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Proposed FTC Rule Would Ban Most Noncompete Agreements

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On January 5, 2023, the Federal Trade Commission published a proposed rule that would categorically ban noncompete agreements between employers and a broad class of "workers," including independent contractors and unpaid interns, senior executives, and everyone in between. The proposed rule has no immediate impact and is likely to be challenged in court if it is made final, but companies should be aware of the development and consider alternative approaches to protect misuse of their confidential information.

Historically, the enforceability of employee noncompete agreements has been largely left to the states, with the vast majority of states evaluating these covenants under a reasonableness standard that accounts for employers' legitimate interests in protecting confidential information and preventing free riding. Only a handful of states – most notably, California, Oklahoma and North Dakota – have imposed broad bans. Against this backdrop, if made final, the proposed rule would be a sea change in the enforceability of employee noncompete agreements.

The proposed rule was announced one day after the FTC announced settlements with several companies and individuals for allegedly imposing illegal restrictions on workers via noncompete agreements. These actions follow earlier Biden administration efforts to protect competition in labor markets.

The proposed rule is now subject to a public comment period for 60 days. If the FTC does issue a final rule, it would become effective only 180 days following publication. It is not expected to go into effect until the end of 2023, at the earliest.

Key provisions of the rule

The proposed rule could dramatically alter restrictive covenants law in the US. Below are some key takeaways.

'Worker' defined broadly

The proposed rule would apply broadly to all employees, independent contractors, externs, interns, volunteers, apprentices and sole proprietors who provide services to a client or customer.

No application to noncompete agreements between corporate entities

Notably, the proposed rule is designed to protect people not businesses, and therefore it would not apply to noncompete agreements between corporate entities. For example, while the rule would apply to protect franchise workers, it would not apply to noncompete agreements between franchisees and franchisers.

Limited application to deals

The proposed rule would not apply to noncompete agreements entered into between merging or transacting companies, and it generally would not affect the use of noncompete agreements in deals, except in one fairly limited circumstance.

Recognizing the legitimate interest companies have in protecting the value of businesses they are acquiring, the FTC excepts from rule coverage noncompete agreements between a buyer and a seller where the person bound by the noncompete is an owner, member or partner holding at least a 25% ownership interest in a business entity and is selling the entirety of the ownership interest in the transaction. The upshot is, merging companies can continue to enter into noncompete agreements with individual stakeholders of 25% or more without running afoul of the rule. In contrast, noncompete agreements with individual stakeholders who hold less than a 25% ownership interest would be prohibited by the rule.

Implications for NDAs, nonsolicitation clauses and other restrictive covenants that could function as noncompete agreements

While indicating that the proposed rule generally would not apply to other types of restrictive employment covenants – such as run-of-the-mill nondisclosure agreements and client or customer nonsolicitation agreements – the FTC has said that such restrictive covenants would be considered noncompete clauses covered by the scope of the rule where they effectively prevent a worker from working in the same field.

Retroactive application

Employers would be required to rescind existing noncompete agreements and individually notify current and former employees within 45 days of recission that those noncompete clauses are no longer in effect. The proposed rule suggests "safe harbor" language for such notices.

Controversial, likely to be challenged in court

The FTC vote to publish the proposed rule was 3 – 1, with Chair Lina Khan and Democratic Commissioners Rebecca Slaughter and Alvaro Bedoya voting affirmatively.

Republican Commissioner Christine S. Wilson voted against the proposed rule, and in a dissenting statement said the rule "represents a radical departure from hundreds of years of legal precedent that employs a fact-specific inquiry" into whether a noncompete agreement is unreasonable or is justified by a legitimate business purpose. She also argued that the commission lacks authority to engage in "unfair methods of competition rulemaking" and has "little enforcement experience" with employee noncompete agreements that would justify this rulemaking.

Wilson's criticisms have been echoed by critics who argue that noncompete agreements are needed to protect investment in employees and prevent sensitive and proprietary information from winding up in competitors' hands. On the other hand, proponents of the rule point to studies and research suggesting that noncompete agreements suppress wages and prevent labor mobility and are often used in situations with uneven power dynamics between companies and their workers.

