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FAQs on FTC Proposal to Ban Employer-Worker Non-Compete Clauses

As discussed in our prior memorandum, the Federal Trade Commission (FTC) recently proposed a rule that would impose a blanket ban on existing and new employer-worker non-compete agreements by classifying them as "unfair methods of competition." The proposed rule would require employers to refrain from entering into new non-compete agreements with workers and to rescind existing non-compete agreements by actively informing former workers subject to such agreements that they are no longer in effect.

The proposed rule is subject to a 60-day comment period and possible revision by the FTC before it becomes final, and comments can be expected from a wide range of interested parties. In addition, there will likely be legal challenges to the FTC's authority to promulgate the rule, which may delay or ultimately prevent the implementation of the final rule.

While it is relatively unlikely that the proposed rule will become effective in its current form, this memorandum addresses frequently asked questions about the scope and application of the proposed rule, the path and premise of expected legal challenges to it and what businesses can do in the interim to anticipate a potential final FTC rule restricting the use of employer-worker non-compete agreements.

General

Q. What is the FTC proposing to do?

A. The FTC is proposing to ban virtually all existing and future non-compete clauses in agreements between "employers" and "workers." The FTC asserts that these clauses are "unfair methods of competition," which are illegal under Section 5 of the FTC Act, and the rule would create a mechanism for the FTC to take action against businesses that maintain, include or attempt to include non-compete clauses in their contracts with their workers, or represent to workers that they are subject to non-compete clauses.

Q. Hasn't the FTC already brought enforcement actions against businesses for having non-competes with workers?

A. Yes. The day before the proposed rule was announced, the FTC settled allegations against three businesses that their non-compete agreements with their workers were unfair methods of competition that violated the FTC Act. The employers in those actions did not contest the administrative actions, and agreed to cease imposing non-compete restrictions on workers and business ventures, to notify affected workers that they were no longer bound by non-compete restrictions, to provide notices to workers responsible for hiring and recruiting and to provide clear notices to relevant employees that they may freely seek or accept employment with the employer's competitors. Because the companies settled, no court ruled on whether the non-compete clauses violated the FTC Act.

Q. How would the proposed rule change existing laws governing non-competes?

A. Currently, the legality of employer-worker non-competes is determined by the laws of the individual states. California, North Dakota and Oklahoma prohibit employment non-compete clauses. Several other states and the District of Columbia permit employment non-competes in limited contexts. For example, Colorado, Illinois, Maine, Maryland, Massachusetts, Nevada, New Hampshire, Oregon, Rhode Island, Virginia, Washington and the District of Columbia permit non-compete clauses only for employees making more than a statutory minimum. Those minimums vary but, for example, in D.C., non-compete clauses are enforceable only against employees making at least $150,000 per year.

The proposed rule purports to preempt all state and local laws that are inconsistent with its provisions. This means that states still could enforce their own non-compete laws as long as those laws are broader–but not narrower–than the FTC's proposed rule. In addition, the proposed rule's categorical ban on non-competes would be inconsistent with decades of common law precedent, under which the reasonableness of a non-compete clause is examined on a case-by-case basis, with a focus on the duration and geographic scope of the non-compete clause at issue, as well as any purported justification for it.

Scope of the Proposed Rule

Q. What types of non-compete agreements would be prohibited by the proposed rule?

A. Generally, *post-employment* non-compete provisions in employer-worker agreements are prohibited by the proposed rule. These are defined as contractual terms between an employer and a worker that prevent the worker from seeking or accepting employment, or operating a business, after the conclusion of the worker's employment with the employer.

Q. Would non-disclosure agreements, non-solicitation agreements or other restrictive employment covenants be prohibited by the proposed rule?

A. Certain restrictive covenants would be prohibited under the proposed rule if the FTC deems them to be "de facto" non-competes. According to the FTC, such "de facto" competes could include a non-disclosure agreement that is "written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer," a training repayment agreement that "requires the worker to pay the employer or a third-party entity for training costs if the worker's employment terminates within a specified time period, where the required payment is not reasonably related to the costs the employer incurred for training the worker" or a liquidated damages provision that "require[s] the worker to pay the employer a sum of money if the worker engages in certain conduct."

However, the FTC notes that "restrictive employment covenants–such as non-disclosure agreements and client or customer non-solicitation agreements" that "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" would not be prohibited by the proposed rule.

