Schulte Roth&Zabel

Alert

FTC Proposes Rule to Ban Non-Compete Clauses

January 10, 2023

On Jan. 5, 2023, the Federal Trade Commission ("FTC") released a Notice of Proposed Rulemaking to prohibit the use of non-compete clauses in worker contracts.[1] The proposed rule, if enacted in its present form, would (i) ban all non-compete agreements with workers and (ii) void all non-competes currently in existence. The proposed rule will soon be published in the *Federal Register*, after which the public will have 60 days to submit comments. The rule will become effective 60 days after a final rule is published.

The proposed rule is part of a larger challenge to non-compete agreements, which have come under increased political scrutiny in recent years. In July 2021, the Biden Administration published an executive order directing the FTC to curtail the use of such provisions in employment contracts. Since then, the FTC has taken legal action against three employers for imposing non-compete restrictions on workers in violation of the FTC Act.[2] Various states, including Oregon, Nevada, Illinois, Maine, Maryland, Massachusetts, New Hampshire, Rhode Island, Virginia, Washington and Colorado have passed laws placing limitations on the use of non-compete agreements. Legislation limiting the use of non-competes has been proposed in other states including New York and Connecticut.

Proposed Rule

The proposed rule provides that it is an unfair method of competition and a violation of Section 5 of the FTC Act (which prohibits unfair competition) for an employer to "enter into or attempt to enter into a non-compete clause with a worker, maintain a non-compete with a worker, or, under certain circumstances, to represent to a worker that they are subject to a non-compete clause where the employer has no good faith basis to believe that the worker is subject to an enforceable non-compete clause."[3]

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." Importantly, the FTC proposes that a "functional test" be used to determine whether a clause is a "*de facto* non-compete." A clause will be considered a non-compete provision if it will 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." The FTC notes that while non-solicitation agreements and

[1] The proposed rule applies more broadly to "worker contracts" rather than "employment contracts" because it covers all workers, regardless of legal status, including independent contractors.

[2] The three cases all involved large employers who each required hundreds of their employees, including factory workers and security guards, to agree to non-compete clauses.

[3] Employer is broadly defined to include any natural person, partnership, corporation, association or other legal entity, including anyone acting under authority of state law, that hires or contracts a worker to work for the person. Worker is defined as a person who works, whether paid or unpaid, for an employer, including independent contractors, externs, interns, volunteers, apprentices or sole proprietors who provide a service to a client or customer.

non-disclosure agreements typically do not prevent a worker from seeking or accepting employment or operating a business, if such covenants are "so unusually broad in scope that they function as such" by preventing a worker from seeking or accepting employment, then they would be considered *de facto* non-compete clauses. The FTC does not discuss whether long notice periods or "garden leave" periods would be considered *de facto* non-competes as well, though based on the fact they prevent a working from "seeking or accepting employment" it is a possibility.

Existing Non-Competes

The proposed rule would invalidate all existing non-competes. Employers will be required to rescind existing non-compete clauses no later 180 days after publication of the final rule, as well as refrain from entering into new non-compete agreements. Employers will be required to provide individualized notice to a worker that the worker's non-compete has been rescinded and is no longer in effect within 45 days of the rescission. Notice requirements apply to both current workers and former workers for whom the employer has contact information readily available.

Sale of Business Non-Competes

The proposed rule provides for a limited exception for non-compete clauses between the seller and buyer of a business. A non-compete clause entered into by a person who is selling a business is permissible, but only if the restricted party is at least a 25 percent owner of the business.

Public Comments

Public comments to the proposed rule are due 60 days after it is published in the *Federal Register*. The FTC has the opportunity to adjust the proposed rule in response to public comment before it becomes finalized. The FTC invited comments on most aspects of the proposed rule and potential alternatives including:

- Whether non-compete clauses are "unfair" methods of competition under Section 5 that negatively affect competitive conditions in labor markets.
- Whether the rule should apply uniformly to all workers or whether there should be exemptions or different standards for different categories of workers, using one or more thresholds based on a worker's job functions, earnings, some other factor or a combination of factors. This includes whether "senior executives" or other highly skilled workers should be exempted from the rule, or subject to a rebuttable presumption rather than a ban; and whether low and high wage workers should be treated differently under the rule.

Next Steps

The FTC may modify the proposed rule before it is finalized in response to public comments. In addition, legal challenges to the proposed rule are highly likely to occur and may delay its implementation once it becomes final. In her dissenting statement in the proposal, FTC Commissioner Christine S. Wilson questioned whether the FTC has the authority to engage in "unfair methods of competition" rulemaking,

and argued that the rule may exceed the limits imposed by the Supreme Court's major questions doctrine and the non-delegation doctrine.[4]

Authored by Mark E. Brossman, Benjamin Kozinn, Ian L. Levin, Ronald E. Richman, Martin L. Schmelkin, Max Garfield, Adam B. Gartner and Scott A. Gold.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

[4] The major questions doctrine is the authority the Supreme Court can use to review FTC's interpretation of the law, and to determine whether the FTC has exceeded its authority. The non-delegation doctrine is a principle in administrative law that Congress cannot delegate its legislative powers to other entities, including agencies like the FTC.