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Client Alert Commentary

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New FTC Rulemaking Seeks to Ban Most Non-Competes

FTC proposes a new rule that would ban non-competes in most situations; brings enforcement actions challenging non-competes as unfair methods of competition.

On January 5, 2023, the Federal Trade Commission (FTC) issued a Notice of Proposed Rulemaking (the Proposed Rule) that would ban post-termination non-compete clauses and require employers to rescind existing ones, while also significantly limiting deal-based non-compete clauses.[1]

The Proposed Rule comes just one day after the FTC announced it has taken legal action against three separate companies and two individuals, challenging their non-compete agreements as unfair methods of competition under Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (FTC Act). The FTC concurrently announced settlements with the parties, in each case requiring the defendants to rescind all existing non-compete agreements and barring them from entering into any agreements with future non-compete clauses.

The FTC's Proposed Rule and enforcement actions follow President Biden's July 9, 2021 Executive Order on Promoting Competition in the American Economy, in which the administration encouraged the FTC to use its rulemaking authority to "curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility." Separately, the US Department of Justice Antitrust Division (Antitrust Division) has pursued efforts to criminalize employee non-solicitation and non-poach agreements between competitors.[2] Companies must navigate these issues carefully as they assess how best to manage their human resources and protect their business interests.

Understanding the Proposed Rule on Non-Compete Clauses

The Proposed Rule, if finalized, could radically change restrictive covenants law in the US. Some key takeaways include the following:

- Employers would be barred from entering into a non-compete clause that prevents a worker from seeking or accepting employment or operating a business after the conclusion of the worker's employment with the employer. The term "worker" is broadly defined to include not only employees but also independent contractors, sole proprietors, volunteers, interns, and any other individuals who work, whether paid or unpaid, for an employer. The Proposed Rule is not limited to workers with specific classifications, titles, or compensation levels.

- *De facto* non-compete clauses that effectively prohibit workers from seeking or accepting new employment would also be banned. As an example of a potential *de facto* non-compete, the Proposed Rule cites a non-disclosure clause that is so broad that it prohibits the worker, as a practical matter, from working for a new employer in the same field as the worker's previous employer.

- The Proposed Rule does not expressly address non-solicitation agreements; however, like non-disclosure agreements, non-solicitation agreements could be viewed as unlawful *de facto* non-compete clauses if they are too broad. If the Proposed Rule takes effect, all restrictive covenants (including customer and employee non-solicitation agreements and non-disclosure prohibitions) must be carefully reviewed and tailored to avoid classification as *de facto* non-competes.

- The Proposed Rule provides a narrow exception for a non-compete clause entered into by a substantial owner, member, or partner upon the sale of a business entity or when any such person otherwise disposes of all ownership interests; however, this exception requires that the restricted person holds *at least* 25% ownership interest in such business entity, though the Proposed Rule does not explain how to determine ownership interest. Due to the significant interest required to qualify as a substantial owner, member, or partner, most deal-based non-compete clauses would end under the Proposed Rule. The sale-based exception under the Proposed Rule is notably even more restrictive than existing California Business and Professions Code §§ 16601, 16602 and 16602.5, which generally permit non-compete clauses entered into upon the sale of a business or termination of a partner or member's interest in a business, respectively, but with no bright-line threshold for interest percentage.

- The Proposed Rule does not apply to a non-compete clause entered into by a franchisee in the context of a franchisee-franchisor relationship.

- If the Proposed Rule takes effect, employers will need to rescind *all existing* non-competes within 180 days of publication of the final rule. Within 45 days of the rescission, employers would need to provide individual notices to all current and former workers stating that they are no longer subject to the post-termination non-compete clause. The Proposed Rule provides a model notice form for this purpose. It is not clear whether and how employers could also rescind the severance, equity interests, or other consideration provided to the employees for such non-competes.

Historically, the enforceability of non-compete clauses has been largely left to state common law, under which employment-based non-compete clauses are generally enforceable in most states to the extent they are reasonable and necessary to protect legitimate employer interests. In a few states (California, Oklahoma, and North Dakota), there have been long-standing effective bans on post-termination non-compete clauses. In more recent years, an increasing number of state legislatures have passed statutes to restrict the use of non-compete clauses; however, none of these recent changes has gone so far as to ban post-termination non-compete clauses broadly, though some states have banned non-compete clauses with low-wage earners. Although the Proposed Rule allows states to impose more stringent restrictions, based on current law, it would effectively end the long-standing ability of an individual state to determine the enforceability of non-compete clauses within its jurisdiction.

The Proposed Rule Has No Immediate Effect

No immediate action by employers is required, though employers may wish to consider some proactive measures identified below. The Proposed Rule will need to clear several hurdles before it becomes effective. First, the Proposed Rule is subject to a 60-day public comment period, during which the public

is invited to remark on the Proposed Rule.[3] Once the comment period closes, the FTC may elect to modify the Proposed Rule before deciding whether to invite further comments or issue final rulemaking. The FTC would issue the final rule upon a majority vote of the then-sitting FTC Commissioners.[4] If the final rule is issued, it will become effective at that point — at least on its face.

