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Client Alert

FTC Proposes Rule to Categorically Ban Non-Compete Agreements

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Yesterday, the Federal Trade Commission proposed a sweeping new rule that would ban employers from including non-compete terms in employment agreements with virtually all of their workers – from janitors to senior executives. Describing such agreements as an "exploitative practice that suppresses wages, hampers innovation, and blocks entrepreneurs from starting new businesses," the FTC's rule deems non-compete agreements to be an "unfair method of competition" under Section 5 of the FTC Act, without regard for any business justifications or reasonableness. Potential rulemaking against non-compete clauses has been percolating for some time and has support from the White House, but the breadth of the proposed rule is nonetheless surprising.

The FTC's push for this rule under its Section 5 authority surely will spark legal—including constitutional—challenges that could delay implementation of any final rule for months, if not years. Companies need not immediately start rescinding or avoiding reasonably tailored non-compete agreements with employees, but should take note that the FTC is not likely to sit on the sidelines and wait for a final rule to come into effect before taking further action against some employers based on the scope of their non-compete agreements. The proposed rulemaking and the FTC's recent enforcement actions targeting specific companies' use of non-compete provisions as violations of Section 5 reflect the FTC's and DOJ's aggressive approach to antitrust enforcement in the labor markets – including the FTC's desire to bring enforcement actions in this area even before any final rule goes into effect.

The Proposed Rule

The FTC's proposed rule categorically deems all non-compete agreements with workers "unfair methods of competition" and requires that companies cease using these provisions and rescind any existing agreements (and provide notice to current and former employees). The Commission's proposal is based on its conclusion that non-compete agreements are inherently exploitative and coercive to employees, suppress wages and harm competition for labor, and harm innovation and new market entry. The rule rejects the traditional fact-specific analysis under federal law that weighs the potential anticompetitive effects and procompetitive benefits of any given restrictions in favor of a bright-line rule prohibiting all non-compete agreements as unfair methods of competition, which is similar to the approach taken in states like California that generally prohibit the use of non-compete agreements. The proposed rule also flatly rejects common business justifications for such provisions, such as the protection of intellectual property, trade secrets, and other proprietary and competitively sensitive information, claiming that other, less restrictive alternatives exist to protect those interests.

The proposed rule defines non-compete agreements as "contractual terms 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." The rule adopts a "functional test" to determine if a particular contract term is a "non-compete" within the purview of the rule, and contemplates that broad non-disclosure agreements or similar covenants could amount to *de facto* non-compete agreements that would be also banned under the FTC's proposal. The proposed rule does not specifically address non-solicitation agreements.

The proposed rule also covers nearly all types of "workers," adopting an expansive definition that includes paid or unpaid independent contractors, externs, interns, volunteers, apprentices, and sole proprietors. There is also no exception for senior executives or other highly skilled or highly paid workers for whom non-compete agreements are often commonplace, although the notice of proposed rulemaking does seek public comment regarding whether the adoption of these provisions for different categories of employees should be subject to different treatment.

The only proposed exception to the rule's broad prohibition on non-compete agreements is for those agreements entered into in connection with the sale of a business. However, even in that case, the exception would apply only for those individuals who hold a 25% or greater ownership interest in the business being sold. Non-compete agreements entered into in connection with the sale of a business – and thus subject to the rule's exemption – would still be subject to other federal antitrust and state laws that prohibit non-competes that are overly broad in their duration, geographic scope, and scope of prohibited post-employment activities.

The proposed rule also explicitly states that it preempts state laws, regulations, orders, or interpretations to the extent they are inconsistent with the FTC's rule. But if state law provides "greater protection" to workers, the proposed rule would not preempt state law. In other words, the FTC's proposed rule seeks to provide a "regulatory floor, not a ceiling."

Wilson Dissent

The FTC issued the notice of proposed rulemaking on a 3-1 vote. Commissioner Wilson dissented, noting that the proposed rule "represents a radical departure from hundreds of years of legal precedent" that has employed a fact-specific inquiry regarding whether non-compete provisions are reasonable in both their scope and duration, as well as in light of the business justification for their adoption. Instead, Commissioner Wilson argues that the Commission replaces that evaluation with "an unsubstantiated conclusion" that non-competes have a tendency "to generate negative consequences" for consumers and others, and uses that approach to "summarily … condemn conduct it finds distasteful."

Road Ahead

The proposed rulemaking is the latest in the FTC's push to rein in the use of non-compete agreements and follows the White House's call to limit non-competes and the FTC's November Policy Statement that vowed to reinvigorate the use of Section 5 of the FTC Act. Any final rule, however, is likely to face an immediate challenge

to its legality that could lead to years of litigation and uncertainty. There is little precedent for an FTC rulemaking on unfair methods of competition, and the FTC could face a range of potential arguments involving both process and substance including, that it lacks the statutory authority to promulgate this rule or any rule on unfair methods of competition, the Commission lacks Congressional authorization to undertake this initiative, or, even if it does, that such authority is an impermissible delegation of legislative authority.

Commenters are invited to weigh in on the proposed rulemaking, which is subject to a 60-day notice and comment period. While it is uncertain whether, when, or in what form the proposed rule will go into effect, companies should assume that the antitrust agencies will continue to focus significant resources on their enforcement efforts in the labor markets.

Takeaways

It is highly likely that any final rule will be tested in the courts, but until there is a judicial determination of the validity of the rule there will be a potentially prolonged period of uncertainty for firms that have used or would like to use non-competes. In the short term, the FTC is likely to continue to pursue additional challenges to non-compete clauses under Section 5, as interpreted in its recent statement. Those challenges might be prompted by employee complaints and stand-alone investigations, but the agency also will be on the lookout for non-competes in connection with its merger review authority and might demand rescission as a condition of approval. During this period of uncertainty, it may be prudent for companies with significant non-competes to consider reviewing their policies towards use of non-competes and, when deemed necessary, well-document the reasons for their use. In particular, employers should ensure that their non-compete agreements are narrowly tailored as to:

- **Duration.** Non-competes that apply for one year after the employee leaves employment are more likely to be justifiable. Non-competes lasting two to five years may be defensible depending on the overall factors supporting the longer term and state law. Non-competes over five years are likely to raise the most risk, although there are some cases that have upheld non-competes up to 10 years in specific circumstances.
- **Geography.** Non-competes should be limited to the geographic area where the employer operates and the employee provides services. For example, for companies that provide products and services to customers in a local area, the non-compete should be limited to that area or a reasonably limited mileage radius around the office where the employee works. For senior executives of a company with national operations, a nationwide non-compete might be defensible, but may require greater business justification.
- **Prohibited Activities.** Non-competes should only prevent the employee from engaging in a directly competing business to the business that he or she participates in for the employer. Non-competes that prohibit the employee from working in a business providing different products or services are likely to raise antitrust risks.
- **Covered Employees.** Agency scrutiny has primarily – but not exclusively – focused on non-competes that apply to lower-level employees, where the agencies question the necessity for provisions to protect a

legitimate business interest through a non-compete. Non-competes that apply to more senior executives may raise less risk, depending on the circumstances.

Companies that want to re-examine their existing non-compete agreements or who want to submit a public comment in response to the FTC's proposed rule can contact Crowell's antitrust, labor, or trade secrets teams, including the contacts for this alert.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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