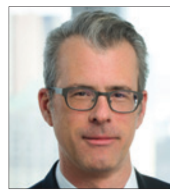
New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW. NYLJ.COM
ALM.
VOLUME 269—NO. 29
TUESDAY, FEBRUARY 14, 2023

ANTITRUST TRADE AND PRACTICE

Expert Analysis

# The Wide-Ranging Impacts of the FTC's Proposed Non-Compete Clause Rule



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On Jan. 5, 2023, in a 3-1 vote, the Federal Trade Commission (FTC or Commission) issued a sweeping notice of proposed rulemaking to ban non-compete clauses in employment contracts (the Proposed Non-Compete Clause Rule). Following on the FTC's announced expansive approach to Section 5 of the FTC Act (see Statement of Enforcement Policy Regarding Unfair Methods of Competition Under Section 5 of the FTC Act (Nov. 10, 2022)), the proposed rule "would provide that it is an unfair method of competition—and therefore a violation of Section 5—for an employer to enter into a non-compete clause with a worker …." (Non-Compete Clause Rule, 88 Fed. Reg. 3482, 3541 (Jan. 19, 2023) (to be codified at 16 C.F.R. 910)). According to the Commission, non-compete clauses are "exploitive and coercive at the time of contracting"; they prevent workers from leaving jobs, decrease competition for workers, lower wages, and discourage new business and innovation (id.).

The Proposed Non-Compete Clause Rule would prevent employers from entering into non-compete clauses in employment contracts and would require employers to inform current and former employees that existing non-competes are invalid. It is difficult to overestimate the effect this rule would have on thousands, if not millions, of non-compete agreements in employment contracts today. Under the proposed rule—which seeks to preempt current state laws—current and former employers would be required to rescind any non-compete clauses within 180 days after publication of the final rule. (Id. at 3536.) The proposed rule also would prohibit contracts with terms that are "de facto" non-compete clauses, such as broad non-disclosure or non-solicitation agreements that effectively prohibit the employee from working in the same field. The proposed rule provides a narrow "sale of business" exception for 25% owners, members, or partners in the sold business, but does not provide an exception for key employees or executives who do not have ownership interests in the target business. (Id. at 3484).

Such a far-reaching proposed rule is almost inevitably going to lead to legal challenges should

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it be finalized in a substantially similar form. For just one example, the day the Proposed Non-Compete Clause Rule was announced, the U.S. Chamber of Commerce (the Chamber) called it "blatantly unlawful" and an action that "overturns well-established state laws which have long governed [the use of non-competes]." (Press Release, U.S. Chamber of Commerce, The FTC's Noncompete Rulemaking is Blatantly Unlawful (Jan. 5, 2023)). As discussed below, because the FTC has limited experience enforcing non-competes and uncertain legal authority in this area, the proposed rule would significantly change the status quo of employment non-competes.

## FTC Experience With Non-Compete Clauses

Some question whether the Commission possesses the necessary experience and evidence to support the scope of the proposed rule. In her January 5 dissenting statement, Commissioner Christine Wilson wrote that "the current record shows that studies in this area are scant, contain mixed results, and provide insufficient support for the scope of the proposed rule." (Id. at 3540). This is, at least in part, because enforcement of employment non-compete agreements has mainly been left to state law over the 100-year history of the FTC.

In recent years, the FTC has challenged few non-compete provisions. Although the Proposed Non-Compete Clause Rule distinguishes between non-compete clauses in labor contracts—which the Commission states directly harm workers—and non-compete clauses in merger agreements—which the Commission acknowledges can protect legitimate business interests—prior to last month, the Commission had not brought any cases that challenged non-compete clauses in employment contracts or concluded that such provisions harm competition in labor markets. As of this article's publication, the only litigated non-compete case by the current FTC leadership was a June 2022 action that challenged a non-compete clause contained in a merger agreement between retail fuel outlets. (See Fed. Trade Comm'n Statement regarding In the Matter of ARKO Corp./Express Stop (June 10, 2022)). In that case, the FTC argued only that the non-compete provisions embedded within the merger agreement were too broad because they extended beyond the geographical scope of the fuel outlet assets being purchased.

In what may be an attempt by the FTC to establish its relevant precedent and experience, on Jan. 4, 2023—one day before announcing the Proposed Non-Compete Clause Rule—the Commission announced three consent agreements which resolved allegations that non-compete provisions in labor contracts constitute an unfair method of competition. According to FTC Chair Lina Khan, "[t]hese cases highlight how non-competes can block workers from securing higher wages and prevent businesses from being able to compete." (Press Release, Fed. Trade Comm'n, FTC Cracks Down on Companies that Impose Harmful Noncompete Restrictions on Thousands of Workers (Jan. 4, 2023)). In one complaint, the agency took action against a Michigan-based security guard company and its key executives for using what the Commission called coercive non-competes on low-wage employees. These non-compete provisions prevented more than a thousand security guards from working for a competitor within a 100-mile radius for two years after departure. The company had continued to enforce the provisions even after a Michigan state court had held them unreasonable and unenforceable. (See *Prudential*

*Security v. Pack*, No. 18-015809-CB (Mich. Cir. Ct. Dec. 13, 2018)). In the other complaints, the Commission ordered two of the largest U.S. glass container manufacturers to stop imposing non-compete clauses on their workers because the provisions obstructed competition and impeded new companies from hiring the highly specialized talent needed to enter the market.

