FTC Proposes Federal Rule to Ban Noncompetes with Employees

January 9, 2023

On January 5, 2023, the Federal Trade Commission ("FTC") proposed a new rule, which remains subject to public comment and, if finalized, would ban post-employment noncompete agreements with employees. The proposed rule would also require employers to rescind existing noncompetes and provide individualized notice of this rescission to current and former employees. Employers would likewise be barred from representing to an employee that the employee is covered by a noncompete clause. The proposed rule would also impact seller noncompetes, prohibiting post-employment noncompetes with seller-employees who owned less than 25% of the business entity at the time they entered into the noncompete.

The FTC's proposed rulemaking was issued in response to President Joe Biden's July 2021 executive order urging the FTC to ban or limit noncompete agreements.[1] The rulemaking also comes on the heels of recent FTC and state Attorney General enforcement actions with respect to noncompetes. The proposed rule is based on a preliminary finding by the FTC that noncompetes constitute an unfair method of competition and therefore violate Section 5 of the Federal Trade Commission Act.

Any final rule would supersede the ever-changing hodgepodge of state laws governing noncompetes, except to the extent any state law provides greater worker protections than the FTC's final rule. Still, the ultimate scope of any final rulemaking by the FTC on noncompetes is unclear. In addition, we can expect legal challenges to the enforcement of any final rule.

Requirements of the Proposed Rule

The proposed rule would ban employers from entering into, attempting to enter into or maintaining a post-employment noncompete with any worker.

[1] Our Debevoise Debrief on President Biden's executive order can be accessed here.

Which Workers Are Covered by the Proposed Rule?

The proposed rule would broadly apply to any paid or unpaid workers, including employees, independent contractors and sole proprietors who provide services to a client or customer. The definition is intended to cover gig economy workers, such as rideshare drivers. A franchisee in the context of a franchisor-franchisee relationship would not be considered a worker for purposes of the proposed rule.

What Is Considered a Noncompete Clause Under the Proposed Rule?

Under the proposed rule, a noncompete clause is defined as a 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 definition would include traditional noncompete clauses but also any "de facto noncompete clause" that has the same functional effect as a noncompete. The proposed rule includes two nonexclusive examples of de facto noncompete clauses: (1) a nondisclosure agreement between an employer and worker that is written so broadly that it effectively precludes the worker from working in the same field following a termination of employment; and (2) a contractual term requiring a worker to repay the employer for training costs if the worker's employment terminates within a specified time period where the required payment is not reasonably related to the costs the employer incurred for training the worker.

Although not listed as examples in the text of the proposed rule, the notice of proposed rulemaking also states that other types of restrictive covenants can be so broad in scope that they serve as de facto noncompete clauses, including client or customer nonsolicitation agreements, no-business agreements (which prohibit the worker from doing business with former clients or customers of the employer, whether or not solicited by the worker), employee non-solicitation agreements and no-hire clauses and liquidated damages provisions. The notice of proposed rulemaking specifically provides that contractual provisions requiring workers to pay damages if they compete against their employer would be considered noncompete clauses under the proposed rule. We expect the proposed rule in its current form would likewise prohibit noncompete clauses designed to comply with the "employee choice" doctrine, where terminated employees can choose to comply with noncompete agreements and receive post-employment compensation and benefits or forfeit such compensation and benefits to compete with their former employer, along with "forfeiture-for-competition" provisions, where post-employment compensation and benefits are forfeited if the employee engages in competitive activity.

What Would Be the Effect on Existing Noncompete Clauses?

Under the proposed rule, an employer would be required to rescind any existing noncompete clauses no later than the compliance date of the final rule. The employer must also provide notice to any worker within 45 days of rescinding the noncompete clause in an individualized communication on paper or in digital format (e.g., email or text message) that the worker's noncompete clause is no longer in effect and may not be enforced against the worker. The proposed rule includes safe harbor model language for this notice. An employer would also be required to provide this notice to any former worker, provided that the employer has the worker's contact information readily available. ("Readily available" is not defined.) The notice requirement does not extend to former employees whose noncompetes have elapsed prior to the compliance date.

What Would Be the Impact on Seller Noncompetes?

The proposed rule would also significantly limit noncompete clauses entered into with workers in connection with the sale of a business. A noncompete with any worker-seller who owned less than 25% of the business entity would be prohibited under the proposed rule, though noncompetes with a worker-seller who owned at least 25% would be permissible.

