Frequently Asked Questions About the FTC's Proposal to Ban Non-Compete Agreements

Insights
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When the federal government proposed a rule that would ban most non-competition agreements, many employers lined up with questions and concerns about the scope of the proposal and what it might mean for their day-to-day businesses. After all, non-competes have become a commonplace strategy for businesses of all types and sizes, and this rule would not only prevent employers from entering into new non-competes but would also require them to rescind those currently in place. The good news: we're here to help. This Insight presents a series of frequently asked questions about all aspects of the proposal as developed by leaders of our Employee Defection and Trade Secrets Practice Group and will be updated as new developments occur in the coming months.

TABLE OF CONTENTS

Big-Picture Overview

What happened?

The Federal Trade Commission (FTC) issued a proposed rule on January 5, 2023 that would prohibit employers from using non-compete clauses with workers.

What does the proposed rule do?

The proposed rule, if adopted in its current form, would require employers to:

- rescind all existing non-competes no later than the rule's compliance date (which is not yet determined); and
- provide notice to current and former workers that the workers' non-compete clauses are no longer in effect. The proposed rule provides model language employers can use to satisfy this

notice obligation.

How does the agency define "non-compete" clauses?

The proposed rule defines "non-compete clause" to mean a contractual term that blocks a worker from working for a competing employer, or starting a competing business, within a certain geographic area and period of time after the worker's employment ends.

Why did the FTC do this?

In July 2021, President Biden issued an Executive Order titled "Promoting Competition in the American Economy." It 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."

More than a year later, the agency followed through on the president's request. With the release of the proposed rule, FTC Chair Lina Khan opined that non-compete clauses "block workers from freely switching jobs, depriving them of higher wages and better working conditions, and depriving businesses of a talent pool that they need to build and expand." The agency further stated that it believes non-compete clauses negatively affect competition in labor markets by suppressing wages and labor mobility, and by preventing new businesses from forming, stifling entrepreneurship, and preventing novel innovation that might otherwise occur if workers were not restricted from sharing their ideas. The FTC estimates that the proposed rule would increase workers' earnings in the U.S. by between $250 and $296 billion per year, and that the ban will close racial and gender gaps by 3.6 and 9.1%.

Return to Table of Contents

Specific Ins and Outs of the Rule

Would the proposed rule prohibit non-solicitation, non-recruit, or confidentiality clauses?

Generally speaking, no. However, employers will need to proceed with caution with restrictive covenants such as customer non-solicitation, employee non-recruit, or confidentiality provisions. While the rule's definition of a "non-compete clause" does not mention other types of covenants, and the FTC's main concern is focused on clauses that prevent a worker from seeking or accepting employment with another person or entity or starting their own business after the conclusion of the worker's employment with the employer, there could be trouble ahead. That's because the FTC has made clear that the title of any given clause is not outcome determinative. Just because a clause is called, for example, "a non-disclosure" clause, it may still violate the proposed rule if its scope and burden is so broad as to be the functional equivalent of a non-compete clause. To that end, the agency will use a "functionality test" to make this determination.

What is the functionality test?

The title of a contractual provision will not dictate whether it is a non-compete clause. If a covenant is so broad that it serves as a *de facto* non-compete, it would not be permitted under the proposed rule.

For example, a non-disclosure provision prohibiting use or disclosure of confidential information is generally fine, but it would become problematic if "confidential information" is defined too broadly. A recent case in the securities industry involved a non-disclosure clause that prohibited use or disclosure of any information concerning the securities industry. That clause was deemed by a court to be a *de facto* non-compete that precluded employment with a competitor. The FTC cited this case as an example of a non-disclosure provision that would be a *de facto* non-compete.

What are the potential penalties for violations of the proposed rule?

The FTC has the authority to issue a complaint in situations where it believes its rules have been violated. If a respondent contests the charges, the complaint is adjudicated before an administrative law judge (ALJ) in a trial-type proceeding. Upon conclusion of the proceeding, the ALJ issues an "initial decision" setting forth findings of fact and conclusions of law and a recommendation for either a "cease and desist" order or dismissal of the complaint. The FTC and the respondent may appeal the initial decision to the full Commission. After the Commission issues a final decision, the matter may be appealed in court.

