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Employee Benefit Plan Review

The Federal Trade Commission Takes on Noncompetes

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The Federal Trade Commission (FTC or Commission) is in the midst of a major rulemaking that could impact nearly every labor and service relationship in the nation. In short, the FTC is attempting to ban most noncompete agreements nationwide.

This comes after President Biden issued an executive order recommending that the FTC use its rulemaking authority to limit noncompetes and "other clauses or agreements that may unfairly limit worker mobility." While this rule is unlikely to take effect in its current form, employers that rely on these types of agreements to protect their interests or who utilize them in negotiations with new or departing employees should take notice.

What Exactly Would the Proposed Rule Prohibit?

Employers would be prohibited from entering into, attempting to enter into, or maintaining a noncompete agreement with an employee. The proposed rule defines these broadly 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." This would cover agreements made both at the start and throughout an individual's employment. It would also make it considerably easier (and more lucrative) for employees to leave a job and either go work for a direct competitor or launch an enterprise of their own.

The rule would extend to a swath of employees (or "workers") including independent contractors, interns, volunteers, and others. The rule does not distinguish between classes of employees, either in title or wage. Even more, it would cover most employers, regardless of their size. That said, in the preamble to the proposed rule, the FTC recognizes that the proposed rule would not apply to entities that are not subject to the FTC Act, which includes 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 entities not "organized to carry on business for its own profit or that of its members." In addition, the proposed rule does not apply to a noncompete clause entered into by a franchisee in the context of a franchisee-franchisor relationship.

Would This Apply to Existing Noncompete Agreements?

Yes. Employers would have an affirmative burden of notifying their current and

former workers that any existing noncompete agreement is rescinded. Compliance would be mandatory within 180 days of the final rule and the FTC estimates $1.02 to $1.77 billion in one-time costs associated with direct compliance.

What About Other Types of Restrictive Covenants?

While the proposed rule would only outright ban noncompetes, other types of employment agreements would likely be affected. The rule would prohibit de facto noncompete agreements, defined as clauses that have "the effect of prohibiting 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." Under this standard, agreements would be subject to a "functional test" to determine whether an otherwise lawful clause is truly a prohibited noncompete. While this would likely be subject to legal debate, the rule expressly calls into question nondisclosure agreements and training reimbursement requirements.

How Many Employees Would Be Impacted?

While noncompetes are often associated with highly-skilled, high-wage employees like corporate executives, they are also used in some lower-paid workforces. According to the FTC, an estimated 30 million people – about one in five American workers – are currently bound to one.

Does the Proposed Rule Include a "Sale of Business" Exception?

The proposed rule contains a narrow exception for noncompete agreements in connection with the sale of a business. Under the exception, the seller of a business may enter a noncompete agreement with a buyer that restricts owners with at least a 24 percent ownership stake in the seller's business from competing with the buyer's business. This "sale-of-a-business" exception would apply both to sales of all assets of a company and to the sales of only a single division or subsidiary.

According to the FTC, "noncompete clauses between the seller and buyer of a business may be distinct from noncompete clauses that arise solely out of employment because they may help protect the value of the business acquired by the buyer." It further notes that restricting such noncompete agreements "could potentially affect business acquisitions, including the incentives of various market actors to start, sell, or buy businesses."

The proposed rule would not apply to a noncompete entered into by a person who is selling a business entity or otherwise disposing of all of the person's ownership in a business entity. It would not apply to a person who is selling all or substantially all of a business entity's operating assets, when the person restricted by the noncompete clause is a substantial owner of, or substantial member or substantial partner in, the business entity at the time the person enters into the noncompete clause.

- A "substantial owner, substantial member, and substantial partner" is defined as an owner, member or partner holding at least a 25% ownership interest in a partnership, corporation, association, limited liability company or other legal entity, or a division or subsidiary thereof, regardless of the consideration paid.
- Noncompete clauses covered by the exception would remain subject to federal antitrust law as well as all other applicable law.

How Would the Proposed Rule Apply to Executive Compensation Arrangements?

