

Memorandum

FTC Issues Proposed Rule Barring Non-Compete Clauses With Workers, Spurring Questions About Agency's Rulemaking Authority

January 6, 2023

Introduction

On January 5, 2023, the Federal Trade Commission (“FTC” or “Commission”) announced a Notice of Proposed Rulemaking (“NPRM”) for a broad ban on non-compete clauses in agreements between employers and workers (the “Proposed Rule”). The Proposed Rule would prohibit non-competes by designating them as “unfair methods of competition” under Section 5 of the FTC Act. If finalized in its current form, the Proposed Rule would bring about a landmark change in the legality of non-compete clauses under federal law by (1) overriding, at least in some situations, more nuanced state laws that govern non-competition clauses and (2) replacing the fact-specific, case-by-case approach currently applied under federal antitrust law. In short, the Proposed Rule would do away with the more nuanced legal review of employee non-compete clauses that currently exists and replace it with a *per se* ban on virtually all employee non-compete clauses.

The Proposed Rule is subject to a 60-day public comment period and may be adjusted depending on the public's response. For example, the FTC has explicitly asked for comments as to whether senior executives and/or other highly paid individuals should be exempt from the ban. Additionally, there is a significant chance of litigation if the final rule resembles the Proposed Rule, as there are serious questions regarding the FTC's authority to promulgate the Proposed Rule.

Background

A hallmark of employment agreements, non-compete clauses have historically been viewed as appropriate tools that help protect against the misuse or misappropriation of trade secrets and proprietary information, to protect investors and their investments against free-riding, and to ensure the viability of innovation and new competitive strategies. However, non-compete provisions have sometimes been criticized as being too restrictive on the free movement of labor.

In light of these competing interests, federal and most state laws historically have considered employee non-compete clauses that are of a reasonable duration, have a tailored scope and that protect legitimate interests to be lawful.

The Biden Administration, however, has indicated since at least 2021 that it would seek to make changes to the way the federal antitrust laws address non-compete clauses. Indeed, the NPRM is in line with the Biden Administration’s July 9, 2021 Executive Order, which specifically encouraged FTC Chair Lina Khan “to exercise the FTC’s statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses.” Chair Khan subsequently [stated](#) that the FTC was considering using its rulemaking authority as well as individual enforcement actions to target the use of non-compete agreements by employers. Since then, the FTC has negotiated non-enforcement of non-compete clauses as part of several settlement agreements ending merger challenges.¹ However, there were no Commission enforcement decisions directly challenging the use of non-compete agreements until January 4, 2023—the day before the Proposed Rule was announced.² These recent enforcement actions, which the defendants settled, involved conclusory allegations by the FTC that employers of low-wage security guards, manufacturing workers, and engineers imposed non-compete clauses in violation of FTC Act Section 5, but provided no actual evidence of anticompetitive effects caused by the non-compete clauses.

Proposed Rule

Broad Scope. The Proposed Rule would impose a broad prohibition on the use of non-compete clauses in agreements between employers and their workers. In this context, “workers” covers both employees and independent contractors, and the Proposed Rule does not include any distinction between executives/professionals (such as physicians) and other types of workers. As written, the Proposed Rule would make it illegal for an employer to enter into or even attempt to enter into a non-compete clause with a worker, maintain a pre-existing non-compete clause with a worker, or “represent to a worker that the worker is subject to a non-compete clause where the employer has no good faith basis to believe that the worker is subject to an enforceable non-compete clause.”

Retroactive Application. The Proposed Rule would not just be prospective but would also require employers to rescind all existing non-compete clauses and individually notify current and former employees of the change, even if the existing non-compete clauses were a material form of consideration in the employment or separation context.

Narrow Sale of Business Exception. The Proposed Rule includes a narrow exception for non-compete clauses in M&A transactions, but only for “substantial owners” who are selling a business entity or otherwise disposing of all of the person’s ownership interest in the business entity (or all or substantially all of a business entity’s operating

¹ See Decision and Order, Seven & I Holdings Co., Ltd., and Marathon Petroleum Corp., Docket No. C-4748 (Nov. 8, 2021), <https://www.ftc.gov/system/files/documents/cases/2010108c4748sevenmarathonorder.pdf>; Decision and Order, DaVita Inc. and Total Renal Care, Inc., Docket No. C-4752 (Jan. 12, 2022), https://www.ftc.gov/system/files/documents/cases/211_0056_c4752_davita_utah_health_order.pdf.