However, if the Proposed Rule takes effect, many in the business community expect that any final rule will be subject to immediate legal challenge and potential injunctive stays, which would delay — if not entirely undermine — the Proposed Rule's effect. One likely challenge to the Proposed Rule would be that it violates the so-called "Major Questions Doctrine," which the US Supreme Court cited in *West Virginia v. Environmental Protection Agency*, 597 U.S. (2022). The Court's decision in this case effectively negated a proposed Obama-era clean power plan proposed by the Environmental Protection Agency (EPA) under the Clean Air Act (CAA) because it was deemed to have impacts across industries and the authorities of multiple federal agencies, and therefore was outside the power given to the EPA under the CAA. These likely challenges could span years and multiple administration changes, making the future of the Proposed Rule unclear.

Putting the Proposed Rule in Context: Recent FTC Enforcement Actions

Whether the Proposed Rule ultimately goes into effect or not, it stands as a clear FTC policy statement on non-compete clauses generally. Recent FTC enforcement actions further demonstrate that, even without the Proposed Rule, the FTC is prepared to challenge non-compete clauses as violations of the FTC Act's prohibition against unfair methods of competition.[5]

On January 4, 2023 — just one day before the FTC announced its Proposed Rule — the FTC announced enforcement actions against three companies and two individuals under the FTC Act.[6] In parallel, the FTC announced proposed consent decrees requiring each party to drop all non-compete restrictions imposed on current and former employees and preventing each party from entering into any future non-competes with any current or future business ventures.

The complaints, facts, and terms of the consent decrees mirror the scope of the Proposed Rule in several ways. For example, in its complaint against two security companies and their owners (Prudential Security, Inc. and Prudential Command Inc.), the FTC claimed the parties used superior bargaining power to require low-wage security guards to sign contracts prohibiting them from working for a competing business within 100 miles for two years after leaving Prudential, subjecting the employees to a $100,000 penalty for any alleged violation of the term. While current employees were relieved of these non-competes when Prudential sold most of its business in August 2022, approximately 1,500 former employees remained subject to the restrictions.

The remedy proposed by the FTC likewise tracks the Proposed Rule. In the Prudential case, for example, the associated consent orders prohibit the employers from enforcing, threatening to enforce, or imposing non-competes against any prior, current, or future employees. In addition, the consent decrees:

- prevent the employers from communicating to any relevant employee or other employer that the employee is subject to a non-compete;
- require the employers to rescind the challenged non-competes without penalty to employees;
- require the employers to provide copies of the consent order to relevant current and past employees;

- require the employers to provide a copy of the complaint and consent order to current and future directors, officers, and employees responsible for hiring and recruiting; and

- for the next 10 years require the employers to provide clear and conspicuous notice to new relevant employees that they may freely seek and accept a job elsewhere at any time following employment.

Proactive Measures for Employers to Consider

Latham & Watkins will be monitoring the Proposed Rule and any other developments related to antitrust enforcement of non-competes, non-solicit, and non-poach agreements (as well as any other labor-related restrictions) closely. In the meantime, employers may wish to conduct an inventory of their agreements with current and former workers to assess whether any include non-compete or *de facto* non-compete clauses that would need to be rescinded, should the Proposed Rule take effect in its current form. With respect to any new non-compete clauses currently being negotiated, employers may wish to expressly preserve the ability to rescind the consideration provided for such non-compete clauses, should they later need to be rescinded.

Even if the Proposed Rule does not take effect, given the current FTC's general disdain for certain restrictive covenants and its recent enforcement actions, companies may wish to begin evaluating with counsel the business justification, necessity, and scope of their non-compete clauses and similar covenants. Companies should do so both in the contexts of employment agreements generally and M&A activity, to determine if they would be better served with limiting their reliance on such clauses and covenants or eliminating them entirely. Doing so may help avoid being targeted by the FTC and stay ahead of future bans or restrictions in this space.

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Endnotes

1 Non-Compete Clause Rulemaking, FTC Federal Register Notices (Jan. 5, 2023), https://www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking.

2 While not the focus of this Client Alert, please note that the Antitrust Division has actively prosecuted wage-fixing and no-poach (mutual non-solicitation) agreements between competitors as antitrust crimes. Most recently, in October 2022, the Antitrust Division secured its first guilty plea for criminal wage-fixing against a healthcare staffing company, and in December 2022, the Division survived a motion to dismiss a no-poach indictment against a group of aerospace executives. The Antitrust Division has signaled a strong interest in continuing to prosecute these matters.

3 Those interested in submitting a public comment on the Proposed Rule can do so electronically via www.regulations.gov, or by submitting a physical copy to the FTC. Comments should be marked "Non-Compete Clause Rulemaking, Matter No. P201200" so that they are routed appropriately. The comment will be placed on the public record, including the submitting party's name and state. All comments will be due within 60 days of the Proposed Rule being published in the Federal Register. (The Proposed Rule has not yet been published at the time of this writing, but we expect it will be shortly.) The FTC describes the process by which to submit public comments in more detail in its official rule-making statement, available at https://www.ftc.gov/system/files/ftc_gov/pdf/p201000noncompetenprm.pdf.

4 On the date that the FTC issued Proposed Rule, FTC Commissioner Christine S. Wilson issued a dissenting statement expressing her lack of support for initiating the proposed rulemaking.

5 Notably, as the FTC emphasized in a recent policy statement, conduct that is reasonable under the antitrust requirements of the Sherman Act might still constitute an "unfair method of competition" under the FTC Act. *See* https://www.ftc.gov/system/files/ftc_gov/pdf/P221202Section5PolicyStatement.pdf.

6 The FTC's description of its enforcement actions is available at https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc-cracks-down-companies-impose-harmful-noncompete-restrictions-thousands-workers.