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FTC proposes rule to prohibit non-compete agreements

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In a sweeping and controversial move, the FTC has proposed a rule that would bar almost all employment non-competes and require rescission of existing non-competes. The proposed rule is subject to a 60-day comment period, after which the FTC can prepare and announce the final rule. Any final rule will likely face significant hurdles before being implemented, such as questions about if it exceeds the FTC's rulemaking authority or if it conflicts with existing case law allowing non-competes.

The FTC's proposed rule

On January 5, 2023, the Federal Trade Commission (FTC or Commission) voted 3-1 along party lines to publish a proposed rule that, if finalized, would impose a near-complete ban on employers offering, entering, and maintaining non-compete agreements with their workers, by defining such arrangements as *per se* methods of unfair competition (Proposed Rule).[1] Importantly, the FTC's proposed prohibition is categorical: it makes no distinction and provides no exemption based on a worker's earnings or job function, or on whether a worker acts in a competitively sensitive function for their employer. Notably, the Proposed Rule also reflects the policy position adopted by the Biden administration in an executive order in July 2021, which took the position that non-competes are unlawful under the antitrust laws.

Under the Proposed Rule, employers would be required: (1) to rescind any existing non-compete clauses with their employees and contractors within six months of the publication of the final rule; and (2) to provide individualized, advance notice to their workers and former workers covered by such agreements that their non-compete agreements are no longer in effect and cannot be enforced.[2]

The Proposed Rule is subject to a 60-day comment period, after which the FTC will consider the public's input before issuing a final version of the rule. The final rule may differ from the proposed rule if the Commission decides that the public's input contains persuasive new data or policy arguments, questions, or criticisms. As discussed below, the regulation may also face significant legal hurdles to implementation.

The Commission voted to issue the notice of the proposed rulemaking (NPRM) with support from all three Democrats and a dissent from the sole Republican commissioner. In support of the Proposed Rule, the majority cites a number of studies suggesting that the enforcement of non-compete clauses could reduce worker earnings,[3] increase consumer prices, increase industrial concentration, and inhibit entrepreneurial ventures. [4]

In her dissent, Republican Commissioner Christine Wilson criticized the Democratic majority for relying on a limited body of evidence to justify the proposed rule and for discounting the business justifications of non-compete agreements.[5] Commissioner Wilson also noted how "one study illustrates clearly, in the financial services sector, the negative unintended consequences of suspending non-compete provisions, including higher fees and broker misconduct."[6]

The Proposed Rule represents a culmination of recent actions and policy statements from the FTC as well as President Biden and the DOJ's Antitrust Division focus on competition in labor markets. In July 2021, President Biden issued an Executive Order on Promoting Competition in the American Economy, which specifically directed the FTC to curtail the use of non-compete clauses (among other priorities).[7] In February 2022, the DOJ argued in a statement of interest filed

in a Nevada state court case that certain employer-employee non-competes may be illegal agreements under Section 1 of the Sherman Act.[8] The Proposed Rule also follows a July 2022 memorandum of understanding between the FTC and the National Labor Relations Board that outlined the two agencies' intent to cooperate on labor market regulatory issues, including the use of non-compete agreements.[9]

On January 4—one day prior to the FTC's publication of the Proposed Rule—the FTC brought enforcement actions against a security services company and two glass manufacturing companies, alleging that each used employee non-competes as an "unfair method of competition."[10] The relief the FTC sought in these cases closely resembles the compliance obligations under the Proposed Rule. As Commissioner Wilson notes in her dissenting statement for the NPRM, these actions mark the first times the Commission has concluded that non-compete clauses harm competition in labor markets.[11] These enforcement actions may signal not only how the FTC might enforce the final version of the Proposed Rule,[12] but also how the Commission might use its asserted Section 5 authority to police particularly broad non-competes even if the Proposed Rule is not ultimately implemented. The defendants each agreed to settle the FTC's suit and terminate the use of non-competes, so these cases will have limited significance as legal precedents.

