FTC Proposes the End of Employment-Based Non-Compete Agreements

Insights
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The federal government just announced a proposed rule which would ban non-compete agreements between nearly *all* employers and *all* workers — employees, independent contractors, externs, interns, volunteers, apprentices, and even sole proprietors who provide a service to a client or customer. When announcing the new proposed rule this morning, the Federal Trade Commission (FTC) stated the widespread use of non-competes agreements is an "often exploitative practice that suppresses wages, hampers innovation, and blocks entrepreneurs from starting new businesses." Indeed, the agency estimates about one in five employees across the country are subject to some form of non-compete agreement. By announcing this proposed rule, the FTC believes it will increase wages by almost $300 billion per year and help 30 million Americans expand their career opportunities. What do employers need to know about this dramatic development?

Overview of Proposed Rule

The proposed rule has three critical components:

1. it would prevent employers from entering into non-compete clauses with workers;
2. it would require employers to take active steps to rescind existing non-compete clauses; and
3. it proposes explicit notice requirements applying to both current and former employees.

What is Considered a Non-Compete Clause Under the Proposed Rule?

Under the proposed rule, a "non-compete" clause is defined "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 also includes a functional test to help determine whether a restriction qualifies as a "non-compete clause." Under this test, a contractual term that is a "*de facto* non-compete clause" if the clause explicitly prohibits or otherwise has 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 then gives two examples of "*de facto*" non-compete clauses:

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- **Non-disclosure agreements:** A non-disclosure agreement between an employer and a worker that is written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer.
- **Agreement to repay training costs:** A contractual term between an employer and a worker that requires the worker to pay the employer or a third-party entity for training costs if the worker's employment terminates within a specified time period, where the required payment is not reasonably related to the costs the employer incurred for training the worker.

Who Does the Proposed Rule Impact?

The proposed rule applies to "workers." A "worker" is "a natural person who works, whether paid or unpaid, for an employer." This includes an "independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a client or customer."

The proposed rule excludes a business that is a franchisee, but someone who works for a franchisee or franchisor is still a "worker." In this sense, the proposed rule reserves the governance of franchisee-franchisors to federal antitrust law, but still protects "workers" of those entities.

An "employer" means "a person, that hires or contracts with a worker to work for the person."

These very broad definitions would apply to 99% or more of the US workforce.

What Does the Proposed Rule Prohibit?

As noted above, the proposed rule has three main components: unfair methods of competition, recission requirements, and notice requirements.

Unfair Methods of Competition

Under the proposed rule, an employer cannot do any of the following:

- enter into (or attempt to enter into) a non-compete clause with a worker;
- maintain a non-compete clause with a worker; or
- represent to a worker that they are subject to a non-compete clause where there is no good faith basis to believe that they are.

Rescission of Existing Non-Compete Clauses

The proposed rule also explicitly requires employers to rescind all non-compete clauses already existing as of the proposed rule's compliance date. Otherwise, employers would run afoul of the requirement that they not "maintain" non-compete clauses with their workers. If the rule goes into

effect in its current form, a failure to rescind a non-compete clause will be considered a form of unfair competition and subject to FTC enforcement using its Section 5 authority.

Notice Requirement

The proposed rule also includes specific notice requirements relating to the rescission of non-compete clauses. Under this section, an employer must provide notice to the individual worker that their non-compete clause is no longer in effect and may not be enforced against them. Such notices must follow several guidelines:

- notice must be given in an individualized communication; it cannot be done through a general notice;
- notice cannot be oral; it must be provided either by digital format such as email or text, or on paper; and
- the notice must be provided to the worker within 45 days of the employer's rescission of the non-compete clause.

Notably, the employer must provide this notice to ***both current and former workers*** (at least as to those former workers who are potentially subject to active non-compete clauses as of the compliance date of the proposed rule). But notice to a former worker may not have to be provided if the former worker's contact information is not "readily available."

The proposed rule also includes model notice language. Employers do not have to use this language, however, so long as they use language that effectively communicates that the non-compete clause is no longer in effect and may not enforced against the worker.

Employers who provide proper notice of recission to their current and former workers will be deemed to have complied with the proposed rule's recission requirement.

Are There Any Exceptions to the Proposed Rule?

The proposed rule would not apply to covenants relating to the ***sale of business***. This carve-out is in line with most state-based restrictive covenant laws, which are less critical of covenants incident to the sale of a business rather than to the restricted person's employment.

