FTC Proposes Broad Ban on Worker Noncompete Clauses

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On January 5, 2023, the U.S. Federal Trade Commission (FTC) issued a notice of proposed rulemaking under the FTC Act with far-reaching implications for U.S. employers. If enacted and enforced, the proposed rule would prohibit employers from entering noncompete clauses with workers, and require employers to rescind existing noncompete clauses and actively inform their current and former workers that existing noncompete clauses are no longer in effect. The proposed rule also would prohibit contract terms that amount to "de facto" noncompete clauses, but would provide a narrow "sale of business" exception to the prohibition on noncompete clauses if the worker subject to the clause is at least a 25% owner, member or partner in the applicable business entity at the time the worker enters into the clause.

In the notice, the FTC asserts that noncompete clauses harm workers and undermine competition, viewing the proposed rule as part of the agency's larger effort to promote competition in the labor markets. Critics have observed that the proposed rule would be a dramatic departure from the fact-based reasonableness inquiry that courts have historically applied to noncompete agreements under the antitrust laws and follows the FTC's aggressive November 2022 Policy Statement that claimed broader authority to take enforcement action against methods of unfair competition under Section 5 of the FTC Act. As FTC Commissioner Christine S. Wilson pointed out in a dissenting statement, the January 2023 proposed rule is likely to be subject to legal challenges surrounding the FTC's authority to adopt such a far-reaching ban that would fundamentally alter the treatment of noncompetes. The FTC has invited comments and Commissioner Wilson is encouraging submissions.

Provisions of Proposed Rule

Broad Ban on Noncompetes With Any Workers

The proposed rule would prohibit employers from entering into or maintaining noncompete clauses with workers, or representing to workers that they are subject to noncompete clauses. Compliance would be required 180 days after the date of publication of the final rule in the Federal Register (the compliance date). Under the proposed rule:

- "Worker" means any natural person who works, either paid or unpaid, for an employer, including without limitation an employee, individual classified as an independent contractor, extern, intern, volunteer, apprentice or sole proprietor who provides a service to a client or customer.
- A "noncompete clause" means any 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. This includes any "de facto" noncompete clause that has a similar effect (*e.g.*, a nondisclosure agreement written so broadly that it effectively precludes the worker from working in the same field, or a contract requiring a worker to make certain payments to the employer if the worker's employment terminates within a specified time period).

The proposed rule would not prevent employers from entering into other forms of restrictive covenants with workers (such as nondisclosure and nonsolicitation restrictions), as long as they are not written so broadly as to constitute "de facto" noncompete clauses.

Rescission and Notice Requirements

The proposed rule would require that employers that have existing noncompete clauses with current and former workers rescind the noncompete clauses by no later than the compliance date. Within 45 days of rescinding a noncompete clause, employers would

be required to provide notice to each affected worker that the worker's noncompete clause is no longer in effect and may not be enforced. Employers would be required to notify each worker in an individualized communication in a paper or digital format (*e.g.*, email or text message). The notice requirement would apply to current workers and also to former workers if the employer has a former worker's contact information readily available. The proposed rule includes model language that employers can use to provide the notice to workers, though employers may use different language provided that the notice communicates to workers that their noncompete clauses are no longer in effect and may not be enforced. Employers can comply with the rescission requirement by providing workers with the required notice and are not required to amend the agreements themselves.

Sale of Business Exception

The proposed rule would not apply to a noncompete entered into by a person who is selling a business entity or otherwise disposing of all of the person's ownership in a business entity. The rule also would not apply to a person who is selling all or substantially all of a business entity's operating assets, when the person restricted by the noncompete clause is a substantial owner of, or substantial member or substantial partner in, the business entity at the time the person enters into the noncompete clause.

- A "substantial owner, substantial member, and substantial partner" is defined as an owner, member or partner holding at least a 25% ownership interest in a partnership, corporation, association, limited liability company or other legal entity, or a division or subsidiary thereof, regardless of the consideration paid.
- Noncompete clauses covered by the exception would remain subject to federal antitrust law as well as all other applicable law.