The Proposed Rule now faces a public comment period and is ultimately likely to face a variety of court challenges, including on whether the Proposed Rule exceeds the FTC's competition rulemaking authority and whether the rule is in tension with decisional law on non-compete provisions. Before we discuss these challenges in more detail, we briefly outline here the details of the Proposed Rule itself and its areas of ambiguity.

The scope of the Proposed Rule is broad, capturing a wide variety of employers, workers, and non-compete clauses

- "Employer" is defined as any person or legal entity that hires or contracts with a worker, subject to certain exemptions described below.
- "Worker" is defined as any individual who works for an Employer, whether paid or unpaid, and includes employees, independent contractors, interns, and volunteers—the Proposed Rule draws no distinction between "employees" and any other kind of worker, and there is no exemption in the Proposed Rule based on the level of seniority of the Worker.
  - The FTC has sought comment on whether a different standard should apply to senior executives as well as to "highly paid or high skilled workers who are not senior executives."[13] Further, while the Proposed Rule's definition of "Worker" specifically excludes franchisees, the FTC also has sought comment on whether the final rule should cover franchisor-franchisee non-compete agreements.[14]
- "Non-compete clause" is defined as any contractual term between an Employer and a Worker that prevents the Worker from seeking or accepting employment or operating a business *after* the Worker's employment with the Employer has concluded. The Proposed Rule also covers *de facto* Non-compete clauses, providing the following two non-exclusive examples of such arrangements:
  - non-disclosure agreements (NDAs) written broadly enough to effectively preclude the Worker from working in the same field after leaving their Employer; and
  - contractual terms that require Workers to bear training costs if they terminate their employment within a specified time period—at least where those costs are not reasonably related to the costs the Employer incurred for training the Worker.

The Proposed Rule leaves unclear whether entities exempt from FTC jurisdiction can enter into non-compete agreements

Certain entities are exempt from the FTC's jurisdiction under the FTC Act. Since the Proposed Rule is an exercise of the FTC's Section 5 authority under the Act, entities exempt under the FTC Act would, as a logical matter, also be exempt from compliance with the Proposed Rule. These entities generally include certain nonprofit organizations, banks, savings and loan institutions, federal credit unions, air carriers and foreign air carriers.[15] Additionally, certain activities of common carriers, meatpackers, and poultry dealers are exempt from FTC jurisdiction under the Act. [16] As noted above, however, the DOJ Antitrust Division has similarly raised questions about whether or not non-compete provisions may violate the provisions of Section 1 of the Sherman Act, under which no organizations are exempt.

The Proposed Rule has a limited exception for certain mergers and acquisitions

The Proposed Rule contains a narrow exception for non-compete agreements in connection with the sale of a business. Under the exception, the seller of a business may enter a non-compete agreement with a buyer that restricts Workers with at least a 25% ownership stake in the seller's business from competing with the buyer's business. The FTC states that 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.[17]

As the FTC states in the NPRM, "non-compete clauses between the seller and buyer of a business may be distinct from non-compete 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 non-compete agreements "could potentially affect business acquisitions, including the incentives of various market actors to start, sell, or buy businesses."[18]

The potential scope of the Proposed Rule is uncertain and could be wide ranging

There are a number of significant uncertainties about the scope and application of the Proposed Rule.

First, the Proposed Rule uses broad definitions of "Employer" and "Worker," without connection to well-defined, existing categories in employment law such as those under the Fair Labor Standards Act. Rather, it defines Workers as "those who work, paid or unpaid, for an employer." Similarly, Employers are those "who hire or contract with workers." The broad nature of these definitions leaves unclear, for example, how the Proposed Rule might treat non-competes between equity partners of a venture or those between a company and members of its board of directors.

Second, and more consequentially, the Proposed Rule adopts a broad test for "de facto" non-competes. The FTC provides only a few examples of how the test for de facto non-competes could be applied, and it stresses that the examples are non-exhaustive. This makes it unclear how the FTC might consider other restrictive covenants, including certain "gardening leave" provisions, liquidated damages provisions in partnership agreements, and broadly worded NDAs and non-solicits. For example, it is unclear whether the FTC might characterize gardening leave provisions as simply compensated non-compete periods for which the employer has extended the worker's employment beyond her will. The FTC is likely to be particularly concerned about such arrangements where the gardening leave provision covers a broad geographic scope, lasts a significant amount of time, or results in a significant drop in compensation.

