NPRM, 88 Fed. Reg. 3482, 3536, to be codified at 16 C.F.R. § 910.3.)

  However, to be covered by this exception, the person must own at least 25% of the equity in the company at the time of entering into the non-compete, making this ban more restrictive than California's long-standing non-compete prohibitions (NPRM, 88 Fed. Reg. 3482, 3535-36, to be codified at 16 C.F.R. §§ 910.1(e) and 910.3).
- **Employers not covered by the FTC Act.**Finally, the FTC's supplementary information regarding the proposed rule specifically states that certain employers are exempt from the rule because they are not subject to the FTC's rulemaking jurisdiction under the FTC Act. These employers include:
  - certain banks;
  - savings and loan associations;
  - common carriers;
  - air carriers; and
  - nonprofit organizations.

  (NPRM, 88 Fed. Reg. 3482, 3509; see also 15 U.S.C. §§ 44-45.)

Is the Rule Retroactive?

Simply put, yes. One of the most startling things about the proposed rule is that it not only bans employers from entering into non-competes in the future but voids all existing non-competes. The proposed rule therefore requires that employers both:

- Rescind any non-competes by a specified compliance date (180 days after the final rule is published in the Federal Register).

- Notify current and former employees in an individualized written or electronic communication that their existing non-competes are no longer in effect and will not be enforced. The proposed rule includes model language to be used for this purpose.

(NPRM, 88 Fed. Reg. 3482, 3535-36, to be codified at 16 C.F.R. §§ 910.2(b) and 910.5.)

Note that in some cases employers will have paid significant consideration (in addition to or other than an offer of at-will employment) in exchange for an employee's or former employee's agreement to a non-compete provision. The proposed rule, at least in its current form, does not include any mechanism for employers to recover that past consideration.

Are There Any Ambiguities or Unknowns in the Proposed Rule?

As with many proposed rules and legislation, there are several ambiguities and unanswered questions. For example, the proposed rule is unclear about:

- The scope of what constitutes a "de facto" non-compete. The FTC has stated it will take a functional approach to determine what constitutes a prohibited non-compete (NPRM, 88 Fed. Reg. 3482, 3509). As an example, the FTC specifically mentions confidentiality provisions, which are generally permitted, unless they are written so broadly that they "effectively preclude[] the worker from working in the same field after the conclusion of the worker's employment with the employer" (NPRM, 88 Fed. Reg. 3482, 3535, to be codified at 16 C.F.R. § 910.1(b)(2)(i)). The same de facto non-compete test would also apply to otherwise permissible restrictions such as customer or co-worker non-solicits, or garden leave clauses requiring advance notice of resignation. For example, if the garden leave clause is unduly long, or the employee is not entitled to their full compensation and benefits during the garden leave period, the FTC might deem the clause a prohibited de facto non-compete.
- The application to forfeiture for competition provisions (that is, a provision requiring forfeiture of deferred compensation if the employee engages in prohibited competition, without an outright prohibition on competition) and whether it will it depend on the size of the forfeiture in relation to the individual's compensation. For example, if an individual earning $100,000 per year were required to forfeit deferred compensation of $100,000 if they left and joined a competitor, would the FTC deem that forfeiture a de facto non-compete? Would the result be different if the individual were earning $1,000,000 and forfeited the same $100,000 for engaging in prohibited competition?
- The application to certain ERISA-governed employee benefit plans. It is unclear whether the FTC would view a benefit plan, which is a distinct legal entity from the sponsoring employer, to be an agent of the employer under the proposed rule.

Does the FTC Even Have the Authority to Make This Rule?

Section 5 of the FTC Act empowers the FTC, among other duties, to prevent unfair methods of competition and unfair or deceptive acts or practices affecting interstate commerce. It gives the FTC authority to investigate possible violations, seek monetary damages, prescribe rules to prevent unfair or deceptive practices, and make reports and recommendations to Congress and the public. (15 U.S.C. §§ 41-58). For more on the FTC Act, see Practice Note, FTC Act Section 5: Overview.

Non-compete agreements traditionally have been governed by state laws that vary widely across jurisdictions. Until recently, the FTC has not been actively engaged in regulating non-compete agreements between employers and their workers.

With the NPRM, the FTC is attempting to regulate non-competes as a purportedly "unfair method of competition" under Section 5. News of the proposed rule came directly on the heels of the FTC's announcement that it had entered into consent decrees arising out of two enforcement actions accusing employers of engaging in unfair methods of competition by using non-competes. The FTC had not previously brought enforcement actions regarding these practices.