Q. What types of "employers" would be subject to the proposed rule?

A. The proposed rule broadly defines "employer" as any natural person, partnership, corporation, association, limited liability company or other legal entity (or a division/subsidiary thereof) that hires or contracts with a worker to work for the person.

However, according to the FTC, some employers, including most non-profits (for example, a hospital structured as a not-for-profit corporation), would be exempt from the proposed rule. This is because the FTC Act provides that the FTC can enforce Section 5 against "persons, partnerships, or corporations," which are defined as entities "organized to carry

on business for [their] own *profit* or that of [their] members." Thus, the FTC's authority does not extend to non-profit entities, unless the non-profit is organized by and operates for the benefit of for-profit members, or the non-profit status of the organization is otherwise baseless.

Q. What types of "workers" would be covered by the proposed rule?

A. The proposed rule broadly defines "worker" as any "natural person who works, whether paid or unpaid, for an employer." That includes "without limitation, an employee, individual classified as an independent contractor, extern, intern, volunteer, apprentice or sole proprietor who provides a service to a client or customer." The proposed rule does not draw any distinctions based on skill, seniority or wage/salaried workers.

"Worker" does *not* include "a franchisee in the context of a franchisee-franchisor relationship." The FTC views the relationship between a franchisor and franchisee as potentially more analogous to the relationship between two businesses than the relationship between an employer and a worker. However, the proposed rule would cover natural persons who work for either a franchisee or franchisor.

Q. Does "worker" include a partner in a partnership entity or a member of a company with an ownership stake?

A. This is unclear. On its face, the proposed rule would appear to prohibit non-compete clauses restricting such partners or members who also provide services as "workers" to the entity, even if the partner or member continues to hold their ownership position after the term of employment ends. This approach would create a distinction between partners who provide services to the partnership or its affiliates (who appear to be covered by the proposed rule and therefore could not be subject to non-competes) and partners who do not provide such services (who presumably could remain subject to non-competes). There are strong arguments as to why partners, like other equity owners, should not be subject to a bright line ban on non-competes, particularly for covenants given in their capacity as equity owners.

Q. Does the proposed rule contain any exceptions for senior executives, highly paid workers or highly skilled workers?

A. No. As written, the proposed rule does not distinguish between workers based on skill, pay or seniority. The ban on non-competes applies to any and all workers. However, the FTC recognizes certain differences between senior executives and other workers in its findings and explicitly seeks public comment on several alternatives to the proposed rule's broad prohibition, including whether non-competes between employers and senior executives should be subject to a different standard.

Q. Does the proposed rule contain an exception for non-competes related to the sale of a business?

A. Yes, but it is a narrow exception. The proposed rule would not prohibit an employer-worker non-compete clause entered into by a person selling a business entity, or otherwise disposing of all of their ownership interest in the business entity, or by a person selling all or substantially all of a business entity's operating assets, when the person restricted by the non-compete owns 25% or more of that business entity. This is a much more restrictive definition of "substantial ownership" than even states like California apply, and we expect to see a lot of commentary on this issue. Notably, the proposed rule does not explain what types of ownership interests (e.g., options, warrants or tiered ownerships) are considered in calculating the 25% threshold.

Comments and Timing

Q. What can employers, business entities or other organizations do to comment on the proposed rule?

A. Comments can be submitted electronically here through March 20, 2023. Comments submitted electronically may be submitted anonymously, but are *not* confidential and may be accessed by the public unless the commentor requests and is granted confidential treatment by the FTC. Comments may also be submitted by mail to the FTC.

Q. When might a final rule go into effect?

A. This is uncertain. Given the public comment period, the FTC's subsequent review of comments, a possible promulgation of a revised final rule and other interim developments, we likely will not see a final rule until the end of this year, if not later. Given the likelihood of legal challenges to the proposed rule before it becomes effective, and the possibility of a change in administration in 2024 further delaying the rule's enforcement, it is possible that the FTC will try to propose a final rule before the end of 2023, to ensure that the Biden administration will be able to defend the proposed rule against legal challenges.

Q. When would covered persons and entities have to comply with a final rule?

A. A final rule by the FTC would become effective within 60 days of publication in the *Federal Register*. Compliance with the final rule would be required 180 days after its publication in the *Federal Register*. Written notice must be provided to workers subject to covered non-compete provisions within 45 days of the compliance date. However, it is possible that a court would stay enforcement of the rule by the FTC during the pendency of a legal challenge, which would delay the compliance period.

