ROPES & GRAY

ALERT

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U.S. Federal Trade Commission Publishes Notice of Rulemaking Prohibiting Non-Compete Clauses

On January 5, 2023, the U.S. Federal Trade Commission ("FTC") published a sweeping proposed rule that, if finally issued, would prohibit post-employment non-compete clauses (or other clauses with comparable effect) in agreements between employers and their employees or other workers. Specifically, the FTC's notice of proposed rulemaking, published in a 3-1 vote, provides that the proposed "Non-Compete Clause Rule" would ban virtually all clauses in employment-related agreements that have the effect of restricting workers from seeking or accepting employment following their service with their employer—including voiding such clauses in existing agreements. The ban would be pursuant to Sections 5 and 6(g) of the Federal Trade Commission Act (the "FTC Act"), which declares "unfair methods of competition in or affecting commerce" to be unlawful, and authorizes the FTC to issue rules prohibiting such methods. The rule would also ban non-compete clauses in agreements entered into between an individual selling their ownership interest in a business entity and the buyer of such entity, unless the individual holds a 25% or greater interest in the entity being sold.

We have set forth below a summary of the proposed rule, as well as developing points for employers and investors to watch.

Background

The proposed Non-Compete Clause Rule comes after years of review of such clauses by the FTC and public commentators during both the Trump and Biden administrations, as well as public statements in support of such a rule by members of Congress and state attorneys general. In 2019 and 2020, the FTC hosted a public workshop focused on non-compete issues. In July 2021, President Biden signed Executive Order 14036, "Executive Order on Promoting Competition in the American Economy," which encouraged the FTC to adopt a rule limiting or banning the use of non-competes. Most recently, in November 2022, the FTC issued the 2022 Policy Statement Regarding the Scope of Unfair Methods of Competition, that focused on the agency's redeployment and renewed enforcement of Section 5 of the FTC Act, and positioned the agency to propose a rule regarding non-competes.

Summary and Scope of the Proposed Rule

The proposed Non-Compete Clause Rule would prohibit an employer from entering into an agreement with an employee or other worker that prevents the employee from seeking or accepting employment with another person or entity, or operating a business, following their separation from employment or engagement with the employer. The proposed rule broadly covers not only customary non-compete clauses, but also "*de facto*" non-compete clauses, such as a non-disclosure agreement that is "written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment" or an overly broad customer or employee non-solicit clause.

The proposed rule would require employers to rescind existing non-compete clauses, and to provide individualized, written notice to all current and former workers bound by such clauses, stating that the clause is no longer in effect and may not be enforced against the individual.

The proposed rule would not apply to non-compete clauses contained in agreements in connection with the sale of a business, and entered into between an individual seller (who is also an employee) of such business and the buyer, provided that the individual seller holds at least a 25% ownership interest in the business being sold and is also selling or otherwise disposing of *all* of their ownership interests, or all or substantially all of the business's assets, in connection with the transaction.

Requests for Public Comment and Stated Alternatives to the Proposed Rule

The FTC is seeking comments on all provisions of the proposed rule, with the comment period running for 60 days.

In its notice of proposed rulemaking, the FTC described a number of potential alternative approaches to regulating non-compete clauses that it had considered and on which it specifically seeks comment. For instance:

- Instead of a categorical ban on all non-compete clauses, the FTC's rule could provide that such clauses would be presumptively unlawful, but that employers could rebut that presumption with "clear and convincing evidence" that the non-compete clause "is unlikely to harm competition in the labor markets or identifies some competitive benefit that plausibly outweighs the apparent or anticipated harm" (similar to analyses under antitrust law) or "is necessary to protect a legitimate business interest" (similar to current state law governing non-competes, but with a heightened evidentiary standard).

- Instead of a uniform ban on non-competes for all workers, the rule could prohibit non-competes only for subsets of workers defined by job function, occupation, earnings, or some combination of these and/or other factors. For example, the rule could allow continued use of non-compete clauses with senior executives, or workers who qualify for certain exemptions under the Fair Labor Standards Act, or workers who earn more than a certain salary threshold. Notably, some recent state laws have taken this approach to regulating non-competes.

- The FTC is also considering a blend of these two approaches, such as a prohibition on non-competes for certain categories of workers and a rebuttable presumption of unlawfulness for others.

FTC Commissioner's Dissent; Anticipated Challenges to the Proposed Rule

The notice of the proposed Non-Compete Clause Rule was published despite internal disagreement among the FTC's Commissioners. In her dissent from the FTC's publication, Commissioner Christine Wilson focused on the "radical departure" of the proposed rule from the current legal framework, stating that the rule would impose an overbroad ban without regard to context or fact-specific reasons for entering into non-competes. Her dissent emphasized the legitimate business considerations that can support a non-compete agreement, and argued that the FTC itself acknowledges the importance of these reasons by creating a sale-of-business exemption in the proposed rule, and by soliciting comments on whether senior executives or other categories of employees should be subject to a less stringent standard. Commissioner Wilson also questioned whether non-competes in fact suppress workers' wages and thereby harm competition, describing the literature as a "mixed bag," and anticipated challenges to the FTC's authority to issue the proposed rule under constitutional and administrative law.

We expect that, if the rule is issued, business groups will likely challenge whether the relevant sections of the FTC Act provide the FTC with sufficient authority to issue this proposed rule. There will likely also be challenges to the Non-Compete Clause Rule under the "major questions doctrine"—most notably applied by the U.S. Supreme Court in the 2022 decision *West Virginia v. Environmental Protection Agency*, 142 S. Ct. 2587 (2022)—which requires agencies such as the FTC to identify clear statutory authorization to justify extraordinary rulemakings, such as this one, which have broad-based economic and political consequences. Indeed, the U.S. Chamber of Commerce previously submitted public comment to the FTC asserting that the agency lacked authority under the FTC Act to issue a rule banning non-compete clauses, even prior to the Supreme Court's issuance of the *West Virginia* decision, and Commissioner Wilson noted the strength of such an argument in her dissent.

Going Forward

We will be closely monitoring the proposed Non-Compete Clause Rule as it makes its way through the administrative process. The FTC's final rule will not issue until after the current notice-and-comment period has ended and likely will not become effective until 90 to 180 days after being issued (assuming it has not been stayed pending any court challenges). Public comment may result in at least some alterations to the current proposed rulemaking, so we do not recommend that employers make changes to their use of non-compete agreements in anticipation of the FTC's final rule.

The FTC's proposed rule has the potential for wide-ranging consequences, including for legal issues not addressed in any of the FTC's comments to date. For instance, we are monitoring whether the FTC could take the position that contractual forfeiture-for-competition provisions, including those requiring or permitting the forfeiture or discount repurchase of equity interests or the clawback of severance or equity proceeds, could be considered "*de facto*" non-competes. In addition, under Sections 280G and 4999 of the Internal Revenue Code, the amount of "parachute payments" subject to adverse tax consequences may be reduced by reasonable compensation for refraining from performing services, such as under a non-compete. Ascribing value to a non-compete is a common Section 280G mitigation strategy, particularly for public companies that are not eligible for the shareholder approval exception, which would be limited or eliminated under the FTC's proposed rule. Also, it is not clear from the text of the rule how or whether it would apply to non-competition agreements in certain sophisticated incentive compensation or profits-sharing plans, including carried interest plans, in which the carry vehicle entity (typically an LLC or partnership) is not the employer and the individual is a member of or partner in the carry vehicle entity, not an employee or independent contractor.

Please contact any member of Ropes & Gray's employment or antitrust teams for further guidance or advice on the FTC's proposed rule.