The FTC's lack of long-term experience is in part due to state laws generally regulating the use of non-competes in employment contracts. But even considering the current state laws on the books, the FTC's proposed rule is significantly more expansive. The vast majority of states allow employment non-competes, with only three states (California, North Dakota and Oklahoma) nearly prohibiting outright. An additional 11 states prohibit certain non-competes based upon an employee's earnings or a similar factor (e.g., generally the earnings must be less than $100,000). In contrast, the Proposed Non-Compete Rule is not tailored to earnings or any other objective criteria. Should it take effect, the FTC's proposed rule would preempt states' more customized laws with a generalized ban on these types of contractual arrangements.

## Legal Authority For the Proposed Rule?

The proposed rule follows on the FTC's asserted expansion of its enforcement approach under Section 5 of the FTC Act. Section 5 empowers the Commission to prevent companies from engaging in "unfair methods of competition" (competition authority)

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and "unfair or deceptive acts or practices" (consumer protection authority). 15 U.S.C. §45(a)(1)-(2). Section 6(g) of the FTC Act allows the Commission to "make rules and regulations for the purpose of carrying out the provisions of," among other things, Section 5. 15 U.S.C. §46(g).

There is a debate, however, about whether the FTC's authority under Section 6(g) extends to substantive rulemaking with respect to unfair methods of competition. (See Noah Joshua Phillips, Against Antitrust Regulation, Am. Enterprise Inst. (Oct. 13, 2022)). Fifty years ago, in *National Petroleum Refiners v. FTC*, 482 F.2d 672 (D.C. Cir. 1973), the D.C. Circuit held that the agency has such substantive rulemaking authority because of "contemporary considerations of practicality and fairness" and "the background and purpose" of the FTC Act. Id. at 678, 683. But two years later, Congress enacted the Magnuson-Moss Warranty Act, 15 U.S.C. §2301, et seq., which, according to Commissioner Wilson, effectively superseded *National Petroleum Refiners*. In her dissenting statement, Commissioner Wilson explained the ambiguity in the statute about "whether Congress in enacting the Magnuson-Moss Warranty Act sought to clarify existing rulemaking authority or to grant substantive rulemaking authority to the FTC for the first time. If the latter, then the FTC only has substantive consumer protection rulemaking power, and lacks the authority to engage in substantive competition rulemaking." (88 Fed. Reg. at 3544.) Absent an express grant of authority from Congress permitting the agency to engage in substantive rulemaking in the

competition arena, it is possible that the courts would strike down the Proposed Non-Compete Clause Rule if it were to become final. See, e.g., *AMG Capital Management v. FTC*, 141 S. Ct. 1341, 1349 (2021) (unanimously rejecting FTC's claim that it could assert broad remedial powers under Section 13(b) of the FTC Act without an express grant of authority from Congress).

## Practical Impacts Of the Proposed Rule

As a practical matter, it will likely be some time before companies would ever need to comply with the final Non-Compete Clause Rule. Public comments on the proposed rule are due 60 days from the date that the Federal Register publishes the rule, after which the agency must consider those comments and incorporate them if it issues a final rule. If experience with the recent DOJ/FTC merger guidelines is any indication, this process will likely take several months and potentially longer if there is a legal action challenging the proposed rule. Such a challenge is expected, as a week after the announcement the Chamber vowed to "challenge in court [the FTC's] authority to even make" nationwide rules such as the Non-Compete Clause Rule. (Anna Edgerton & Mark Niquette, *Chamber Vows to Sue FTC Over Non-Compete Ban If Rule Goes Ahead*, Bloomberg Law (Jan. 12, 2023)).

Should a final rule substantively similar to the Non-Compete Clause Rule take effect, the FTC would still need to find ways to enforce violations. This could take the form of an administrative proceeding under Section 5(b) or seeking a district court injunction under Section 13(b) of the FTC Act. In order for the Commission to skip the administrative proceeding and seek to enjoin a defendant in federal court, it must make a showing that the defendant "is violating, or is about to violate" Section 5 and such an injunction is in the public's interest. See 15 U.S.C. §53. Though untested in federal court, the Commission's argument may be that companies that do not rescind existing non-compete agreements and inform employees that they have been canceled have violated the Non-Compete Clause Rule. In such a circumstance, the FTC likely could not seek monetary damages for violations because Section 19 of the FTC Act only specifies monetary remedies for violations of consumer protection rules, and it is silent on remedies for violations of competition rules. See 15 U.S.C. §57(b). While the practical impacts of this rule are still months—if not over a year—away, the FTC's focus on these non-compete clauses is clear and will continue to evolve as it receives public comments.

## Conclusion

The Proposed Non-Compete Clause Rule represents both a concrete manifestation of the FTC's assertion of its increased enforcement views and the first major test of its claimed rulemaking authority. Regardless of whether the proposed rule is finalized in its current broad formulation, it is further evidence of the current FTC's intent to seek to broaden its powers, with a continued focus on labor issues. And while the practical consequences of the proposed rule are many months in the future, it already has created a robust debate by public commentators and almost certainly will continue in the courts as well.

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