Compliance and Enforcement

Q. What would employers have to do to comply if the proposed rule becomes effective in its current form?

A. In order to comply with the proposed rule, covered employers would have to rescind existing non-competes and provide written notice to workers that their non-compete clause is no longer in force. The proposed rule includes model language for this notice. Employers would also be prohibited from entering into or attempting to enforce non-compete agreements with workers.

Q. How would the rule be enforced once effective?

A. The FTC could bring an administrative action against an employer for violations of the FTC Act—the law the FTC is using to promulgate the rule.

Q. Does the proposed rule create a private right of action for a worker to sue an employer?

A. No. There is no private right of action under the FTC Act and therefore individual workers would not be able to sue employers for violating the rule. However, it is possible that a worker could file a declaratory judgment action under state or other existing law in which the worker seeks to void the non-compete provision in the worker's agreement with the employer, and cite in support of that action the FTC's rule and/or the FTC's underlying findings as a basis for that requested relief.

Q. What would the legal consequences be if an employer violated the rule?

A. Because this is the first time the FTC has attempted to issue a rule banning a business practice solely on the basis that the FTC has found the practice to be an unfair method of competition (as opposed to an unfair or deceptive act or practice) under the FTC Act, it is not clear what all of the legal consequences might be. It is anticipated that if it believes that an employer has been or is violating the rule, the FTC would seek an administrative order requiring the employer to cease and desist enforcing covered non-compete clauses, and would seek civil penalties if the employer violated the order. Currently, the FTC is authorized to seek penalties of up to $50,120 for each violation of the FTC Act.

Q. Is there a risk of the FTC bringing enforcement actions against employers with non-competes even before the rule becomes final?

A. Yes. The FTC recently took enforcement actions against three companies that it alleged were engaging in unfair methods of competition through the use of non-competes. The various non-competes at issue applied to hourly, salaried and highly skilled workers, such as engineers. The companies settled with the FTC by agreeing to not enforce, threaten to enforce or impose non-competes against any relevant employees, and to provide notices to employees regarding non-competes.

Implications and Practical Considerations

Q. What are the high-level implications of this rule for mergers and acquisitions?

A. There are concerns that the proposed rule would allow highly valued and knowledgeable employees of an acquired business to work for a competitor immediately post-merger or acquisition. Specifically, under the proposed rule, if an employee who is not retained after a combination or acquisition process is not subjected to a non-compete restriction, they would be free to bring their expertise and experience to a competitor of the surviving entity. This could significantly impact the value of the transaction and the value of the business.

Q. Does the proposed rule prohibit non-compete clauses in effect during garden leave or extended notice periods?

A. The proposed rule does not expressly address garden leave policies or extended notice provisions.

Garden leave is a designated period of time during which an employee who has been given notice of termination or who has resigned or retired is required to stay away from the workplace while remaining technically employed and paid by the employer. Similarly, extended notice provisions require employees to give notice well in advance of officially separating from a company, such that they would not be able to compete during the notice period even if they effectively have stopped providing services to the company. These provisions are generally treated as terms of continued employment. Therefore, the proposed rule—which is limited to post-employment non-competes—would not appear to prohibit garden leave or extended notice provisions.

However, courts have treated garden leave and extended notice periods as non-compete provisions. It is possible that the FTC could interpret these terms as restrictions on an employee's ability to seek new employment, and therefore "de facto" non-compete clauses subject to the rule. This is a point that might be clarified by the FTC and we may see some commentary on this.

Q. Would non-compete clauses be permissible under the rule when the non-compete is made in exchange for benefits like deferred compensation, equity grants or severance?

A. The proposed rule would appear to prohibit post-employment non-compete clauses even when they are agreed to in exchange for deferred compensation, equity grants, severance pay or other benefits. For this reason, if the proposed rule were to become effective in its current form, employers should be careful not to guarantee consideration subject to a non-compete clause because that clause could be deemed invalid, and the employer may nevertheless be required to pay the consideration that was promised.

Q. Would non-compete clauses subject to stock or equity forfeiture in the event the departing worker competes be permissible under the rule?

A. The proposed rule does not expressly address non-competes that are subject to stock or equity forfeiture or clawback provisions, where, for example, a worker might "choose" to compete subject to those consequences. However, it is quite possible that such provisions would be deemed to operate as "de facto" non-compete clauses, particularly where the amount of the forfeiture or clawback or other economic impact on the worker is substantial enough that the FTC would view the worker effectively as having no choice but to agree not to compete. Again, if the proposed rule were to become effective in its current form, employers should be careful not to guarantee consideration subject to a non-compete clause because that clause could be deemed invalid, while the employer must still pay the promised consideration.

