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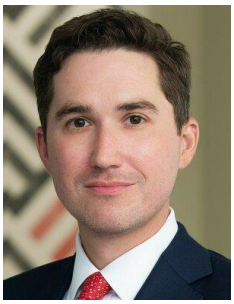
FTC Noncompete Proposal May Herald New Enforcement Era

By **Mike Jones, Zak Johns and Seth Gerber** (January 10, 2023, 4:43 PM EST)



Mike Jones

Zak Johns

Seth Gerber

The Federal Trade Commission announced a notice of proposed rulemaking on Jan. 5, 2023, that would ban employers from entering into and maintaining noncompete clauses with their workers.

With this potential ability for workers to change jobs more freely, employers will become more focused on protecting their innovations by enforcing confidentiality clauses and trade secret laws.

The proposal comes approximately 18 months after President Joe Biden called for the FTC to ban or limit employment contract clauses that restrict workers' freedom to change jobs, and roughly 24 months after the FTC hosted a workshop on whether there is sufficient legal basis and empirical support to promulgate a rule restricting noncompete clauses in employment contracts.

The FTC foreshadowed the proposed rule in November 2022 when it issued new guidance on how it would exercise its authority to regulate unfair methods of competition under Section 5 of the Federal Trade Commission Act. The proposed rule is the FTC's first attempt to apply this broader definition of unfair methods of competition laid out in that guidance.

It also comes immediately on the heels of the agency's first-ever enforcement actions concerning noncompete agreements: On Jan. 4, the FTC announced consent agreements banning three companies from enforcing or imposing noncompetes on certain employees.

Proposed Rule on Prohibiting Noncompete Clauses

The FTC's proposal would prohibit employers from entering into, attempting to enter into, or maintaining noncompete restrictions on their workers, or from representing to their workers that they are subject to noncompete restrictions without a good faith basis to believe the workers are, in fact, subject to legally enforceable noncompete restrictions.

Workers

Biden's 2021 comments on noncompetes seemed to focus on lower-level employees, and both the FTC commentary included with the proposal and the three consent agreements acknowledge and reflect that the justifications for noncompetes vary based on the type of employee restricted.

Nonetheless, the proposed rule defines "worker" in broad terms. It includes all employees, individuals classified as independent contractors, externs, interns, volunteers, apprentices, and sole proprietors who provide a service to a client or customer.

Noncompete Clauses

The rule defines what qualifies as a noncompete clause in expansive terms. Specifically, a noncompete clause would include any "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."

In addition, the rule includes a functional test for determining what constitutes a de facto noncompete clause, which would have the same effect as an express noncompete clause. A similar test is employed by courts in states that have banned noncompete clauses, like California.

As examples of such de facto noncompete clauses, the proposed rule cites:

- A nondisclosure agreement that is written so broadly as to effectively preclude a worker from working in the same field after the conclusion of the worker's employment with the employer; and

- A contractual term that requires a worker to pay the employer or a third party for training costs if the worker's employment terminates within a specified period.

It is unclear whether clawback or similar provisions would be considered de facto noncompete clauses pursuant to the proposed rule.

Other Restrictive Covenants

By contrast, other restrictive covenants that generally do not prohibit workers from seeking or accepting employment after the conclusion of their employment may not qualify as prohibited noncompete clauses.

Restrictive covenants that may still be permissible under the FTC's proposal include reasonably tailored confidentiality clauses and nondisclosure agreements, customer nonsolicitation covenants, and covenants prohibiting concurrent employment.

The proposal clarifies, however, that such covenants would be prohibited as noncompete clauses if they are "so unusually broad in scope that they function as such" — that is, where they operate as de facto noncompete clauses.

Limited Exception

The proposal contemplates a limited exception for noncompete agreements between sellers and buyers of businesses. This exception would only apply if the party restricted by the noncompete clause is an

owner, member or partner with at least a 25% ownership interest in a business entity.

Rescission of Existing Noncompete Agreements

The FTC estimates that one in five American workers, or approximately 30 million people, are subject to noncompete clauses. To address these workers, the proposed rule would require employers to rescind existing noncompete clauses with workers no later than the final rule's compliance date.

The proposal would also require an employer rescinding a noncompete clause to provide notice to a worker that the worker's noncompete clause is no longer in effect. This notice requirement applies to current workers and former workers whose contact information is readily available.

To facilitate compliance, the proposal includes model language that would satisfy this notice requirement. It also establishes a so-called safe harbor that will find the employer compliant with the notice requirement as long as the employer uses the form provided by the FTC. The FTC's model language states:

A new rule enforced by the Federal Trade Commission makes it unlawful for us to maintain a noncompete clause in your employment contract. As of [DATE 180 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE], the noncompete clause in your contract is no longer in effect. This means that once you stop working for [EMPLOYER NAME]:

- You may seek or accept a job with any company or any person—even if they compete with [EMPLOYER NAME].
- You may run your own business—even if it competes with [EMPLOYER NAME].
- You may compete with [EMPLOYER NAME] at any time following your employment with [EMPLOYER NAME].

The FTC's new rule does not affect any other terms of your employment contract.