Practitioners on all sides expect significant challenges to the FTC's authority to issue and enforce the rule, especially given its breadth and scope. Legal challenges to the FTC's authority are based on several theories, including:

- **The non-delegation and major questions doctrines.** Some may argue that the proposed rule is an impermissible delegation of legislative authority and that the FTC lacks authority to engage in "legislative" rulemaking. The Supreme Court's 2022 decision in *West Virginia v. Environmental Protection Agency* applied the "major questions doctrine" to strike down

an environmental regulation on the basis that the EPA did not have "clear congressional authority" to issue a rule concerning an issue of "great political significance" that would affect "a significant portion of the American economy" (142 S. Ct. 2587, 2608-10 (2022)). Many believe a court would find that the FTC similarly lacks authority to issue this rule.

- **Arbitrary and capricious rulemaking.** Some contend that a court would set aside this rulemaking as arbitrary and capricious under the Administrative Procedures Act (APA) (5 U.S.C. § 706).

Commissioner Christine S. Wilson issued a dissenting statement with the proposed rule, noting that the rule is "vulnerable to meritorious challenges" on several grounds and will likely "lead to protracted litigation in which the Commission is unlikely to prevail" (NPRM, 88 Fed. Reg. 3482, 3540). The US Chamber of Commerce similarly issued a statement that the proposed rule is "blatantly unlawful" and announced its confidence that "this unlawful action will not stand" (US Chamber of Commerce: The FTC's Noncompete Rulemaking Is Blatantly Unlawful" (Jan. 5, 2023)).

Given the extent and divergence of public comments and threatened challenges to the proposed rule, it is possible that the FTC will issue a final rule that is substantially revised from the current version. Whatever form the final rule takes, there most certainly will be legal challenges to its constitutionality and enforceability before it becomes effective, if ever.

What Should Employers Do Now?

While the ultimate fate of the proposed rule remains uncertain, there are several steps employers should consider taking during this period of flux:

- **Submit written comments.** Members of the public, including employers, have an opportunity to provide comments on the proposed rule during the comment period. Employers that routinely use non-competes with their workers should consider submitting comments, preferably through industry or trade groups to avoid drawing individual attention from the FTC. The NPRM specifically is seeking comments on several topics, including whether:
  - franchisees should be covered;
  - senior executives should be exempt from the rule or subject to a rebuttable presumption of unenforceability rather than an outright ban; and
  - low-wage and high-wage workers should be treated differently under the rule.

  As of February 3, 2023, the FTC already received nearly 10,000 comments on the proposed rule. The comment period is scheduled to close on March 20, 2023, but on January 31, 2023, 100 industry groups, including the US Chamber of Commerce, requested that the FTC grant a 60-day extension of the comment period. We expect that the FTC will grant this request.
- **Monitor and comply with evolving state law.** Employers should focus on compliance with state non-compete laws, which have been evolving substantially over the past few years. Many states now include compensation thresholds and notice requirements, among other due process-type protections. Employers should ensure that they are in compliance with all applicable laws and pay particular attention with their remote workers who may be entitled to greater protections than those available where the business is primarily located. To view and customize an up-to-date comparison of state non-compete laws, see Quick Compare Chart, State Non-Compete Laws (access may vary by subscription).
- **Review existing non-compete agreements.** While expected legal challenges play out, employers are not legally required to make any immediate changes in their non-compete practices. However, the FTC may continue to flex its regulatory muscle with enforcement actions, likely targeted at companies that use non-competes with low wage workers or in other ways that the FTC may consider to be abusive. Given the current climate, employers should review and evaluate the nature and scope of their non-compete agreements and ensure they are being used to protect legitimate business interests and comply with applicable state laws.
- **Consider a trade secret audit.** Employers should evaluate what they are doing to protect their trade secrets and what they can do better, for example, by:
  - identifying and labelling trade secrets;
  - securing them through limited access and contractual protections; and
  - training employees about the importance of protecting them.

  For more on trade secret audits, see Practice Note, Trade Secret Audits. For customizable training materials, see Standard Document, Protecting a Company's Confidential Information and Trade Secrets: Presentation Materials.

- **Don't panic.** The proposed rule as it stands is unlikely to become the law of the land. But employers should use this opportunity to stay ahead of the legal and regulatory trend toward limiting when and against whom non-competes are enforceable and use their non-compete agreements wisely.