Q. What should my business be doing now?

A. It is important to remember that the rule is only proposed at this stage and is subject to comment and potential revision and legal challenge before it becomes effective. Employers don't *need* to do anything yet, as this is a proposed rule that merely starts a public commentary process. It will take some time before there is a final effective rule.

But employers may want to begin thinking about the potential implications of a final rule on their current approach to employer-worker non-compete clauses, especially if their non-competes restrict a wide range of workers—from administrative assistants to senior executives—in the same or similar ways.

Employers should first identify the key issues they would like to address using non-compete clauses—such as protecting intellectual property, trade secrets, proprietary information and goodwill. Then employers should consider whether those interests might be protected by other narrowly targeted contractual provisions. These might include stronger provisions regarding confidentiality and theft or misuse of intellectual property, trade secrets and proprietary information, or solicitation of customers, clients, investors or employees by a former or departing employee. Employers might also consider including an express acknowledgment by the employee that these provisions are not unfair or unreasonable.

If employers would like to maintain provisions that hew closely to a non-compete obligation, contractual provisions that incentivize an employee not to compete by offering benefits or give the employee the option to forfeit benefits if they choose to compete may have the best chance of not being deemed de facto non-compete clauses under the proposed rule. In addition, employers can consider whether to include language requiring the employee to acknowledge that compensation is subject to continued employment and providing for fixed-term contracts in certain circumstances.

Anticipated Legal Challenges to the Rule

Q. How likely is it that the proposed rule will become effective in its current form?

A. It is unlikely, given the breadth of the proposed rule and the relatively little precedent for the FTC's rulemaking authority in this area. This rule has already generated a high level of interest, and we expect a large number of comments to be submitted. We expect the current rule to be revised in response to those comments before a final rule is proposed.

Q. How might the proposed rule be revised?

A. The FTC itself has suggested that there may be some alternatives to the proposed rule, such as creating a rebuttable presumption that non-competes are unlawful and/or differentiating among categories of workers that would be covered by the proposed rule.

Another area in which the FTC may soften the rule concerns the protection of intellectual property, trade secrets and other proprietary information, as many employers use non-competes to prevent theft and misuse of such information by workers, including using the information to the advantage of the employer's competitor.

Q. Does the FTC even have authority to issue this rule under the FTC Act?

A. This is unclear and likely to be the subject of legal challenges. This is the first time in over 50 years that the FTC has proposed a rule to regulate business practices that it perceives to be "unfair methods of competition." The FTC Act expressly gives the FTC rulemaking authority in the consumer protection area related to unfair or deceptive acts or practices, but there is no clear grant of rulemaking authority for unfair methods of competition. The FTC is relying on Section 6(g) of the FTC Act, which generally provides that the FTC has power "to make rules and regulations for the purpose of carrying out the provisions" of the FTC Act.

The FTC states that it has authority to regulate unfair competition, citing to a single D.C. Circuit opinion from the 1970s—*National Petroleum Refiners*—which suggests that the FTC has rulemaking authority when the FTC regulates both deceptive practices and unfair methods of competition (but not solely the latter). Notably, the FTC has not enacted any rules concerning unfair methods of competition since *National Petroleum Refiners* was decided. And, in 2021, in *AMG Capital Management, LLC* v. *FTC*, the Supreme Court held that the FTC cannot assert broad remedial powers without an express grant of statutory authority. The U.S. Chamber of Commerce has already released a statement indicating that it will challenge the final rule on the basis that the FTC lacks authority to promulgate it.

Q. What other legal challenges are likely to be made against the proposed rule?

A. There are several other potential legal challenges to the proposed rule, including:

- Major questions doctrine. Even if the FTC has rulemaking authority in this context, the proposed rule may be challenged on the basis that it violates the major questions doctrine, which requires Congress to speak clearly when authorizing agency action on an issue of "national significance." The Supreme Court cited this doctrine in *West Virginia* v. *EPA* (2022), where it held that the EPA lacks authority to regulate greenhouse gas emissions because such a regulation impacts multiple industries and implicates the authority of multiple agencies, and therefore needs to be authorized clearly by Congress. Should the proposed rule remain as broad as currently proposed, given the anticipated impact on the U.S. economy overall (the FTC itself states that the proposed rule is expected to invalidate 30 million non-competes and increase wages by almost $300 billion nationwide), we can expect a challenge under the major questions doctrine.

