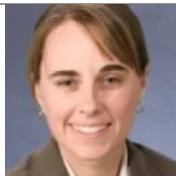


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## Skadden Discusses the FTC's Plan To Limit Noncompetes

*By Anne E. Villanueva, Joseph M. Rancour and Luke J. Cole* June 22, 2023

### Comment

As part of its declared focus on fostering competition in the labor market, the Federal Trade Commission (FTC) has proposed to ban most noncompetition agreements, or noncompetes, restricting the activities of former employees. Noncompetes can be a useful tool for employers to safeguard their confidential information, trade secrets and goodwill from unfair competition by former employees. While the federal antitrust laws apply to noncompete agreements, historically, these kinds of clauses have been assessed under a fact-specific reasonableness standard by the federal agencies and courts. Restrictions in noncompetes have traditionally been governed by state law, and the FTC's proposal has provoked criticism that the proposed rule would ignore the legal framework adopted by the states on this issue. If the commission moves forward with a ban of noncompetes, it will almost certainly face legal challenges.

But the FTC is not alone in viewing noncompetes with suspicion. Several states have also moved to limit noncompetes in recent years, and other states could decide to follow the FTC's lead.

### The Current Law of Noncompetes Is a Patchwork of State Laws

State laws governing post-employment noncompetes vary widely. A few states, notably California, generally prohibit post-employment noncompetes. California does have several exceptions, however, including an important one for individuals selling their interests in a business.

Other states, such as Delaware and New York, allow post-employment noncompetes, but they generally require that such agreements be reasonable in duration, geographic scope and the kinds of competition they prohibit. For example, in 2022, Delaware's Court of Chancery declined to enforce a noncompete in connection with the sale of a business that it found was too broad in terms of geography and the types of competition it prohibited. Moreover, the court declined to "blue pencil" or rewrite the noncompete in order to make it enforceable, invalidating it in its entirety. This decision marked a shift in Delaware's approach to noncompetes and it is especially important since many noncompetes signed in connection with transactions are governed by Delaware law.

Many state legislatures have taken steps to limit post-employment noncompetes in recent years. For example:

- Several jurisdictions – including Colorado, the District of Columbia, Illinois, Oregon and Washington – now limit noncompetes to those who earn more than a certain amount each year. These salary thresholds can reach six figures — as high as \$150,000 in the District of Columbia.
- Massachusetts has gone even further and requires former employees to be paid during any noncompete period.

### The FTC's Proposed Rule on Noncompetes Would Be Broader Than Most State Laws

- The FTC's proposed rule would bar even noncompetes that would generally be found to be reasonable under existing state law.
- The rule would designate noncompetes to be a form of "unfair competition" under Section 5 of the FTC Act.
- The rule would prohibit entering into new post-employment noncompetes.
- The rule would require employers to rescind any existing noncompetes with current or former employees, and notify them of the rescission.

Other restrictive covenants that are often used to protect employees from unfair competition, such as confidentiality or non-solicitation agreements, would *not* be prohibited by the proposed rule. However, agreements that operate as *de facto* noncompetes would be.

In addition, the FTC would allow noncompetes as part of the sale of “all or substantially all” of a business’s assets where the seller owns 25% or more of a business being sold.

The FTC’s proposal is just one of a number of recent examples of federal antitrust regulators focusing on the intersection of competition and labor. The FTC has challenged noncompete clauses as “unfair methods of competition” in several recent administrative cases that have been resolved through consent orders requiring the respondents to drop their noncompetes and prohibiting them from imposing or enforcing noncompetes against relevant employees. The FTC and the Department of Justice (DOJ) have issued joint guidelines on the exchange of HR information on wages or benefits and its potential impact on competition in the labor markets. In addition, the DOJ has aggressively pursued a number of criminal antitrust cases involving alleged “no-poach” agreements among firms competing in the labor markets, but has thus far failed to secure criminal convictions across four recent cases.

## **The FTC Restrictions Could Complicate the Purchase of Businesses**

The FTC’s 25% ownership threshold would reduce the flexibility that buyers now have when negotiating to protect the goodwill of a business they are acquiring. By contrast, California and New York do not put a specific threshold on the percentage of ownership required to make a noncompete enforceable. By limiting the sale-of-business exception to substantial owners, the FTC rule would limit the protection the buyer of a business can obtain where an individual seller is responsible for a meaningful portion of a business’s goodwill but owns less than 25% of its equity.