At bottom, businesses will need to determine on a case-by-case basis whether their restrictive covenants with their workers might prohibit them from seeking or accepting employment or operating a business after they conclude their employment. If the Proposed Rule is implemented, the FTC will likely be aggressive in applying its de facto non-compete standard.

The Proposed Rule likely faces significant legal challenges

Significant legal challenges may limit the FTC's ability to implement a final version of the Proposed Rule—a point that Commissioner Wilson makes clearly in her dissenting statement.[19] Such challenges include that (i) the FTC did not properly consider evidence demonstrating the benefits or harms of non-compete agreements, (ii) the FTC does not have the competition rulemaking authority under the FTC Act required to issue the Proposed Rule, and (iii) Congress did not give the FTC clear authorization to address a "major question" such as the prohibition of non-competes. In addition, there is considerable case law from the courts that upholds non-compete provisions under circumstances when they are appropriately tailored in scope and ancillary to the business justification at issue—which is in tension with this Proposed Rule.

Subject to how the final rule is implemented, there could be administrative process-based challenges to the final rule, including claims that the FTC's decision was arbitrary and capricious for a variety of reasons, such as: (i) the FTC did not adequately consider studies that highlight the pro-competitive benefits of non-compete agreements when formulating the final rule; or (ii) that the FTC did not adequately consider any other issues raised by public comment.

There are at least two distinct possible challenges to the FTC's authority to promulgate the Proposed Rule. The first is whether the FTC has the competition rulemaking authority required to issue the Proposed Rule and, in particular,

whether the FTC has the authority under the FTC Act to proscribe an unfair method of competition.[20] The second issue is, even assuming the FTC has rulemaking authority in this area in general, whether Congress has given the FTC clear authorization to prohibit non-competes in such a broad fashion. The Supreme Court outlined a "major questions" doctrine in its June 2022 decision in *West Virginia v. Environmental Protection Agency*, which the Court used to apply a heightened level of scrutiny over the EPA's rulemaking authority.[21] That doctrine will likely be invoked in challenges to other agencies' actions, particularly where that action affects a large swath of the American economy.[22] Given the breadth of the proposed prohibition on non-competes, there is a significant possibility that the Proposed Rule will face a "major questions" challenge.

Key takeaways

The Proposed Rule marks a highly ambitious step in U.S. antitrust authorities' increased focus on labor markets over the last several years.

We believe the FTC likely will issue a final rule after public comment that includes, at most, modest modifications. Immediately after publication of the final rule, we expect business groups will sue to invalidate the rule on multiple grounds. Given the broad effect of the rule and deviation from the status quo, there is a good chance that courts will block the implementation of the final rule until those legal challenges are resolved. Thus, it could be a significant period of time before the final rule goes into effect—if it ever does.

Nevertheless, it is likely that antitrust agencies will continue to take bold steps in their efforts to promote and regulate competition in the labor markets. Indeed, the FTC has made clear through the enforcement actions filed last week that it does not view the Proposed Rule as necessary to challenge employers who enter into broad non-competes with their employees. Further, as noted above, in at least one recent court filing, the DOJ has articulated its view that certain non-competes are appropriate for criminal or civil enforcement under the Sherman Act.[23]

We will continue to monitor and provide updates on the government's efforts in this area. In the meantime, as questions arise related to how to treat non-competes in ordinary course contracts and in M&A-related agreements, please contact our antitrust team any time.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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[1] Fed. Trade Comm'n, Non-Compete Clause Rulemaking, Matter No. P201200 (Jan. 5, 2023), https://www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking (hereinafter, "Proposed Rule"); Fed. Trade Comm'n, 16 C.F.R. Part 910, Non-Compete Clause Rule Notice of Proposed Rulemaking, https://www.ftc.gov/system/files/ftc_gov/pdf/p201000noncompetenprm.pdf (hereinafter "NPRM").

[2] As described below, the term "Employer," "Worker," and "Non-compete clause" are each defined in the Proposed Rule.