After a cease-and-desist order is finalized, the Commission may seek an array of remedies in court including civil penalties, restitution, damages, injunctive relief, orders of rescission or reformation of contracts. The FTC may also make referrals to the U.S. Department of Justice for criminal prosecution.

Will the proposed rule be retroactive?

Yes, the rule would invalidate prior non-compete clauses. In addition to prohibiting the future use of non-competes, the proposed rule would prohibit employers from "maintaining" non-competes with workers. It would require employers to rescind such clauses and notify workers they are no longer bound by them.

Would the retroactive provision of the proposed rule invalidate an entire existing agreement containing a non-compete clause, or just the non-compete clause itself, leaving other restrictive covenants intact?

Only the non-compete clause would be impacted by the proposed rule. The model language for notification to workers of rescission contained in the proposed rule includes the following: "The FTC's new rule does not affect any other terms of your employment contract."

Could we face retroactive liability for existing agreements?

Employers should not face retroactive liability for use of a non-compete clause prior to enactment of the rule. The proposed rule states that an employer can comply with the rule by rescinding prior non-compete clauses no later than the compliance date, which would be 180 days after the date of publication of the final rule.

Return to Table of Contents

Scope of Rule

Does the proposed rule preclude all non-competes?

The proposed rule would not apply to a non-compete clause entered into in a sale-of-business context. This includes agreements between a person selling a business entity or otherwise disposing of all of the person's ownership interest in the business entity, or someone who is selling all or substantially all of a business entity's operating assets. This exception only applies when the person restricted by the non-compete clause is a substantial owner of, or a substantial member or substantial partner in, the business entity at the time the person enters into the non-compete clause.

The terms "substantial owner," "substantial member," and "substantial partner" are defined to mean an owner, member, or partner holding at least a 25% ownership interest in a business entity. The FTC's Notice of proposed rulemaking (NPRM) notes that after the 60-day comment period, the FTC may elect to change the percentage of ownership interest for purposes of these definitions to a smaller or larger percentage, "for example, 50% or 10%."

Does the proposed rule preclude non-competes with independent contractors?

Yes, the proposed rule would apply to independent contractors, as well as anyone who works for a business, whether paid or unpaid.

My state has a statute that allows non-competes. What effect would the proposed rule have on state law?

The proposed rule states that it supersedes any inconsistent state statute, regulation, order, or interpretation. State statutes, regulations, orders, or interpretations that afford greater protection to workers would be allowed. For example, a state law prohibiting non-competes and non-solicitation provisions would be permissible; a state law allowing non-competes would not.

Return to Table of Contents

Next Steps: Rulemaking, Legal Challenges, and Predictions

Does the FTC have the authority to do this?

Since the proposed rule was issued, many have questioned the FTC's authority. The first to do so was the sole Republican Commissioner on the FTC, Christine Wilson. In her words:

"The NPRM 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."

Will the content of the proposed rule change? What alternatives to a complete ban on non-competes are being considered by the FTC?

The NPRM states that the FTC is considering alternatives to a complete ban on non-competes despite the fact that the agency has preliminarily concluded that a uniform ban on non-competes would best advance the proposed rule's objectives and would better ensure that workers are aware of their rights.

These alternatives focus on what the FTC describes as two key dimensions of alternatives related to the proposed rule's final design:

- instead of a categorical ban on non-competes, the FTC could adopt a rebuttable presumption of unlawfulness pursuant to which it would be presumptively unlawful for an employer to use a non-compete clause, but the use of a non-compete clause would be permitted if the employer could meet a certain evidentiary burden, based on a standard that would be articulated in the Rule; and
- instead of applying to all workers uniformly, the Rule could include exemptions or different standards for different categories of workers, which could be based on a worker's job functions, occupations, earnings, another factor, or some combination of factors.

The NPRM also seeks comment on whether the FTC should adopt disclosure requirements in lieu of a full ban on non-competes, requiring employers to disclose non-competes prior to making an employment offer. It also wants to explore the idea of requiring employers to explain the terms of the non-compete and how the worker would be affected by the signing of the non-compete.

The NPRM additionally seeks comment on whether the FTC should require employers to report certain information to the FTC relating to their use of non-competes in lieu of a complete ban. This

certain information to the FTC relating to their use of non-competes in lieu of a complete ban. This could include requiring employers that use non-compete clauses to submit a copy of the clause to the FTC, in order to facilitate the agency's monitoring of the use of such clauses and to discourage employers from using non-compete clauses where not justified under existing law.

