Special Report

# A Deeper Dive into FTC's Proposed Non-Compete Rule

By Clifford R. Atlas, Erik J. Winton, Daniel J. Doron & Daniel F. Thornton

January 10, 2023


## Meet the Authors

Clifford R. Atlas
(He/Him)
Principal
(212) 545-4017
Clifford.Atlas@jacksonlewis.com

Erik J. Winton
Principal
(617) 367-0025
Erik.Winton@jacksonlewis.com

Daniel J. Doron


The Federal Trade Commission (FTC) proposed a new rule that, if made final, would (at least on its face) effectively prohibit non-compete agreements other than in very limited circumstances.

This special report follows up on our initial alert.

## What Is in the Proposed Rule?

The proposed rule, which would supersede all contrary state laws, is remarkable for its sweeping definition of "non-compete clauses" that fall within the ban.

The ban would extend to "de facto" non-compete clauses — that is, other contractual provisions that have the "effect" of prohibiting workers from seeking or accepting employment or operating a business after the conclusion of the worker's current employment. In this regard, the ban may implicate broadly drafted non-disclosure-of-confidential-information restrictions and repayment-of-training-costs provisions. The ban also could implicate customer non-solicitation restrictions, depending on the surrounding facts.

If adopted, the proposed rule will require all employers that use any agreement with a non-compete clause (or with a clause that could be deemed to be a non-compete clause under the expansive definition in the proposed rule) to take action to *rescind* the non-compete clause. Remarkably, any provision negotiated in exchange for the non-compete (for example, a severance provision) would remain intact. This recission action will require individualized communications from the employer to all current employees, as well as former employees.

Further, while the proposed rule contains a sale-of-business exception, even that is exceptionally narrow, being limited to individuals with at least a 25 percent ownership stake in the business.

*Non-Compete Clauses Prohibited*

The proposed rule declares it to be an "unfair method of competition" for an employer to:

i. Enter into or attempt to enter into a non-compete clause with a worker;

ii. Maintain with a worker a non-compete clause; or

iii. Represent to a worker that the worker is subject to a non-compete clause where the employer has no good faith basis to believe the worker is subject to an enforceable non-compete clause.

The restriction applies to employees, independent contractors, interns, and volunteers alike. It also applies to independent contractors who are engaged through their own

(He/Him)
Principal
212-545-4026
Daniel.Doron@jacksonlewis.com

Daniel F. Thornton
Of Counsel
267-319-7802
Daniel.Thornton@jacksonlewis.com

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Restrictive Covenants, Trade Secrets and Unfair Competition

business entity if the individual is a sole proprietor of the entity through which they are engaged.

*"Functional Test" for Prohibited Non-Compete Clause*

The proposed rule defines a prohibited non-compete clause as "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."

It states, however, that a vaguely described "functional test" will apply to determine whether a contractual provision is a prohibited non-compete clause. It also expressly brings within the purview of the ban any contractual term that operates as a "*de facto* non-compete clause" in its effect.

The proposed rule gives two examples of such "*de facto* non-compete clauses":

i. 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.

ii. 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 period, where the required payment is not reasonably related to the costs the employer incurred for training the worker.

The proposed rule does not address whether a customer non-solicit provision would be deemed a prohibited non-compete clause. The FTC's supplementary materials, however, state that "the definition of non-compete clause would generally not include other types of restrictive covenants—such as non-disclosure agreements ('NDAs') and client or customer non-solicitation agreements—because these covenants generally do not prevent a worker from seeking or accepting employment with a person operating a business after the conclusion of the worker's employment with the employer." However, under the definition of "non-compete clause," the proposed rule provides: "such covenants *would* be considered non-compete clauses where they are so *unusually* broad in scope that they function as such." (Emphasis added.)

The supplementary materials also mention "no-business agreements" (prohibiting a worker from doing business with former clients or customers of the employer), "no-recruit agreements" (prohibiting the worker from hiring or recruiting the employer's workers), and "liquidated damages provisions" (requiring the worker to pay the employer a sum of money if the worker engages in certain conduct) as other types of agreements that "can sometimes" be broad enough in scope to fall within the proposed rule's definition of non-compete clause.

When exactly such "sometimes" might occur is not defined. That, presumably, would be determined on a case-by-case basis.

