Client Alert

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Proposed Rule Attempts to Ban Non-Compete Clauses as Method of 'Unfair Competition' Under Section 5 of FTC Act

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Key Points

- In an unprecedented step, the Federal Trade Commission has proposed a categorical, nationwide ban on non-compete clauses between employers and employees (or independent contractors). According to the FTC's Director of Policy Planning, this would also include a ban on training repayment agreements and non-solicitation agreements that have the same effect as non-compete clauses.
- The Commission is currently accepting comments on the proposed rule through March 6, 2023, raising the possibility that a proposed rule could go into effect this year.
- If enacted, the proposed Non-Compete Clause Rule will almost certainly be subject to a legal challenge on various grounds, including that the Commission lacks authority to issue binding regulations for "unfair methods of competition," under the major questions doctrine addressed in *West Virginia v. EPA* and/or under the non-delegation doctrine.
- The proposed rulemaking does not necessitate any change in business practices at this time, but businesses should pay close attention to the proceedings as they unfold.

Overview

On January 5, 2023, the Federal Trade Commission (FTC or the "Commission") released a Notice of Proposed Rulemaking (NPR) for the Non-Compete Clause Rule that would, among other things, make it unlawful for an employer to:

- Enter into or attempt to enter into a non-compete clause with a "worker."[1]
- Maintain with a worker a non-compete clause.
- Under certain circumstances, represent to a worker that the worker is subject to a non-compete clause.

Contact Information

If you have any questions concerning this alert, please contact:

Corey W. Roush
Partner
croush@akingump.com
Washington, D.C.
+1 202.887.4115

Robert G. Lian Jr.
Partner
blian@akingump.com
Washington, D.C.
+1 202.887.4358

J. Matthew Schmitten
Counsel
mschmitten@akingump.com
Washington, D.C.
+1 202.887.4543

Taylor Randleman

trandleman@akingump.com
Washington, D.C.
+1 202.887.4003

The NPR is based on a preliminary finding by the FTC that non-competes constitute an "unfair method of competition" and therefore violate Section 5 of the Federal Trade Commission Act.

The proposed rule follows the FTC's recent Section 5 policy statement (the "Policy Statement"), which described the agency's plans to leverage Section 5 of the FTC Act to give the FTC more rulemaking authority. Like the Policy Statement, the NPR was issued on a party-line vote of 3–1, with Commissioner Christine Wilson dissenting. The NPR also follows President Biden's July 2021 competition executive order, which directed the FTC "to exercise [its] statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

Though the FTC Act is more than a century old, the proposed Non-Compete Clause Rule represents the agency's first attempt at issuing binding regulations under Section 5 to prohibit an alleged "unfair method of competition."

Current Law on Non-Compete Clauses

A non-compete clause is a contractual term between an employer and a worker that purports to prevent the worker from accepting employment (or certain roles) with a competitor, or operating a competing business, after the conclusion of the worker's employment with the employer. A typical non-compete clause limits the worker from performing particular categories of work for a competitor in specified geographic areas for a fixed period of time after a worker's employment ends. Breaches of those agreements can give rise to claims for money damages and injunctive relief by the employer.

State law has historically been the principal authority governing the enforceability of non-compete clauses. Indeed, non-competition provisions are widely used and have been upheld by common law courts longer than the United States has been a country.[2] As a general rule, courts subject non-competition restrictions to more exacting scrutiny than other contractual terms because they are considered a restraint of trade and out of concern that they are the product of unequal bargaining power between employers. As a result, there are variations in terms of how states treat non-compete restrictions. A few states, like California, Oklahoma and North Dakota, categorically bar non-compete clauses in employment agreements; several others have passed laws placing various limits on when non-compete agreements can be utilized. Most states generally enforce them so long as they are reasonable in time, scope and geography and protect an employer's legitimate business interest (i.e., trade secrets, specialized training or customer relationships).

Overview of the Proposed Rule

The FTC's proposed rule defines the term "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. The proposed rule applies a functional test for whether a term is a non-competition restriction, examining the net effect of the restriction as opposed to how it is labeled. For example, a non-disclosure provision that has the effect of limiting or barring post-employment competition could fall within

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the scope of the proposed rule. As the FTC's Director of Policy Planning noted on a conference call held on January 11, 2023, this "functional test" could mean that the proposed rule would prohibit things like (a) training repayment agreements if they are "so disproportional" that they functionally work like a non-compete and (b) non-solicitation agreements to the extent that they "make it so that someone functionally could not leave." But she clarified that the functional test would not cover non-disclosure agreements or efforts to enforce trade secret protections.