Coverage

Buried in the Preamble to the proposed rule, the FTC recognizes that the proposed rule would not apply to entities not subject to the FTC Act, which includes certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers and foreign air carriers, and persons subject to the Packers and Stockyards Act of 1921, as well as entities not "organized to carry on business for its own profit or that of its members."

State Laws Superseded

The proposed rule purports to supersede any state statute, regulation, order or interpretation to the extent that such statute, regulation, order or interpretation is inconsistent with the rule. State rules will not be considered inconsistent if the protection afforded to workers is greater than the protections provided under the proposed rule.

Proposed Rule Departs From Long-standing Precedent and Is Likely To Face Legal Challenges

We anticipate challenges to the proposed rule that will focus on whether the FTC has the authority to adopt a nationwide ban on noncompete clauses. On the same day the FTC issued the proposed rule, Commissioner Wilson issued a dissenting statement that outlined potential legal challenges to the rule on the basis that (1) the FTC lacks authority to engage in this type of rulemaking based on the history of Section 6(g) of the FTC Act and ambiguity as to whether rulemaking authority extends to substantive competition rules, (2) the rule is barred by the "major questions doctrine" recently addressed by the Supreme Court in *West Virginia v. EPA*, which found that a "clear statement" from Congress is needed to support assertions of broad authority that have great political or economic significance, and (3) even if the FTC has the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the nondelegation doctrine. The proposed rule seeks to change a lengthy history of case law recognizing the legitimacy of noncompete clauses that are determined to be reasonable, including well-settled federal appeals court precedent recognizing that noncompetes "are legal [under Section 5 of the FTC Act] unless they are unreasonable as to time or geographic scope."[1]

Given the likelihood that any final FTC rule will be subject to multiple legal challenges, any attempts at implementation or enforcement may be subject to protracted litigation, and the rule may ultimately be invalidated by the courts.

FTC Push To Block Noncompete Agreements and Assert Broad Authority To Police 'Unfair Competition'

The day before issuing the notice of proposed rulemaking, the FTC announced that it took legal action against three companies and two individuals to prevent them from enforcing noncompete restrictions against thousands of workers. This action is the first time that the FTC filed suit to block noncompete restrictions in this context, and, together with the proposed rule, highlights the FTC's aggressive new commitment to restricting the enforcement of noncompete agreements and other conduct it deems to constitute unfair competition.

The FTC's actions are consistent with its recent effort to dramatically expand its authority to prevent "unfair methods of competition" under Section 5 of the FTC Act. Until recently, the FTC chose to bring very few stand-alone claims under its competition authority as a matter of policy. However, on November 10, 2022, the FTC updated its Policy Statement to claim expansive authority to challenge conduct beyond what the courts have

[1] *Snap-On Tools Corp. v. Fed. Trade Comm'n*, 321 F.2d 825, 837 (7th Cir. 1963).

historically recognized as actionable under antitrust laws such as the Sherman Act and Clayton Act. While the FTC's Policy Statement and proposed rule demonstrate an effort to dispense with fact-based assessments of conduct in favor of *per se* rules, it is notable that the potential alternative rules provided in the proposed rule implicitly acknowledge that noncompete clauses may be justified in certain scenarios.

FTC Enforcement

To enforce violations of the final rule, the FTC could potentially commence an administrative proceeding under Section 5(b) or seek a district court injunction under Section 13(b) of the FTC Act. Accordingly, the FTC could seek to enjoin a defendant in federal court when the defendant "is violating, or is about to violate" Section 5 and such an injunction is in the public's interest.[2] In this case, the FTC could seek an injunction forcing companies to follow the noncompete clause rule, including via rescinding existing noncompete agreements and informing current and former workers that they have been canceled.

