DAVIS GILBERT

Labor + Employment

The FTC's Sweeping Proposal to Ban Non-Competes

The Bottom Line

- In the three weeks since the proposed rule was released, the FTC has received over 5,600 comments, and many more are expected from interested individuals, companies, industry groups and trade associations.
- Until the final rule, if any, is implemented, companies should continue to review and consider the laws in the states in which they operate, many of which have significantly changed in the past few years.
- Interested parties are strongly encouraged to have their voices heard by submitting comments via this link.

On January 5, 2023, the Federal Trade Commission ("FTC") released a Notice of Proposed Rulemaking with a proposed rule that would almost universally prohibit the use of non-competes by employers. The proposed rule would prohibit employers from (1) entering into or attempting to enter into non-competes with their workers; (2) maintaining pre-existing non-competes; and (3) representing to a worker that the worker is subject to a non-compete.

The FTC is accepting comments on the proposed rule through March 20, 2023 and this comment period could be subsequently extended. Based on comments received, the FTC will consider whether to revise the rule before publishing a final version. In its current form, the final rule would take effect 60 days after its publication in the Federal Register and employers would have 180 days to comply.

This alert discusses the key elements of the proposed rule and analyzes certain unintended and/or uncontemplated consequences that may result if the FTC publishes the proposed rule in its current form.

Key Definitions

The proposed rule features an expansive definition of what constitutes a "non-compete clause" – namely "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." In an apparent effort to stretch the proposed rule's application, the FTC includes a "functional test," where certain other restrictions, such as non-disclosure agreements or agreements that require repayment of training costs, are prohibited if they operate as "*de facto*" non-competes by having the effect of prohibiting workers from seeking or accepting other employment.

The proposed rule's definition of "worker" is expansive as well. It includes independent contractors, externs, interns, volunteers, apprentices and sole proprietors who provide a service to a client or a customer. Excluded from this definition, however, are franchisees in the context of a franchisee-franchisor relationship.

Rescission and Notice Requirements

In connection with the proposed rule's prohibition on "maintaining" non-competes, employers would be required to rescind existing non-competes with workers. In rescinding such non-competes, employers would be obligated to provide individualized written notices to both current and *former* workers that their non-competes are no longer in effect and will not be enforced. The proposed rule offers model notice language for employers to use to comply with this obligation.

Exception for the Sale of a Business

The proposed rule would still permit non-competes in connection with a sale of business, and a person who is selling their business can still agree to a non-compete as part of the sale. However, the exception is a narrow one. It applies only to a "substantial owner, substantial member, or substantial partner," defined as someone who holds at least a 25% ownership interest in the selling business entity. The FTC has specifically invited comment regarding that 25% figure and has suggested that it may be open to altering that number in the final rule (offering 10% or 50% as two alternative possibilities).

Takeaways and Considerations

The expansive breadth of the proposed rule not only lumps all non-competes together, but also lumps all employees together. Similarly, there is no acknowledgement of any legitimate need for employers to protect their businesses through the use of non-competes, nor any attempt to narrow the definition of the term "non-compete" to ensure that other post-employment covenants remain viable. Further, the proposed rule does not address a number of meaningful issues associated with non-competes that courts and state legislatures often consider.

- The FTC has specifically invited comment on whether different standards are appropriate depending on a worker's salary level. Multiple states, including Illinois, Virginia and Washington, prohibit non-competes for employees earning below a set salary threshold, but permit them for higher-paid employees. The FTC has also indicated that it would consider comments about whether the rule should differentiate between workers (and whether they can be subject to non-competes) by criteria other than earnings, such as job function or occupation.

- There are unanswered questions regarding the proposed rule's "functional test," which would prohibit restrictions against employees that have the same *effect* as a non-compete. The FTC included two non-exhaustive examples of clauses that would be impermissible under this test: (1) a broad non-disclosure agreement that would effectively prohibit a worker from working in a given field and (2) a contractual requirement for a worker to repay training costs where the required payment is not reasonably related to the costs the employer incurred for training the worker.

  These examples leave much open to interpretation. It is unclear whether other restrictions might be deemed sufficiently similar to those illustrative examples so as to be prohibited under this "functional test." For instance, the proposed rule does not discuss clawback agreements outside of the training costs context, including clawbacks of signing bonuses, discretionary bonuses or equity. Similarly, a number of other common restrictions – such as non-solicitation agreements, non-servicing agreements and no-hire agreements – may run afoul of the proposed rule under this "functional test." The FTC has yet to address such concerns, and the broad definitions and language in the proposed rule could call into question the enforceability of any and all post-employment covenants.

- The proposed rule's directive to rescind existing non-competes does not acknowledge the consideration offered to employees in exchange for such agreements. In certain cases, employers have provided the worker with additional discretionary compensation (*e.g.*, a cash bonus, stock or severance) in exchange for the worker's agreement not to compete. The proposed rule would appear to deprive employers of the benefit of their bargain, while seemingly allowing workers to retain the benefit(s) they received. If such agreements are no longer effective, does that mean that employers can recover any consideration paid in exchange for a non-compete, or that any unvested benefits will no longer vest? The FTC has not addressed any of these questions.

Looking beyond the substance, we expect challenges to the constitutionality of this proposed rule. There is a looming constitutional question about whether the FTC has the authority to engage in such rulemaking under the FTC Act and whether the FTC has the authority to promulgate this rule. In light of the Supreme Court's recent decision in *West Virginia v. EPA*, it would appear that, if published, the rule would be ripe for constitutional challenge.

For More Information

Please contact the attorneys listed below or the Davis+Gilbert attorney with whom you have regular contact.

David Fisher

Partner
212 468 4861
dfisher@dglaw.com

Daniel Friel

Associate
212 237 1509
dfriel@dglaw.com