When will the proposed rule become effective?

There will be a 60-day notice and comment period during which the public can provide input concerning the proposed rule. This time period could be extended past the current due date of March 20, 2023.

After the comment period closes, the FTC could move to finalize the rule or adopt alternatives. It's anybody's guess how long that could take.

Even if enacted as is, once finalized, the rule would not become effective until 60 days after publication of the final rule in the Federal Register. In addition, there would be a 180-day compliance period (running from the date of publication) during which employers would be allowed to work towards compliance.

How can I submit input during the 60-day comment period?

You can file comments online or in written form. The FTC will consider only those comments received by March 20, 2023.

- For written comments: Write "Non-Compete Clause Rulemaking, Matter No. P201200" on your comment; this also should be written on the envelope if you file your comment on paper. Paper comments should be mailed to the following address: Federal Trade Commission, Office of the Secretary, 600 Pennsylvania Avenue NW, Suite CC-5610 (Annex C), Washington, DC 20580.
- Online submissions may be filed on the federal government's website.

All comments will be placed on a publicly accessible website. For this reason, you should ensure that your comment does not include any sensitive or confidential information.

Will the proposed rule pass?

The proposed rule is likely to pass in some shape or form. It is a culmination of many efforts dating back at least to the FTC's January 2020 workshop on non-compete clauses, which the FTC mentions multiple times in its NPRM. It also has behind it the weight of President Biden's July 2021 Executive Order on Promoting Competition in the American Economy.

Christine Wilson, the sole FTC Commissioner opposed to the rule, seems to believe the rule will pass. In her dissenting statement, she strongly encourages the submission of comments from "all interested stakeholders," noting "this is likely the only opportunity for public input before the Commission issues a final rule." As noted above, after outlining the proposed rule, the NPRM

proceeds to invite comment on certain alternatives. All of the signs indicate the Commission fully intends to pass a rule in some shape or form.

Return to Table of Contents

Practical Gameplan for Employers

Assuming the proposed rule becomes effective, what can I do to protect my trade secrets, confidential information, and customer relationships?

As noted above, the proposed rule does not expressly ban non-disclosure and non-solicitation provisions. However, it will apply a functionality test that could invalidate such provisions if they are found to be *de facto* non-compete provisions. Carefully drafted non-solicitation, confidentiality and non-disclosure clauses should withstand such scrutiny, enabling employers to protect confidential information and customer relationships, as well as the poaching of employees by other employees. Additionally, employers could still rely on the federal Defend Trade Secrets Act and state trade secret statutes to protect trade secret information.

Employers should make sure they utilize appropriate policies, procedures and training regarding the handling and use of confidential and trade secret information.

What should we do now?

As the proposed rule is still in the 60-day comment period, and employers would have 180 days after the date of publication of any final rule to comply, not much immediate action is required. It is far from clear what the final rule, if any, will look like, and whether it will survive legal challenge. However, there are some preliminary steps you can consider to put yourself in the best position should the final rule take effect later this year:

- Revisit your restrictive covenants — including non-solicitation and confidentiality provisions — to ensure they are reasonably tailored to protect your legitimate interests. The day before it issued the NPRM, the FTC announced three consent orders forcing three employers to drop their non-competes against thousands of workers. Sounding a lot like the analysis in the NPRM, the consent orders found that the employers use of non-competes was a method of unfair competition, and it required them to terminate the agreements and notify the employees who signed them. While the proposed rule is pending, there is no reason to believe the FTC will relent on its investigative and enforcement efforts.
- You should ask whether the non-competes your company uses are necessary to protect your legitimate interests. You should also consider whether you can protect your interests with a less burdensome covenant such as a properly tailored customer non-solicitation or confidentiality provision.

provision.

- Speak up and file a comment if you have something to say. Support your comment with data when possible, but be careful not to disclose confidential information. Coordinate with your Fisher Phillips attorney if you would like guidance on this process.
- Get your trade secrets house in order. This is perhaps more important now than ever. The FTC cites the availability of trade secret protection as a factor that mitigates the harm of abrogating non-competes. You should identify your trade secrets and put proper policies and procedures in place. Limit trade secret access only to those who need it; train employees how to handle trade secrets and protect against theft; and implement suitable technological controls.

Conclusion

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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