- Nondelegation doctrine. Even if the FTC has rulemaking authority in this area, the proposed rule may be challenged on the basis that Congress impermissibly delegated its authority to the agency. This is a likely challenge, particularly given the vague language in the FTC Act concerning the FTC's authority to regulate unfair competition. Notably, Congress has considered multiple times, but failed to enact, several statutes that would have banned or severely limited non-compete clauses. This legislative history may be cited in support of a challenge based on the nondelegation doctrine, arguing that non-competes should be Congress' prerogative to legislate and that Congress has attempted to do so in the past.

- Preemption. The proposed rule may be challenged because, if finalized in its current form, it would preempt state laws that are less restrictive (such as rules involving salary thresholds or applying a rebuttable presumption that a non-compete provision is reasonable). This could lead to a legal challenge concerning the preemption issue, questioning whether courts can enforce the federal law against the states' preexisting regimes.

- Violation of the Administrative Procedure Act. The proposed rule may also be attacked as an arbitrary and capricious agency action. The court may set aside agency action found to be arbitrary, capricious or an abuse of discretion if there is no rational connection between the facts found and the choice made by the agency. It is possible that the court finds that the FTC did not consider all the relevant factors and made a clear error in judgment by proposing a categorical ban on non-competes.

Q. What is the likely timing and path of such a legal challenge?

A. An action challenging the rule could be filed in federal district court as soon as it is issued in final form. Legal challenges are likely to be filed prior to the effective date of the final rule and seek injunctive relief in order to stop the rule from going into effect.

There is speculation that a plaintiff might chose a venue in the Fifth Circuit (perhaps in Texas) given that Circuit's recent track record of ruling against the current Administration. Depending on the timing of any ruling by the appeals court, it is likely that the losing party would appeal to the Supreme Court because of the importance of questions concerning the scope of the FTC's rulemaking authority. As a result, it could be years before we know the fate of any final rule.

Q. Would the proposed rule become effective during the pendency of a legal challenge?

A. The answer depends on the timing and scope of the legal challenges to the proposed rule, including the relief sought. We expect that challengers, particularly those seeking a ruling that the proposed rule exceeds the FTC's rulemaking authority, would seek a nationwide preliminary injunction during the pendency of the lawsuit. If such a preliminary injunction were granted, the final rule would not become effective until after the resolution of the lawsuits.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Robert A. Atkins
+1 212-373-3813
robert.atkins@paulweiss.com

Joseph J. Bial
+1 202-223-7318
jbial@paulweiss.com

Andrew C. Finch
+1 212-373-3417
afinch@paulweiss.com

Jarrett R. Hoffman
+1-212-373-3670
jhoffman@paulweiss.com

Brad S. Karp
+1 212-373-3316
bkarp@paulweiss.com

Randy Luskey
+1 628 432-5112
rluskey@paulweiss.com

Jean M. McLoughlin
+1 212-373-3135
jmcloughlin@paulweiss.com

Jacqueline P. Rubin
+1 212-373-3056
jrubin@paulweiss.com

Kannon K. Shanmugam
+1 202-223-7325
kshanmugam@paulweiss.com

Joshua H. Soven
+1 202-223-7482
jsoven@paulweiss.com

Eyitayo St. Matthew-Daniel
+1 212-373-3229
tstmatthewdaniel@paulweiss.com

Aidan Synnott
+1 212-373-3213
asynnott@paulweiss.com

Brette Tannenbaum
+1 212-373-3852
btannenbaum@paulweiss.com

Laura C. Turano
+1 212-373-3659
lturano@paulweiss.com

Liza M. Velazquez
+1 212-373-3096
lvelazquez@paulweiss.com

Lawrence I. Witdorchic
+1 212-373-3237
lwitdorchic@paulweiss.com

Reuven Falik
+1 212-373-3399
rfalik@paulweiss.com

Jared P. Nagley
+1 212-373-3114
jnagley@paulweiss.com

Pietro J. Signoracci
+1 212-373-3481
psignoracci@paulweiss.com

Associate Tiffany Gee Ching Lo and Practice Management Attorney Mark R. Laramie contributed to this Client Memorandum.