² See Complaint, Ardagh Glass Group S.A., File No. 211-0182 (Jan. 4, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/2110182ardaghdraftorder.pdf; Complaint, Prudential Security, Inc., File No. 221-0026 (Jan. 4, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/2210026prudentialsecuritycomplaint.pdf; Complaint, O-I Glass, Inc., File No. 211-0182 (Jan. 4, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/2110182o-iglasscomplaint.pdf.

assets). A “substantial owner” is defined as an owner, member, or partner holding at least a 25% ownership interest in a business entity. Also, the Proposed Rule would not apply to franchisees in the context of a franchisee-franchisor relationship (although the Proposed Rule would apply to employees of the franchisee or other employees that work at the franchise). The FTC specifically asked for public comment on whether this franchisee exception is appropriate.

Open Questions

The Proposed Rule is ambiguous in several important ways, which presumably will be the subject of commentary during the notice period and hopefully be addressed more as part of the final rule.

Shareholders / Equityholders / Partners. The Proposed Rule does not expressly address whether a customary non-compete provision that is ancillary to another legitimate relationship—such as in a shareholder agreement or partnership agreement—would be covered by the Proposed Rule if parties to that agreement also might be deemed workers that provide services for the relevant, underlying company or partnership. There are strong arguments as to why non-compete provisions in this context are different and thus should be outside the scope of the Proposed Rule.

“De Facto” Non-Competes. The term “non-compete clause” is broadly defined to include provisions that do not explicitly limit competition if they have the effect of prohibiting a worker from seeking or accepting work with a competitor after termination of employment. For example, while there are strong arguments that typical non-disclosure agreements and contracts restricting solicitation of client and customers should not be prohibited, such provisions may be considered de facto non-compete agreements if they are so unusually broad in scope that they effectively function to prevent a worker from seeking or accepting future employment in the same field. That said, NPRM provides that non-disclosure agreements and client/customer non-solicitation agreements generally would not be considered non-competes in most instances.³

It is similarly open for interpretation whether the Proposed Rule would apply to provisions which do not preclude future competitive activity entirely but would penalize such behavior with a forfeiture of compensatory rights, such as forfeiture of outstanding equity awards, previously unpaid bonuses, or severance payments, as “de facto” non-competes. For example, the Proposed Rule states that “training-repayment agreements,” a type of liquidated damages provision in which a worker agrees to pay the employer for the employer’s training expenses if the worker leaves their job before a certain date, can be de facto non-compete agreements where the required payment is not reasonably related to the costs the employer incurred for training the worker.

Intrastate Business Activity. The Proposed Rule also raises questions about its applicability to businesses operating solely intrastate. The FTC’s jurisdiction is limited to interstate commerce and many non-compete clauses are local and not interstate in scope. Accordingly, there are good arguments that intrastate non-compete

³ The NPRM also states that the Proposed Rule does not impact clauses related to the non-solicitation of employees.

clauses, which have traditionally been regulated at the state level, are outside the bounds of the FTC’s authority to regulate and no clear arguments as to why the FTC may supersede state law as applied to them.

Enforceability

The Proposed Rule’s inconsistency with existing federal law interpreting non-compete clauses presents significant questions regarding enforceability.

Historically, the enforceability of non-competes has mostly been a matter of applicable state law, while federal courts have evaluated non-compete clauses for illegality under Section 1 of the Sherman Act using the so called “rule of reason,” weighing the scope and duration of the clause, as well as any asserted business justifications, to determine whether the clause is unreasonable (and thus unenforceable). Notice of Proposed Rulemaking for Non-Compete Clause, 58 (Jan. 5, 2023). To date, attempts to challenge non-compete clauses on federal law grounds have generally been unsuccessful: complainants have only succeeded in 2 of the 17 cases identified by the FTC in the NPRM. *Id.* The only litigated FTC case applying Section 5 of the FTC Act to a non-compete clause also resulted in a finding that the conduct was lawful. *See Snap-On Tools Corp. v. Fed. Trade Comm’n*, 321 F.2d 825, 837 (7th Cir. 1963). Many states have also enacted their own statutory frameworks governing non-compete clauses, which vary widely from prohibitions that closely resemble the Proposed Rule in some states to narrower restrictions based on industry, income level, and job type, among others.

As noted above, the FTC’s Proposed Rule attempts to overrule the “rule of reason” approach historically applied by the judiciary in favor of a *per se* ban with only narrow exceptions.