The rule would also limit buyers’ ability to enter into noncompetes with key employees who are not owners or fall below the 25% threshold.

As the FTC itself notes, noncompetes with founders and key employees of acquired businesses occur in more than 75% of transactions. Limiting noncompetes with these key individuals would increase uncertainty among buyers about their ability to protect their investment in the acquired business, and that may affect the transaction value.

## **Legal Challenges to the FTC’s Rule Are Likely**

The FTC’s proposed rule was published on January 19, 2023, and the comment period ran through April 19, 2023, with over 26,000 comments submitted. If adopted by the commission, the rule could go into effect as soon as October 16, 2023.

Legal challenges to the proposed rule, if enacted, are likely. The FTC approved the rule in a 3–1 vote with then-Commissioner Christine S. Wilson dissenting. She said that the proposed rule is susceptible to legal challenges on various grounds, including that (1) the FTC may lack authority to engage in this type of substantive competition rulemaking based on the history of the FTC Act, (2) the rule is potentially barred under the “major questions doctrine” as 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) it could be found to be an impermissible delegation of Congressional authority under the nondelegation doctrine. Wilson, who stepped down from the FTC in March 2023, also pointed out that the rule would ban conduct that is currently allowed in 47 states and that has been permitted by courts interpreting federal antitrust laws.

Interest groups have also weighed in. The U.S. Chamber of Commerce has called the proposed rule “blatantly unlawful” and an attack on “well-established state laws,” and has said it is prepared to go to court if the rule is adopted.

Suits to block the rule would likely be filed when the measure is approved, well ahead of the effective date.

## **Companies Can Prepare Now for the Possibility of New Constraints on Noncompetes**

If the FTC’s proposed rule is finalized and survives legal challenges, employers will face the difficult task of rescinding their existing post-employment noncompetes and notifying affected workers of the rescissions in accordance with the regulation. Whether employers must do so while the issue is being litigated will depend on whether a court issues an injunction against the proposal while the case is pending.

Even if the FTC’s proposal is struck down by legal challenges, state laws that narrow the scope and/or application of allowable noncompetes will remain. Some states may follow the FTC’s lead and implement new or additional restrictions on noncompetes.

To prepare for these scenarios, employers will need to take an inventory of every noncompete to which they are a party — a potentially time-consuming process.

Employers can take proactive steps to protect themselves from allegations of unfair competition no matter the outcome of the FTC’s proposal:

- Frequently review all existing restrictive covenants for compliance with applicable state law. Usually, the relevant law is that of the state where the employee regularly works. The law of the state where the employer is headquartered or otherwise located should be considered, as well.
- Consider what alternative restrictions are permitted to protect the employer’s interests — requiring, for example, that employees sign broad agreements to protect trade secrets and other confidential information (with necessary carveouts for any disclosures that employees are permitted to make under applicable state or federal law).

- Where permitted, consider non-solicitation agreements with employees that bar them from recruiting customers or other employees (keeping in mind that such agreements are usually only enforceable where they are deemed to be reasonable under state law).
- In negotiating transactions, be mindful of any limitations on noncompetes that may apply. The value of a company may be reduced if the former owners or key employees are free to compete with it after a sale.

## Restrictions on Noncompetition Agreements Vary Widely by Jurisdiction

The current patchwork of laws surrounding noncompetes varies by state – therefore, it is important for employers to consider the relevant framework for the states in which they operate, regardless of the outcome of the FTC’s proposed rulemaking. While no means exhaustive, examples of recent proposed and enacted laws regarding post-employment noncompetes at the federal and state level include:

### FEDERAL

**FTC Proposal** Broad prohibition with narrow exception for sale of a business, limited to those selling >25% stake.

### STATES

<b>California</b>	Long-standing broad prohibition, but with an exception for certain sales of a business.
<b>Colorado, District of Columbia, Illinois, Oregon and Washington</b>	Laws enacted between 2020 and 2022 restrict noncompetes to employees making salaries over a certain threshold, ranging from \$75,000 to \$250,000, depending on the jurisdiction and the employee’s profession.
<b>Massachusetts</b>	Former employees must be paid during noncompete period, which can last no longer than one year in most circumstances.

*This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on a version of the firm’s article, “The FTC’s Plan To Limit Noncompetes Could Pose an Array of Practical Problems,” dated Spring 2023 and available [here](#).*