[3] NPRM at 19-29.

[4] NPRM at 39, 79.

[5] Christine S. Wilson, Comm'r, Fed. Trade Comm'n, "Dissenting Statement of Christine Wilson Regarding the Notice of Proposed Rulemaking for the Non-Compete Clause Rule," at 1, 9 (Jan. 5, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/p201000non-competewilsondissent.pdf (hereinafter, "Dissenting Statement").

[6] Dissenting Statement at 1, 8.

[7] *See* Davis Polk, client update, "President Biden signs Executive Order on promoting competition" (July 12, 2021), https://www.davispolk.com/insights/client-update/president-biden-signs-executive-order-promoting-competition, *and* Davis Polk, client update, "President Biden's Executive Order on Competition: One year later" (Aug. 25, 2022), https://www.davispolk.com/insights/client-update/president-bidens-executive-order-competition-one-year-later

[8] Stmt. of Interest, *Beck v. Pickert Medical Grp.*, No. CV21-02092, Nev. Second Judicial District Court (Feb. 25, 2022). In the last few years, the Antitrust Division has also increased criminal enforcement against companies that have entered into no-solicit and/or no-hire agreements with their competitors for workforce talent. Dep't of Justice, Antitrust Division, Antitrust Division Spring Update 2019, No-Poach Approach, https://www.justice.gov/atr/division-operations/division-update-spring-2019/no-poach-approach#:~:text=In%20particular%2C%20the%20Division%20protects,compete%20for%20those%20employees%27%20labor

[9] Fed. Trade Comm'n & Nat'l Labor Relations Bd., Memorandum of Understanding Between the Federal Trade Commission (FTC) and the National Labor Relations Board (NLRB) Regarding Information Sharing, Cross-Agency Training, and Outreach in Areas of Common Regulatory Interest (July 19, 2022) at 1, https://www.ftc.gov/system/files/ftc_gov/pdf/ftcnlrb%20mou%2071922.pdf

[10] Fed. Trade Comm'n, Press Release, FTC Cracks Down on Companies That Impose Harmful Noncompete Restrictions on Thousands of Workers (Jan. 4, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc-cracks-down-companies-impose-harmful-noncompete-restrictions-thousands-workers; In the Matter of Prudential Security, File No. 2210026 (Jan. 4, 2023) (Complaint); In the Matter of O-I Glass, Inc., File No. 2110182 (Jan. 4, 2023) (Complaint); In the Matter of Ardagh Group, File No. 2110182 (Jan. 4, 2023) (Complaint).

[11] Dissenting Statement at 5-6.

[12] The NPRM cites the Commission's policy statement in support of the FTC's preliminary determination that non-competes are an unfair method of competition, signaling how the FTC intends to interpret its Section 5 authority going forward. NPRM at 69, n.230.

[13] NPRM at 151-52.

[14] NPRM at 153-54.

[15] NPRM at 112-13.

[16] 15 U.S.C. § 45(a)(1); *see* NPRM at 6, 151-53. In 2018, the Ninth Circuit, sitting *en banc*, held that the FTC's jurisdiction over common carriers is limited "only to the extent that they engage in common-carriage activity. By extension, this interpretation means that the FTC may regulate common carriers' non-common-carriage activities." *Fed. Trade Cmm'n v. AT&T Mobility*, 883 F.3d 848, 863-64 (2018).

[17] NPRM at 107, 129-32.

[18] NPRM at 130-31.

[19] Dissenting Statement at 10-13.

[20] Davis Polk, client update, "FTC interprets "unfair competition" broadly in new Section 5 policy statement" (Nov. 15, 2022), https://www.davispolk.com/insights/client-update/ftc-interprets-unfair-competition-broadly-new-section-5-policy-statement#_ftn2

[21] 597 U.S. ____ (2022).

[22] A separate Davis Polk client update provides background information on the major questions doctrine and its implications beyond the EPA. Davis Polk, client update, "A basic primer on the major questions doctrine" (July 14, 2022), https://www.davispolk.com/insights/client-update/basic-primer-major-questions-doctrine

[23] *See* note 8, *supra*.