The removal of noncompete clauses would represent a fundamental shift in the negotiation of new executive compensation arrangements in many jurisdictions in a transaction context. Many executive compensation arrangements, including employment agreements, severance plans, equity plans and award agreements, contain provisions that would qualify as noncompete clauses under the proposed rule.

It is not clear from the text of the proposed rule how or whether it would apply to noncompetes in certain sophisticated incentive compensation or profits-sharing plans, including carried interest plans, in which the carry vehicle entity (typically an LLC or partnership) is not the employer and the individual is a member of or partner in the carry vehicle entity, not an employee or independent contractor.

The inclusion of a noncompete clause, and the duration of the noncompete clause following an executive's termination of employment, is often subject to significant negotiations as part of the executive compensation arrangements. For example, where otherwise permissible under applicable state law, employment or severance agreements often provide that an executive will receive severance payments for a specified period of time following a qualifying termination of employment if, among other things, the executive does not compete with the company or violate any other applicable restrictive covenants during the severance period.

Even in instances where the severance is paid in a lump sum immediately upon a qualifying termination of employment, the severance is often provided at least partially in consideration of the applicable restrictive covenants. Similarly, many equity awards are made at least partially in consideration of the applicable restrictive covenants included in the equity award agreement.

Will the FTC's Proposed Rule Become a Final Regulation?

In short, the proposed rule faces a long and winding road ahead. First,

it is subject to public notice-and-comment period and the Commission must collect and consider public comments before promulgating a final rule.

By design, proposed rules are often broad and leave room for narrowing based on public comment. To that end, the FTC has explicitly asked for public comment on a range of issues. Of particular note to employers, the FTC has sought input on:

(1) Whether senior executives or other highly paid workers should be exempt;
(2) Whether other legal tools like trade secrets law and confidentiality agreements are sufficient to safeguard their investments and interests in the absence of enforceable noncompetes;
(3) Whether the FTC should adopt a "rebuttal presumption" that noncompetes are unlawful in lieu of an outright ban; and
(4) Whether any other alternative to the FTC's rule may better serve workers and employers.

We already have seen thousands of public comments come in, though an analysis from the FTC is still quite a while away.

Even if the rule is finalized, court challenges are essentially guaranteed. These will likely focus on whether the Commission actually has the authority to adopt a nationwide ban on noncompetes. This will include whether the FTC has authority under Section 6(g) of the FTC Act to engage in this type of rulemaking, whether the rule is barred by the "major question's doctrine" which requires a "clear statement" from Congress to support assertions of broad authority or that have great economic and political significance, and whether this rulemaking marks an impermissible delegation of legislative authority under the non-delegation doctrine.

What Should Employment Managers Do in Response to the Proposed Rule?

While the proposed rule is unlikely to take effect soon, noncompetes are increasingly disfavored and facing increased scrutiny. Prudent actions in the coming months may include:

- *Reviewing Your Agreements, Past and Present*. Employers should be aware of how various state laws already impact the enforceability of these agreements. This includes reviewing contracts and terms for existing employees as well as former workers who may still be subject to noncompetes or related restrictions.
- *Preparing for New Negotiation Dynamics*. The proposed rule would become effective 60 days after the rule is published but delay compliance for 180 days after publication. It also would offer a 45-day period to provide employees notice of any rescissions – if it does not succumb to legal challenges. That means there are at least several months before any ban becomes effective. However, because the publicity surrounding the rulemaking is bound to affect negotiations, employers may want to consider alternative approaches such as ensuring noncompetes are not overly broad or do not target lower-wage workers.
- *Considering Different Types of Agreements*. While the proposed rule would preempt state laws, noncompetes are already enforced differently across the country. Three states – California, North Dakota, and Oklahoma – are the most restrictive in terms of enforcement. Some 11 other jurisdictions, including Washington, D.C., and Illinois, only enforce them for specific groups of workers, often related to earnings. Still others limit their geographic scope and duration, making it a challenge for employers working in multiple states to keep up. As a result, employers may want to consider alternative agreements such as targeted nondisclosure clauses or confidentiality agreements and post-employment consulting agreements, taking care that these alternatives are justified by legitimate interests.

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