Next Steps

The publication of the NPRM in the Federal Register is the first step in the FTC’s rulemaking process and triggers a 60-day public comment period. The FTC may, but is not required to, make changes to the Proposed Rule based on public comments or its own further analysis, after which it is expected to issue a final rule. We anticipate significant public comment, particularly with respect to the application of the Proposed Rule to all non-competes, as opposed to situations where employers might use lengthy non-compete agreements for rank-and-file employees.

Legal Challenges Likely

If the Proposed Rule is finalized in its current form, it will raise serious questions about how far the FTC can push its authority beyond the scope of traditional antitrust enforcement. In the past, federal courts and the FTC itself have extended the scope of Section 5 of the FTC Act beyond the scope of the other federal antitrust statutes only in exceptionally limited circumstances, and have typically considered the enforcement scope of Section 5 of the FTC

Act to be roughly coterminous with the Sherman, Clayton, and Robinson-Patman Acts.⁴ The Proposed Rule reflects a significant departure from that approach, and could subject the Proposed Rule to legal challenges.

The vote to publish the NPRM was 3-1, with Republican Commissioner Christine Wilson opposed.

Commissioner Wilson’s dissent listed the “many reasons” why she opposed the Proposed Rule and believes it is vulnerable to “meritorious challenges . . . in which the Commission is unlikely to prevail.”⁵ In particular, Commissioner Wilson cited her view that the Proposed Rule is a “radical departure from hundreds of years of legal precedent that employs a fact-specific inquiry” into the legality of non-compete clauses. She also cautioned that there is insufficient evidence to support the Proposed Rule because the Commission has only just begun enforcement actions challenging non-compete clauses and the academic literature contains mixed results that do not provide support for the scope of the rule.

Finally, Commissioner Wilson’s strong dissent identified a number of potential concerns about the FTC’s authority to issue the Proposed Rule at all, including the following:

- *First*, the NPRM purports to issue the Proposed Rule pursuant to Sections 5 and 6(g) of the FTC Act. However, Section 5 does not grant the FTC rulemaking authority, and it is contested whether Section 6(g) grants the FTC substantive rulemaking authority; indeed, FTC Commissioners testified for decades before Congress that it did not.
- *Second*, the FTC’s authority to issue the Proposed Rule could be subject to challenge under the major questions doctrine, which evaluates administrative agency actions by asking “whether Congress in fact meant to confer the power the agency has asserted” and looks to whether the “history and the breadth of the authority that the agency has asserted, and the economic and political significance of that assertion, provide a reason to hesitate before concluding that Congress meant to confer such authority.” *West Virginia v. EPA*, 142 S. Ct. 2587, 2608 (2022).
- *Third*, the Proposed Rule could be subject to constitutional challenge under the nondelegation or other doctrines.

Conclusion

The Proposed Rule marks a radical departure from existing treatment of non-compete clauses in federal and state law, and represents an attempt by the FTC to substantially expand its authority under Section 5 of the FTC Act. This broad action is in keeping with other aggressive steps taken by the Biden Administration to expand antitrust

⁴ See, e.g., *Atlantic Refining Co. v. FTC*, 381 U.S. 357, 369 (1965); *FTC v. Brown Shoe Co.*, 384 U.S. 316, 321 (1966); *Official Airline Guides v. FTC*, 630 F.2d 920, 927 (2d Cir. 1980); *Boise Cascade Corp. v. FTC*, 637 F.2d 573, 581-82 (9th Cir. 1980); *E. I. Du Pont de Nemours & Co. v. FTC*, 729 F.2d 128, 142 (2d Cir. 1984).

⁵ See Christine S. Wilson, Comm’r, Fed. Trade Comm’n, Dissenting Statement Regarding the Notice of Proposed Rulemaking for the Non-Compete Clause Rule, 1 (Jan. 5, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/p20100ononcompetewilsondissent.pdf.

enforcement through a “whole-of-government” approach. If enacted in its current form, the Proposed Rule would substantially alter employer-worker relations and create significant challenges for employers worried about leakage of competitively sensitive information to rival firms. Moreover, by removing an important tool for enforcing confidentiality provisions, it could create increased risks of coordinated effects between rival firms, as a worker with knowledge of a company’s competitive plans would be free to leave their employer and join a competitor without any delay. Finally, the Proposed Rule is at real risk of legal challenge if finalized in its current form, the outcome of which is highly uncertain.

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