By contrast, the FTC may be unable to seek monetary relief for violations of this competition rule. Section 19 of the FTC Act enables the FTC to seek monetary relief for violations of consumer protection rules on unfair or deceptive practices,[3] but it is silent regarding remedies for unfair methods of competition. In addition, the Supreme Court held in *AMG Capital Mgmt., LLC v. FTC* that courts may not grant equitable monetary relief such as disgorgement or restitution under Section 13(b) of the FTC Act.

Potential Impact on Executive Compensation

Many executive compensation arrangements, including employment agreements, severance plans, equity plans and award agreements, contain provisions that would qualify as noncompete clauses under the proposed rule. The inclusion of a noncompete clause, and the duration of the noncompete clause following an executive's termination of employment, is often subject to significant negotiations as part of the executive compensation arrangements. For example, where otherwise permissible under applicable state law, employment or severance agreements often provide that an executive will receive severance payments for a specified period of time following a qualifying termination of employment if, among other things, the executive does not compete with the company or violate any other applicable restrictive covenants during the severance period. Even in instances where the severance is paid in a lump sum immediately upon a qualifying termination of employment, the severance is often provided at least partially in consideration of the applicable restrictive covenants. Similarly, many equity awards are made at least partially in consideration of the applicable restrictive covenants included in the equity award agreement.

The removal of noncompete clauses would represent a fundamental shift in the negotiation and design of new executive compensation arrangements in many jurisdictions. The requirement to rescind existing noncompete clauses and inform current and former employees that they have been canceled would result in employers — in many cases — losing the "benefit of the bargains" they made.

In addition, the removal of the ability to enter into, maintain and enforce noncompete clauses would eliminate a common mitigation technique used to manage the loss of deduction and 20% excise tax imposed on employees under Sections 280G and 4999 of the Internal Revenue Code for certain excess "parachute payments," which are generally payments made in connection with a change in control to certain individuals where the payments exceed 300% of the person's average taxable compensation during the five taxable years preceding the year in which the change in control occurs.

A key exemption in the 280G regulations provides that the term "parachute payment" does not include any payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the change in control date. For purposes of Section 280G, "reasonable compensation for personal services" expressly includes reasonable compensation for refraining from performing services, such as under a noncompete clause, but only to the extent that it is demonstrated by clear and convincing evidence that the noncompete clause substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the noncompete will be enforced against the individual. Assuming that these conditions are met, a portion of the parachute payments may be attributed to the executive's noncompete clause as reasonable compensation for post-closing services, which often significantly reduces the aggregate parachute payments, including, in some cases, to a level that avoids any imposition of the excise tax. However, if the final FTC rule broadly prohibits noncompete clauses for executives, this common mitigation technique will no longer be available. This may impact the incentives provided to, and retention of, executives in connection with M&A transactions that may result in the imposition of the loss of deduction and 20% excise tax, particularly in the context of public company transactions where other mitigation strategies (such as obtaining a cleansing shareholder vote) are not available.

[2] 15 U.S.C. § 53.

[3] 15 U.S.C. § 57b(b).

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Potential Impact on M&A Transactions

The application of the proposed rule to noncompete clauses entered into with individuals who are workers and/or equity owners in connection with M&A and investment transactions is currently unclear. On its face, the proposed rule purports to apply to such transactions and could have a material impact on how parties approach the use of noncompete clauses accordingly. Generally, the proposed rule would be far more restrictive than currently applicable laws of many states that govern the use of noncompetes. Buyers and sellers in M&A and investment transactions routinely use noncompete clauses to protect the interests of the relevant businesses (and buyer) and for which separate and valuable consideration is received by the individual agreeing to the noncompete clause. The sale of business exception in the proposed rule is very narrow in scope and would not allow transaction participants to use noncompete clauses in the same manner going forward, which could have a material impact on how parties structure transaction consideration and other terms. Further, buyers in transactions often seek to enter into noncompetes with key employees who might not be selling shareholders, but the proposed rule would prohibit that practice unless the employee owns 25% or more of the target. Finally, the proposed rule would invalidate noncompete clauses entered into in connection with completed transactions.