The notice of proposed rulemaking states that the FTC believes it may be appropriate to exempt seller noncompetes entirely from coverage under the rule, so the fate of this element of the rule seems particularly uncertain. It is worth noting that the three states that currently prohibit employee noncompetes—California, North Dakota and Oklahoma—permit enforcement of such clauses when entered into between the seller and buyer of a business. However, seller noncompetes have been under greater scrutiny recently both at the federal and state level as restraints on trade.[2] If the FTC exempts seller noncompetes from its final rulemaking, as suggested in its notice, the final rule would clarify that these clauses remain subject to federal antitrust law and all other applicable law, including state law requiring noncompete clauses to be tailored to protect a legitimate business interest and to be limited in duration, geographic area and the scope of activity prohibited.

What Would Be the Impact on State Noncompete Laws?

Any final rulemaking by the FTC would supersede any state statute, regulation, order or interpretation to the extent inconsistent with the FTC's final rule. The proposed rule clarifies that a state law is not inconsistent with the rule (and will not be preempted) if

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[2] A recent decision from the Delaware Court of Chancery invalidated a seller non-compete that went beyond the buyer's legitimate business interest of protecting the goodwill of the acquired company. Our Debevoise Update on *Kodiak Building Partners, LLC v. Philip D. Adams* (Del. Ch. Oct. 6, 2022) can be accessed here.

it provides workers greater protection than the FTC's rule. The FTC's intent is that its proposed ban on noncompetes establishes a regulatory floor for state action.

State laws governing noncompetes have been evolving in recent years as more and more states have enacted legislation to limit their use. While the majority of states currently permit the enforcement of noncompetes, subject to reasonableness limitations imposed by case law, some states ban employee noncompetes entirely or prohibit them for specific subsets of employees (e.g., lower-paid employees or certain occupations). Other states have adopted a variety of limitations on noncompetes, including limitations on the length of noncompetes, notice requirements or requirements to provide continued compensation during the period in which a noncompete is in effect. The FTC's rule, if adopted as proposed, would preempt most elements of existing state noncompete laws, except in a few limited circumstances where a state law provides greater worker protection than the FTC's rule.

Until the FTC's rulemaking is finalized, state law continues to govern the enforceability of noncompete agreements. Before a final rule has been adopted, the proposed rule should not have any formal impact on any currently pending disputes in federal or state court regarding noncompete enforcement.

What Happens Next?

The proposed rule is subject to a comment period that runs for 60 days after publication of the notice of proposed rulemaking in the Federal Register. The effective date of the final rule would be 60 days after the final rule is published in the Federal Register, and the compliance date would be 180 days after the final rule is published in the Federal Register.

Any final rulemaking by the FTC on noncompetes could differ from the proposed rule in a number of ways. The FTC's notice of proposed rulemaking seeks comment on all aspects of its rule, including its findings that noncompetes are an unfair method of competition under Section 5 of the Federal Trade Commission Act. The notice also seeks comment on some possible alternatives to its proposed categorical ban, including the adoption of a rebuttable presumption of unlawfulness (which would allow an employer to use noncompete clauses if it met an evidentiary burden) and/or the adoption of different rules for different categories of workers based on job function or occupation, earnings, another factor or some combination of factors. Although the FTC sets forth its basis for covering executive employees in the notice of proposed rulemaking, it specifically seeks comment on whether it should adopt different standards for noncompete clauses with senior executives. The FTC also seeks comment

on rulemaking alternatives that do not explicitly limit noncompetes, including a rule that requires employers to disclose noncompetes to workers (e.g., before an employment offer is made), or a rule that requires employers to report information to the FTC regarding their use of noncompete clauses. And as noted above, the FTC seems open to exempting noncompetes between the seller and buyer of a business from its rulemaking.

Even if the FTC adopts the categorical ban on noncompetes as proposed, we expect legal challenges to its enforcement on jurisdictional and constitutional grounds.

Advice for Employers

Employers should stay on top of legal developments in this area—not just at the FTC level but also in those states where business employees work. We recommend that employers avoid entering into noncompete agreements with low-wage earners, even in those states where such noncompetes are permitted, without a compelling business reason for doing so. We also recommend that employers focus on enhancing trade secret protections beyond the use of noncompetes. For example, employers can take steps to ensure that they have in place effective and enforceable policies and non-disclosure and confidentiality agreements and invention assignment agreements.

Finally, we recommend that employers before or soon to be before the FTC in other contexts (e.g., merger review under the Hart-Scott-Rodino Act) be aware of, evaluate and consider proactively modifying their use of noncompetes. If such employers are using noncompetes broadly, the FTC may hold up their mergers or subject them to separate post-closing investigations.

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Please do not hesitate to contact us with any questions.

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