"Worker" is defined broadly to include any natural person, including an employee; individuals classified as an independent contractor, extern, intern, volunteer or apprentice; or sole proprietor who works for or provides a service (whether paid or unpaid) to an employer, client or customer.

In terms of substantive prohibitions, the proposed rule would deem an employer who maintains, enters into or attempts to enter into a non-compete clause with a worker as engaging in an unfair method of competition—and therefore violating Section 5 of the FTC Act. Under certain circumstances, the proposed rule would also make an employer's representation to a worker that the worker is subject to a non-compete clause an unfair method of competition.

Significantly, the proposed rule would require employers to rescind existing non-competes and actively inform workers that they are no longer in effect. To that end, the proposed rule includes a safe harbor provision for employers who comply with the requirement to rescind existing non-compete clauses and provide notice that it is compliant with the proposed rule to the affected workers.

The proposed rule also would purport to supersede any state statute, regulation, order or interpretation to the extent that such statute, regulation, order or interpretation is inconsistent with the FTC's rule.[3] The rule would not apply to the sale of a business unit and, as the FTC's Director of Policy Planning noted, would not apply to areas that are not otherwise generally subject to the FTC's jurisdiction (banks and, potentially, nonprofits).

Proposed Alternatives

In addition to a categorical, nationwide ban on non-compete agreements between employers and employees (or independent contractors), the NPR describes several potential alternatives for which the FTC is soliciting public comment. Most options would involve a less draconian prohibition, but at least one is more prohibitive than the proposed rule.

Discrete Alternatives

The NPR describes four "discrete alternatives" that change the proposed ban on two dimensions: (1) potentially creating two different classes of "employees" with different prohibitions and (2) changing the categorical ban to a presumptive ban for one or both classes.

	Non-Exempt Employees	Exempt Employees
Alternative #1	Categorical, nationwide ban	Rebuttal presumption of unlawfulness

	Non-Exempt Employees	Exempt Employees
Alternative #2[4]	Categorical, nationwide ban	No prohibition
Alternative #3	Rebuttal presumption of unlawfulness	
Alternative #4	Rebuttal presumption of unlawfulness	No prohibition

While the FTC is soliciting public comment on these alternatives, the NPR does explicitly note the FTC's "preliminary concerns . . . about the rebuttal presumption approach and about differentiating among categories of workers."

What Employees Would Be "Exempt" Under These Alternatives?

In connection with the alternatives to the proposed rule, the NPR seeks input on which employees would be considered exempt, framing several potential options:

- Workers who qualify for Fair Labor Standards Act (FLSA) exemptions for executive or learned professionals.[5]
- Workers who earn more than $100,000 per year.
- "Named executives officers" as defined in Securities and Exchange Commission (SEC) Regulation S-K43 8F.
- A new, bespoke (and unspecified) definition of "senior executives."

Other Alternatives – Disclosure or Reporting Rule

There are two more alternatives described in the NPR that would create no prohibition at all but, rather, create obligations to provide notice to employees or to make disclosures to the Commission itself.

The proposed disclosure rule would simply require that any employee subject to a non-compete clause be given formal notice of the same "before making the employment offer." The potential reporting rule would require notice not just to the employee but also disclosure to the FTC.[6]

Franchisor/Franchisee

Unlike the other alternative proposals for which the FTC is soliciting public comment, this alternative could potentially *expand* the coverage of the proposed nationwide categorical ban on non-competes. Under the current proposed rule, "[t]he term worker does not include a franchisee in the context of a franchisee-franchisor relationship." However, the FTC notes explicitly that perhaps the rule *should* cover franchisee-franchisor contracts:

> By restricting a franchisee's ability to start a new business, franchisor/franchisee non-compete clauses could potentially stifle new business formation and innovation, reduce the earnings of franchisees, and have other negative effects on competitive conditions similar to non-compete clauses between employers and workers. Franchisor/franchisee non-compete clauses could also potentially be exploitative and coercive in some cases, such as where there is an imbalance of bargaining power between the parties. While the relationship between franchisors and franchisees may, in some cases, be more analogous to a

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> business-to-business relationship, many franchisees lack bargaining power in the context of their relationship with franchisors and may be susceptible to exploitation and coercion through the use of non-compete clauses.