If the proposed rule is adopted in its present form, it appears certain that disputes will arise over whether NDAs, customer non-solicitation provisions, the other types of provisions mentioned above, or other possible restrictions an employer might use will pass muster under the FTC's nebulous "functional test." Employers using broad non-disclosure provisions, or broad customer non-solicitation provisions, may face significant uncertainly as to whether the FTC or a court would second-guess the validity of those post-employment obligations.

The FTC's second example of a *"de facto* non-compete clause," concerning the repayment of training costs, creates further uncertainty over the variety of contractual provisions and executive compensation that employers use to retain employees (many of which employers regard as carrots, rather than sticks). Examples include retention bonuses, equity grants, and other forms of incentive compensation that would be forfeited if an employee separates from the employer within a specified period of time.

*Rescission and Notice of Rescission*

The proposed rule requires:

> an employer that entered into a non-compete clause with a worker prior to the [date that is 180 days after publication of the final rule] must rescind the non-compete clause no later than the [date that is 180 days after publication of the final rule].

Somewhat confusingly, the proposed rule requires a notice of the rescission be sent to current and former employees within 45 days after the date of recission. In practice, this appears to mean the deadline to send such rescission notices would be the 225th day following publication of the final rule. With respect to former workers, the employer must send notices only to those former workers whose contact information the employer has readily available.

The rescission notice must be sent "in an individualized communication ... on paper or in a digital format such as ... an email or text message." The content of the notice must "communicate[] to the worker that the worker's non-compete clause is no longer in effect and may not be enforced against the worker." A model form of notice is included in the proposed rule, but employers are not required to use that model.

While the proposed rule does not prescribe the form a rescission should take, it does provide that an employer who complies with the notice requirement also will be deemed to have complied with the rescission requirement.

Importantly, possibly depending on the specific language of the applicable agreement or plan, the rescission would have no bearing on bargained-for benefits negotiated in consideration for the non-compete clause, whether those benefits are in the form of base compensation, incentive compensation, deferred compensation, or even consideration in connection with the sale of a business (except to the limited extent of the sale-of-business exception described below).

*Sale of Business Exception*

The proposed rule contains an extremely narrow sale-of-business exception. The proposed rule will not apply to a non-compete clause that is entered into:

a. 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

b. By a person who is selling all or substantially all of a business entity's operating assets.

Importantly, however, this exception applies only when the person restricted by the non-compete clause is, at the time the person enters into the non-compete clause, an owner, member, or partner holding at least a 25 percent ownership interest in the entity.

## Are Any Employers Excluded From Coverage Under the Proposed Rule?

Section 5 of the Federal Trade Commission Act (which the FTC cites as the source of its power to promulgate the proposed rule) does not apply to the following industries:

- Banks;
- Savings and loan institutions;
- Federal credit unions;
- Common carriers;
- Air carriers and foreign air carriers; and
- Persons and businesses subject to the Packers and Stockyards Act, 1921 (subject to certain exceptions).

This is something acknowledged by the FTC in their supplementary materials, even if it is not explicitly stated in the proposed rule itself.

## What Are the Potential Implications to Employee Benefits Plans?

Certain executive compensation plans, particularly plans sponsored by tax-exempt entities, defer vesting (and taxation) during the period a participant is subject to a non-competition provision. If the proposed rule becomes effective, participants in these plans could experience immediate tax impacts. Further, as some plans and employment or consulting agreements also contain "clawback" clauses, requiring repayment of previously paid compensation in the event of a non-compete breach, the validity of these would be called into question if the proposed rule becomes final.

## What Is the Status of the Proposed Rule and What Happens Next?

The proposed rule is open for public comment until, at least, March 10, 2023. Members of the public may request that the FTC allow more time to submit comments.

The supplementary materials to the proposed rule identify a number of issues of interest on which the FTC is soliciting comments. They also point out the following four alternative rules for comments (the FTC is not actually proposing any of these alternatives):

1. Categorical ban for some workers (*e.g.,* below a certain compensation threshold or classified as non-exempt) and a rebuttable presumption of unlawfulness to other workers.

2. Categorical ban for some workers and no impact on other workers.

3. Rebuttable presumption of unlawfulness for all workers.

4. Rebuttable presumption of unlawfulness for some workers and no impact on other workers.

Once the comment period has closed, the agency may reopen the comment period, issue a new proposed rule, terminate its rulemaking, or move on to a final rule.