Open Questions

The proposed rule is subject to a 60-day public notice and comment period, and the FTC will review comments and potentially make changes to the final rule based on the comments. The FTC is specifically seeking comments on potential alternative approaches to the proposed rule, including whether:

- noncompete clauses between employers and senior executives should be subject to a different standard than noncompete clauses between employers and other workers;
- the rule should apply uniformly to all workers or exemptions, or whether different standards for different categories of workers should apply; and
- the rule should impose a categorical ban on noncompete clauses or a rebuttable presumption of unlawfulness.

While the proposed rule is drafted as a broad ban with limited exceptions, there are a number of nuances to noncompete restrictions that are not addressed by the rule or are open to interpretation. For example, the proposed rule prescribes a "functional test" for whether additional contractual terms should be treated as "de facto" noncompete clauses because, although these contractual terms do not explicitly prevent a worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer (*e.g.*, nondisclosure agreements, client or customer nonsolicitation agreements, employee nonsolicitation agreements, no-business/non-interference agreements and certain kinds of liquidated damages provisions), they could have the effect of prohibiting workers from seeking or accepting employment with a person or operating a business after termination of employment. The proposed rule includes two examples of "de facto" noncompete clauses based on scenarios from case law: an overly broad nondisclosure agreement that effectively precludes a worker from working in a related field, and a liquidated damages provision requiring a worker to pay the employer or a third party for training expenses not reasonably related to the actual training costs incurred if the worker terminates before a certain date. However, the FTC emphasizes that this list is nonexclusive and there are other provisions that may constitute "de facto" noncompete clauses, depending on the facts. It is unclear whether provisions that cannot be enforced with specific performance but are designed to incentivize workers not to compete (*e.g.*, granting equity that vests only after compliance during a noncompete period, paying cash severance only if a noncompete is not violated, or "clawback" provisions that apply if the worker engages in competition) would be viewed as "de facto" noncompete clauses that have the effect of "prohibiting" workers from competing.

The proposed rule also leaves many unanswered questions regarding the use of noncompete clauses in the transaction setting. For example, it is not clear how the rule would apply to a seller who continues as an employee and equity owner of a business after a transaction, or to an employee who is granted equity. In these cases, it is common for an individual to agree to be subject to a noncompete in such individual's capacity as an equity holder. It also is not clear whether the proposed rule would prohibit provisions that require the forfeiture or return of transaction consideration where a worker competes post-employment. The sale of a business exception also does not address GP staking and other minority investment transactions where there is not a sale of "all of the person's ownership in the business entity, or by a person who is selling all or substantially all of a business entity's operating assets."

The impact to pending litigation and existing injunctions also would need to be addressed. If the proposed rule is implemented in its current form, defendants would likely move to dismiss pending actions to enforce noncompetes and parties subject to injunctions also might seek to challenge noncompetes. Questions would likely then arise regarding the impact of the rule on existing cases and orders from state and local judiciaries.

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Takeaways for Employers

If the proposed rule were to be finalized in its current form and upheld by the courts, employers would be broadly prohibited from entering into noncompete restrictions with workers, and required to rescind any such existing restrictions (which would include individually notifying current and former workers of such rescission). This outcome would dramatically change the landscape of restrictive covenants for employers in most states. However, it is possible, if not likely, that the FTC's final rule (which will not be issued until after the end of the 60-day comment period) may be narrower than the proposed rule. Further, any FTC final rule would not go into effect until 180 days following publication, may be further delayed while it remains subject to legal challenge and ultimately may be invalidated by the courts.

For now, buyers and employers should be aware that changes to restrictive covenant laws may be forthcoming, and be prepared that they may need to review and update their restrictive covenant clauses and practices in the upcoming year. However, at this time, employers are not required to change their restrictive covenant practices based on the proposed rule. We will continue to monitor new developments and keep you apprised of relevant information and deadlines. If you have questions or are interested in commenting on the proposed rule during the 60-day public notice and comment period and would like assistance with crafting a comment, please contact david.schwartz@skadden.com.

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