NPR at 153.

What Prompted the FTC to Issue the Proposed Rule?

In their joint statement, Chair Lina Khan, Commissioner Rebecca Kelly Slaughter and Commissioner Alvaro Bedoya state that non-compete clauses reduce competition in labor markets, suppressing earnings and opportunity even for workers who are not directly subject to a non-compete. In their view, when workers subject to non-compete clauses are blocked from switching to jobs in which they would be better paid and more productive, unconstrained workers in that market are simultaneously denied the opportunity to replace them. This decline in job mobility means fewer job offers and an overall drop in wages, as firms have less incentive to compete for workers by offering higher pay, better benefits, greater say over scheduling or more favorable conditions. Further, the Commissioners contend that evidence indicates that non-compete clauses reduce innovation and competition in product and service markets.

In her dissent to the proposed rule, Commissioner Wilson contends that the proposed rule represents a radical departure from hundreds of years of legal precedent that relied upon a fact-specific inquiry into whether a particular non-compete clause is unreasonable in duration and scope given the business justification for the restriction. Commissioner Wilson also focuses on "the lack of clear evidence to support the proposed rule" and the Commission's failure to demonstrate harm to consumers and competition. She points out that "the current record shows that studies in this area are scant, contain mixed results, and provide insufficient support for the scope of the proposed rule."

What Happens Next?

In another unprecedented move, the Commission is not engaging in rulemaking under the Magnuson-Moss process, which empowers the FTC to issue regulations for unfair and deceptive acts and practices but with highly cabined procedures that make rulemaking more difficult than the default rules of the Administrative Procedures Act (APA). Rather, the Commission is claiming the authority to issue binding regulations via the APA. This move is not without controversy, to say the least. The Commission claims that its authority to create binding regulations can be found in 15 U.S.C. 46(g), which empowers the FTC to:

> From time to time classify corporations and (except as provided in section 57a(a)(2) of this title) to make rules and regulations for the purpose of carrying out the provisions of [the FTC Act].

Using APA procedures, the Commission published the proposed rule in the Federal Register to notify the public and give them an opportunity to submit comments. The Commission has provided for a 60-day comment period, which commenced on January 5, 2023. After the notice-and-comment process, the Commission may proceed with a final rule. After the Commission publishes a final rule, the rule would be effective no less than 30 days after the date of publication in the Federal Register, at

which point one would expect near-certain, immediate challenges in federal court to the rule's enforcement.

At least one of the FTC's commissioners seems to agree that those would-be challenges will be meritorious. As Commissioner Wilson explained in her dissent:

> [The proposed rule, if passed,] is vulnerable to meritorious challenges that (1) the Commission lacks authority to engage in "unfair methods of competition" rulemaking, (2) the major questions doctrine addressed in *West Virginia v. EPA* applies, and the Commission lacks clear Congressional authorization to undertake this initiative; and (3) assuming the agency does possess the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the non-delegation doctrine, particularly because the Commission has replaced the consumer welfare standard with one of multiple goals. In short, today's proposed rule will lead to protracted litigation in which the Commission is unlikely to prevail.

1 Under the proposed rule, "worker" is defined broadly to mean a natural person who works, whether paid or unpaid, for an employer. The term includes an employee, individual classified as an independent contractor, extern, intern, volunteer, apprentice or sole proprietor who provides a service to a client or customer.

2 *See Mitchel v. Reynold*s (1711) 24 Eng. Rep. 347 (K.B.).

3 This clause is in some tension with state action immunity doctrine (also known as Parker immunity doctrine), an 80-year-old principle of federal antitrust law that generally allows states to permit even anticompetitive behavior within their own borders under certain conditions. *See Parker v. Brown*, 317 U.S. 341 (1943); *Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.,* 445 U.S. 97 (1980).

4 Alternative #2 would resemble recent non-compete statutes passed by Rhode Island, Massachusetts and Washington state, though those states differ in how they define exempt classes of employees.

5 See 29 C.F.R §§ 451.100, 541.200.

6 However, the FTC has already expressed its skepticism of these approaches: "The Commission does not believe this alternative would achieve the objectives of the proposed rule." NPR at 155 (about a notice requirement); *see also id*. at 156 (identical statement about a reporting requirement).

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