Prior to the publication of a final rule, the Office of Information and Regulatory Affairs

(OIRA) reviews the rule and must provide a final analysis of the estimated cost of the rule, as measured by the rule's impact on the economy. OIRA, located within the Office of Management and Budget (OMB), is delegated authority by Executive Order (E.O. 12866) and is charged with reviewing any "significant regulatory action." This includes any regulatory action that is likely to result in a rule that may: (a) have an annual effect on the economy of $100 million or more or adversely affect, in a material way, the economy, a sector of the economy, productivity, competition, or jobs; (b) create a serious inconsistency, or otherwise interferes, with an action taken or planned by another agency; or (c) raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in E.O. 12866.

Given that the FTC's own supplementary materials to the proposed non-compete rule state that the rule would increase workers' total earnings by $250 to $296 billion per year and reduce consumer spending by $148 billion in the healthcare sector alone, the FTC is unlikely to dispute that the proposed rule qualifies as a "significant regulatory action." OIRA also may meet with stakeholders during the pendency of its review.

The final rule will then be published in the *Federal Register.* Pursuant to the Congressional Review Act, new final rules must be sent to Congress and the Government Accountability Office before they can take effect. "Major rules" must be made effective at least 60 days after publication in the *Federal Register,* allowing time for Congressional review. "Major rules" are ones determined by OIRA to be likely to result in:

1. An annual effect on the economy of $100 million or more;
2. A major increase in costs or prices for consumers, individual industries, federal, state, or local government agencies, or geographic regions; or
3. Significant adverse effects on competition, employment, investment, productivity, or innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets.

If the House and Senate pass a resolution of disapproval and the president signs it (or if both houses override a presidential veto), the rule would become void and could not be republished by an agency in the same form without Congressional approval. Congress may also exercise its oversight in other ways, such as by holding hearings and posing questions to agency heads, by enacting new legislation, or by imposing funding restrictions.

In addition to governmental review, FTC rulemaking may be challenged through litigation. Typically, litigation concerning such agency rulemaking is commenced after a final rule takes effect. If a final rule is enacted that looks substantially similar to the proposed rule, challenges in the courts are expected. Among the grounds for anticipated legal challenges are:

i. That the FTC was not delegated the authority it claims to have under Section 5 of the Act (the statute the FTC cites for its authority) to engage in this kind of rulemaking; and

ii. The "major questions doctrine" that, on issues of vast economic or political significance, agencies cannot regulate such issues (and courts must not defer to agency interpretations of statutes) unless the agency had *clear* authorization from

Congress.

The “major questions doctrine” was invoked in 2022 when the U.S. Supreme Court used it to thwart the Occupational Safety and Health Administration COVID-19 Vaccination and Testing Emergency Temporary Standard, the Centers for Disease Control and Prevention’s nationwide moratorium on evictions of any tenants who live in a county that is experiencing substantial or high levels of COVID–19 transmission and who make certain declarations of financial need, and the Environmental Protection Agency’s 2015 Clean Power Plan.

Despite extensive press coverage of the FTC’s proposed rule, any change in federal law on non-competes soon is unlikely (if at all). Even without formal change, however, the FTC’s issuance of three orders against employers the day before it issued the proposed rule demonstrates that the FTC, on a parallel track, is committed to exercising its enforcement powers to pursue what it deems to be egregious or abusive overreaches by employers in their use of non-competes.

## There Is No Need to Panic

Employers that use restrictive covenants understandably are nervous about the FTC’s proposed rule. It is still early in the process, however, and the provisions of a final rule are in flux. Even then, if the final rule is issued, there will be significant and substantial legal challenges to it.

What is important now is the same as what has always been important under the many years of well-developed caselaw pertaining to restrictive covenants. Restrictive covenants should be drafted narrowly to protect a legitimate business interest of the employer, such as trade secrets, confidential information, or customer goodwill. The restrictions themselves should be no broader than necessary to protect those legitimate interests, and they must be reasonable in terms of duration, geography, and scope of activities prohibited. Agreements should be drafted in a way to increase the likelihood that any provisions found to be unlawful can be severed from the agreement, leaving other restrictions intact. Finally, restrictive covenants generally should not be used with lower-level workers absent legitimate reasons to do so.

Jackson Lewis attorneys are available to discuss the proposed rule and to assist with reviewing and revising restrictive covenant agreements.