Specifically, the proposed rule would not apply to non-compete clauses:

- entered into by a person who is selling a business entity or otherwise disposing of all of the person's ownership interest in the business entity; or
- by a person who is selling all or substantially all of a business entity's operating assets, when the person restricted by the non-compete clause is a substantial owner of, or substantial

member or substantial partner in, the business entity at the time the person enters into the non-compete clause.

To qualify as "substantial owner, substantial member, and substantial partner," the person (subject to the non-compete clause) must be "an owner, member, or partner holding at least 25 percent ownership interest in a business entity."

How Would the Proposed Rule Impact State Non-Compete Laws?

The proposed rule would preempt any inconsistent state law. In other words, all current state laws would be preempted unless they provide ***greater*** protection to the worker than the proposed rule.

When Will the Proposed Rule Take Effect?

First, there will be a 60-day period during which the public will be allowed to submit comments on the proposed rule. After this period, the FTC will move to make the rule final. The proposed rule would then go into effect 180 days after the date of publication of the final rule. Of course, there will no doubt be legal challenges to the proposed rule at some point along this process. What cannot be predicted at this time is whether such judicial proceedings will derail the proposal or otherwise delay this timeframe.

Main Takeaways for Employers

If finalized in its current form, the proposed rule would drastically change the way employers could use non-compete restrictions.

Incredibly Broad Coverage, Very Narrow Exceptions

By its specific terms, it would apply to virtually every worker and employer in the country, even to independent contractors and unpaid workers. Even the "exceptions" to the rule are not truly exceptions under which non-compete clauses may be used in the employment context. Instead, these exceptions confirm that the use of non-competes *outside of the employment context*, such as those involving franchisees and those incident to the sale of a business are still permitted.

Non-Disclosure Agreements Could Come Under Fire

The use of functional test to define a "non-compete clause" as a *de facto* restriction could also greatly expand the coverage of the proposed rule. As an example, the FTC specifically flagged non-disclosure agreements as potentially being *de facto* non-compete clauses under the proposed rule. This should raise a major red flag for employers.

Non-disclosure agreements, which have historically been subject to lighter scrutiny than true non-competes, tend to be broadly written to protect trade secrets and confidential information. To protect

a trade secret under The Defend Trade Secrets Act and various state-based trade secret laws, employers must show that they have taken reasonable steps to protect the confidentiality of that information.

To make this showing, many employers point to their use of non-disclosure agreements with their workforce, among other steps. If the proposed rule passes in its current form, employers may be placed in a quandary: they will need to tailor existing agreements to comply with the proposed rule while still leaving them broad enough to show the employer is taking reasonable measures to protect its valuable, non-public information.

Could Other Restrictive Covenants Be Swept Up in Rule?

One question employers should be asking is whether the definition of a "non-compete clause" will cover other types of restrictive covenants used by employers such as employee and customer non-solicitation agreements. Under the functional test, a *de facto* non-compete covers exists whenever a clause has the functional effect of prohibiting a worker "from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer."

Could a non-solicitation clause that prevents the worker from, for example, "accepting" business from a former customer be deemed a "de facto" non-compete clause? What if a customer non-solicitation clause effectively bars an employee from seeking a new job because they work in an industry where each competitor is seeking the work of a handful of large clients and they are barred from soliciting former clients? If the FTC takes a hard line as to these questions, the commission may be opening itself up to a host of legal challenges. Proponents of such restrictions will likely argue that this position would render the proposed rule beyond the FTC's rulemaking authority since it would cause a challenge to all otherwise valid non-solicitation clauses (and not just non-competes) every time an employer attempts to include one in an agreement with a worker. Right now, these are all open questions.

Recission Requirements Will Require Massive Effort by Employers

The proposed rule's rescission and notice requirements are also unprecedented in that they explicitly require all employees take affirmative steps to *rescind* and g*ive notice of the rescission* of all covenants entered into prior the creation of this rule to all current and former workers. Employers will need to take their recission and notice responsibilities seriously to avoid running afoul of the FTC Act.

What Should You Do?

Employers should track this proposed rule closely and be prepared to revisit all of your restrictive covenant clauses within the next year. You may want to make sure you have an inventory of all

existing covenants with both current and former employees on hand in order to be in the best position to comply should the rule take effect.

We will continue to monitor the latest developments and provide updates as warranted, so you should ensure you are subscribed to Fisher Phillips' Insight system to gather the most up-to-date information directly to your inbox. If you have questions, please contact the authors of this Insight, your Fisher Phillips attorney, or any attorney in our Employee Defection and Trade Secrets Practice Group.

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