For more information about the rule, visit [link to final rule landing page].

Opposition From Commissioner Christine Wilson

The FTC commissioners split along party lines in a 3-1 vote to publish the notice of proposed rulemaking.

As the lone dissenter on the four-person commission, Republican Commissioner Christine Wilson asserted that the proposal will be challenged, most likely on the grounds that:

- The FTC lacks the authority to engage in "unfair methods of competition" rulemaking;

- The major questions doctrine, addressed by the U.S. Supreme Court in their June 2022 ruling on West Virginia v. EPA, applies, and the FTC lacks clear congressional authorization to undertake this initiative; and

- Assuming the FTC does possess the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the nondelegation doctrine.

In addition, Wilson highlighted the lack of empirical support for the proposal and the proposed rule's cherry-picking of academic studies with results favorable to the rule.

These challenges will likely begin to take shape through public comment in the coming months. If the rule is adopted, they will provide a road map against enforcement action by the agency.

Public Comment

Each of the commissioners published separate statements on the notice of proposed rulemaking detailing their respective support for or criticisms of the proposed rule. Each statement strongly encourages comments from interested stakeholders, with Commissioner Wilson cautioning that "this is likely the only opportunity for public input before the Commission issues a final rule," and emphasizing that "it is important for commenters to address the proposed alternatives to the near-complete ban on noncompete provisions."

Public comments on both the proposed noncompete ban and various alternatives, expressly including limitations for senior executives, are due by March 10, 2023. If adopted by the FTC, the rule would go into effect 180 days after the final version is published.

Initial Impressions

There have been several developments in this space since at least 2016, when the FTC and U.S. Department of Justice released their joint guidance to human resources professionals highlighting potential antitrust concerns with various employment practices, including the use of noncompete clauses. Since that time, both agencies have continued to make labor market antitrust enforcement a priority, most recently culminating in the FTC's proposal.

Against this backdrop, we have the following initial impressions of the proposal.

The proposed rule has garnered significant attention and is likely to draw many comments. As reflected in the commissioners' statements, the agency is interested in hearing from the public on a variety of topics, including the potential impact of the proposed rule, whether there are alternatives or modifications that should be considered, and whether the agency has appropriately considered the costs/benefits and academic literature that addresses noncompete clauses.

These statements suggest that the final version could change based on public input.

The intense recent focus on antitrust enforcement in this area and the current leadership at the FTC strongly indicate that the proposed rule — in some form — will be finalized. The FTC would then enforce this rule.

Echoing Commissioner Wilson's comments, any enforcement action by the FTC is likely to be subject to fundamental challenges directed at the root of the agency's authority to promulgate such a rule. Nonetheless, the potential for enforcement activity should be taken seriously, given the FTC's focus on this area.

With this proposed rule, the FTC is claiming the legal authority to engage in rulemaking solely under the Federal Trade Act's Section 5 prohibition on unfair methods of competition, which the agency has

not done since the late 1960s.

This proposed rule could thus signal the first step toward broad competition rulemaking around other employment practices and other areas.

The FTC and DOJ remain focused on investigating no-poach and wage-fixing issues that involve agreements among competitors. The DOJ in particular has increasingly brought criminal charges against companies and individuals involved with such arrangements.

This rule is another reminder of the continued antitrust enforcement in labor markets. Employers should confirm that they are following best practices in this area and consult with experienced counsel.

Any federal rulemaking that restricts the use of noncompetes would conflict with and displace certain state laws that have struck more nuanced balances that generally allow certain types of noncompetes to be enforced.

The proposed rule anticipates that conflict in stating that the rule "shall supersede any State statute, regulation, order, or interpretation" to the extent inconsistent with the proposed rule.

As one justification for the proposed rule, the FTC cites the innovation that has resulted from the spillover of ideas in places like Silicon Valley, where noncompete clauses are banned under California law. According to the FTC, "If noncompete clauses inhibit innovation by creating barriers to knowledge-sharing, then a prohibition on noncompete clauses, by alleviating those barriers, would increase innovation."

The FTC appears to be valuing the overall economic benefit of innovation over intellectual property dilution caused by employee mobility. This justification for the proposed rule, which is consistent with the narrowing of enforceability of noncompete clauses in numerous states over the last several years, serves as a not-so-subtle reminder to employers of the importance of maintaining appropriately tailored confidentiality clauses and trade secret protection plans.

With a potential nationwide ban on noncompete clauses looming, employers will become more reliant than ever on enforcing confidentiality clauses and trade secret laws to protect their innovative ideas.

Next Steps

Despite the uncertainty surrounding the proposal, employers and parties to existing or potential transactions should review existing noncompete agreements and consider the effect that any final rule could have on such agreements.

Employers should also prepare by analyzing the breadth of their confidentiality clauses. They should also tighten their trade secret protection plans by properly identifying, classifying and protecting trade secrets with reasonable measures.

Mike Jones, Zak Johns and Seth Gerber are partners at Morgan Lewis & Bockius LLP.

Morgan Lewis partners Debra Fischer and Clay Everett, and associates Johnathon Bramble and Pat Huyett, contributed to this article.