FTC enforcement actions highlight the agency's concerns regarding noncompetes

The day before publishing the proposed noncompete rule, the FTC announced it had entered into consent agreements with companies and executives that had noncompetes with employees alleged to be an "unfair method of competition" in violation of Section 5 of the FTC Act.

The allegations in those matters track the FTC's concerns justifying the proposed rule.

- In the matter of Prudential Security, et al. – The FTC alleged Prudential Security, Inc., Prudential Command Inc. and two individual owners exploited bargaining power against low-wage security guards to restrict them from working for a competitor business within a 100-mile radius of their job site for two years and required employees to pay $100,000 for violations. A Michigan state court struck down the restrictions as unreasonable; however, the company still required employees to sign the noncompete agreements. As part of the consent agreement, the companies and owners are banned from enforcing any noncompete restriction on any current or past workers for the next 20 years.
- In the matter of O-I Glass, Inc. and In the matter of Ardagh Group, et al. – Glass container manufacturers, O-I Glass, Inc. and Ardagh Group S.A. – both competing in what the FTC alleged is a highly concentrated market – imposed restrictions on workers for one to two years after leaving their employer, preventing them from performing similar services for competitors in the US, Canada and Mexico. The companies allegedly imposed restrictions on employees in a variety of roles, including engineers, quality assurance and furnace workers. As with the Prudential consent agreement, O-I Glass and Ardagh are prevented from enforcing noncompete agreements on employees for 20 years.

Wilson voted against these actions, expressing concern that the FTC's complaints did not offer evidence of anticompetitive effects in any relevant market. She further noted that the complaints did not assess the

reasonableness of the relevant noncompete agreements and “seem[ed] to treat the noncompete clauses as per se unlawful,” contrary to established case law.

Shifting landscape of state laws still in play while federal rule is being worked out

Employer-employee noncompete agreements have long been unlawful in California, which has labor code provisions closely mirroring the proposed FTC rules. North Dakota and Oklahoma similarly have banned most noncompete agreements. Most other states have statutes or case precedent suggesting that noncompete restrictions are disfavored.

In recent years, many states have taken action to limit use of noncompete agreements – including restrictions on who may be eligible with income limits, requirements for a “garden leave” period of pay commensurate with the restricted period, prohibitions on application to certain industries or professions, consideration that must be given in exchange for restrictions, time employed before enforceability, explicit notice periods and other limiting actions.

Among the states with relatively recent noncompete limitations are Colorado, Illinois, Massachusetts, Nevada and Washington. The trend seems to be moving toward more free movement of talent and restricting the use of noncompete agreements against the majority of the workforce.

The FTC’s proposed ban, if enacted, would likely be far more limiting for companies seeking to enforce restrictive covenants against workers than what’s seen in most states. Not only does the proposed rule contemplate a near blanket ban on noncompete agreements, but also companies would be subject to the notification requirements for any existing noncompete agreements with their workers.

Implications moving forward

While the impact of the ban would be far-reaching, for now it is still a proposal and not a final rule.

Public comments and input from stakeholders will likely raise questions that the FTC will need to consider in assessing the rule’s scope. Enforcing a blanket ban could impose hardships on businesses trying to protect competitive and sensitive information that could be given to a competitor or otherwise misused by a firm’s employees.

Companies should be conscious of the implications of the proposed ban and be proactive in developing policies and procedures that would reduce risk of misuse of sensitive information. More thought will need to go into alternative means of protecting confidential information and intellectual property and preventing free riding on company investments, with other forms of restrictive covenants potentially playing a more important role going forward.

Given the uncertainty, employers may follow existing practices and state laws for the time being. As with nearly all newly adopted rules, employers will almost certainly have notice and a grace period to come into compliance if the rule is finalized. If the rule is never finalized, or is invalidated by court challenges, it may be hard in some states to seek noncompete agreements from employees hired without them in the interim. Nonetheless, given the overall trend of legislatures and courts moving away from restraints on employment, a strategic review of restrictive covenant documentation and enforcement efforts is wise.

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