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FTC Pursues Crackdown on Employee Noncompetes

Update

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Earlier this month, the Federal Trade Commission (FTC) launched unprecedented challenges to noncompete provisions in employment contracts through both rulemaking and individual enforcement actions.

Proposed Rule to Ban Noncompetes

Most significantly, on January 5, 2023, the FTC released a sweeping notice of proposed rulemaking (NPRM), aimed at barring the use of noncompete agreements by deeming those covenants to be an "unfair method of competition" in violation of Section 5 of the Federal Trade Commission Act (FTC Act). As drafted, the new rule would not only prohibit employers from entering into future noncompete covenants with employees or independent contractors (whether paid or unpaid), but would also require employers, within 180 days of publication of the final rule, to rescind existing noncompete clauses in agreements and require the employer to affirmatively notify employees that such clauses are no longer valid.

As justification for the proposed ban, the FTC contends that employee noncompetes suppress wages, hamper innovation, and block entrepreneurs from starting new businesses.

While the proposed prohibition on noncompetes is broad, importantly for deal makers, the rule would include an exception for noncompetes entered into between buyers and sellers of a business, but only where the seller holds a "substantial" (at least 25%) ownership stake. Notably, the new rule is not intended to prohibit customer non-solicitation agreements or confidentiality or non-disclosure agreements, except in the case where these types of provisions are so broad in scope that they function in the same way as a noncompete.

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This NPRM is the agency's first attempt to advance its expanded approach to enforcing the prohibition against unfair methods of competition under Section 5 of the FTC Act, announced in November 2022 through the issuance of a policy statement on the scope of Section 5. The policy statement explicitly notes the FTC's responsibility to protect workers, and follows on obligations identified in President Biden's July 2021 Executive Order concerning competition, which called on the FTC to curtail the use of noncompete clauses and other agreements that may unfairly limit worker mobility.

Under the Biden Administration, the FTC and the Department of Justice (DOJ) have committed significant resources to the protection of workers. In July 2022, the FTC signed a Memorandum of Understanding with the National Labor Relations Board to bolster efforts to protect employees by promoting competitive U.S. labor markets and putting an end to unfair practices that harm workers, focusing on key issues such as labor market concentration, one-sided contract terms, and labor developments in the "gig economy." The FTC also recently challenged noncompetes in connection with the review of two separate mergers, both of which resulted in a settlement that included prohibitions on the use of franchisee or employee noncompetes moving forward. Over the last several months, the DOJ has taken action to criminally prosecute several cases involving no-poaching and wage-fixing agreements among competitors.

The proposed rule was approved 3-1 along party lines, with Republican Commissioner Christine S. Wilson arguing in her dissent that the FTC lacks the rulemaking authority that the Democratic majority claims over unfair methods of competition and noting that prior FTC leadership has for decades acknowledged that the FTC Act's legislative history does not provide the FTC with substantive competition rulemaking authority. Commissioner Wilson also contended that noncompete agreements should be assessed on a case-by-case basis and should take into account legitimate business justifications.

As for the path forward for the proposed rule, the NPRM is subject to a 60-day public comment period through March 10, 2023. It is expected that the FTC would then move to finalize the rule. Even if the rule is modified or narrowed as a result of the public comment process, given the strong negative reaction to the proposed rule from business organizations such as the U.S. Chamber of Commerce, any blanket ban on noncompetes is likely to be challenged in the courts.

In addition to a potential challenge to the FTC's authority to engage in rulemaking concerning unfair methods of competition, one other argument against the rule may be based on preemption. As drafted, the rule would supersede any state laws, regulations or orders that are inconsistent with the federal rule. Traditionally, however, regulation of noncompetes has been left to the states. Multiple states currently have some form of law restricting the ability of employers to enforce noncompete agreements against former employees (often focused on reasonable scope and sometimes barring use with lower-

wage workers), and several states have strengthened their laws in this area in recent years. The FTC's proposed noncompete rule would effectively void state legislation and case law in this area, replacing what is often a nuanced and fact-based analysis of employee noncompetes with a one-size-fits all approach.

While the precise scope of the final noncompete rule remains to be seen, companies should be mindful of the potential ramifications when looking to impose a noncompete agreement on an employee. Employers may also need to rely more on enforcing confidentiality and non-solicitation clauses in employment contracts as well as trade secret laws to safeguard their innovations.

FTC Also Pursues Individual Enforcement Actions

Significantly, the NPRM was released just one day after the FTC announced separate settlements with three companies banning those businesses from enforcing existing noncompetes or entering into new noncompetes with certain types of employees. Those settlements were also approved along party lines, with Commissioner Wilson noting in dissent the failure of the related complaints to offer any evidence of anticompetitive effects in any relevant markets.

The press release issued by the FTC in connection with the settlements signals that more enforcement actions against individual employers should be expected. Specifically, in that release, Rahul Rao, Deputy Director of the FTC's Bureau of Competition, warned that the "FTC will continue to investigate, and where appropriate challenge, noncompete restrictions and other restrictive contractual terms that harm workers and competition."

Some State Legislatures Active as Well

Some states have also been active in imposing new restrictions on noncompete provisions. For instance, last year Colorado further restricted the circumstances under which these covenants can be imposed. In some other state legislatures, such as New Jersey, measures to impose new restrictions are under serious consideration. Of course, a variety of states already maintain restrictions on noncompetes, including near-complete bans in California, Oklahoma, and North Dakota, and more limited prohibitions in certain states for employees earning below a specified income level, such as in Illinois, Washington, Maine, Maryland, Massachusetts, Nevada, Oregon, Rhode Island, Virginia, and now Colorado.

Even if the proposed FTC rule is ultimately blocked by the courts, employers still need to be aware of the risk of individual FTC enforcement actions and the growing number of state law restrictions on covenants not to compete.