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FTC Proposes Rule to Ban Non-Compete Clauses

Client Alert | January 5, 2023

On January 5, 2023, the Federal Trade Commission (FTC) issued a Notice of Proposed Rulemaking (NPRM) to prohibit employers from entering non-compete clauses with workers.[1] The proposed rule would extend to all workers, whether paid or unpaid, and would require companies to rescind existing non-compete agreements within 180 days of publication of the final rule.[2] The FTC will soon publish the NPRM in the Federal Register, triggering a 60-day public comment period.?[3] The rule could be finalized by the end of the year; court challenges to the final rule are likely to follow.

The rule proposal follows recent FTC settlements with three companies and two individuals for allegedly illegal non-compete agreements imposed on workers – the first time the FTC has claimed that non-compete agreements constitute unfair methods of competition under Section 5 of the FTC Act.?[4]

The Proposed Rule Would Broadly Ban Non-Compete Agreements

The proposed rule provides:

> (a) *Unfair methods of competition.* It is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker; maintain with a worker a non-compete clause; or represent to a worker that the worker is subject to a non-compete clause where the employer has no good faith basis to believe that the worker is subject to an enforceable non-compete clause.?[5]

The proposed rule broadly defines non-compete agreements 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.”?[6] It proposes a functional test to determine if a clause is a non-compete provision: to qualify, the provision would have “the effect of prohibiting 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.”?[7] The proposed rule identifies two types of agreements that would constitute impermissible “non-competes”:

- A non-disclosure agreement between an employer and a worker 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 with the employer; and
- A contractual term between an employer and a worker that requires the worker to pay the employer or a third-party entity 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.?[8]

While the proposed rule would not expressly prohibit non-disclosure and intellectual

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property agreements with employees, those agreements could be deemed impermissible non-competes if, pursuant to the provision excerpted above, they are deemed to be written "so broadly" that they "effectively preclude[ ] the worker from working in the same field."?[9] Further, the term "worker" would be defined as "a natural person who works, whether paid or unpaid, for an employer," but would not include a franchisee in a franchisee/franchisor relationship.?[10]

Rescission Requirement, Safe Harbors, and Federal Preemption

The proposed rule would require employers to rescind all existing non-compete provisions within 180 days of publication of the final rule, and to provide current and former employees notice of the rescission.?[11] If employers comply with these two requirements, the rule would provide a safe harbor from enforcement.?[12]? Further, the proposed rule would exempt from its scope certain non-competes entered in connection with the sale of businesses where "the seller of the business is a substantial owner of . . . the business at the time the person enters into the non-compete clause."?[13] For this exception to apply, "substantial owner" is defined as an "owner, member, or partner holding at least a 25% ownership interest in a business entity."?[14] This exception also applies under California law, recognizing the need to protect the goodwill of a business.?[15]

The proposed rule would preempt all state and local rules inconsistent with its provisions, but not preempt State laws or regulations that provide greater protections.?[16] As a practical matter, the proposed rule would override existing non-compete requirements and practices in the vast majority of states.

Concerned Parties Should Submit Public Comments

A sixty-day public comment period will begin once the FTC publishes the NPRM in the Federal Register. After the notice-and-comment period concludes, the FTC will consider the comments and then publish a final version of the rule. Enforcement may begin 180 days after publication of the final rule (although, as discussed below, the final rule is likely to be challenged in court).

The final rule's terms will depend in part on the FTC's response to comments submitted by interested parties during this notice-and-comment period, including legal and practical objections raised to the rule. Thus, concerned parties are advised to submit robust comments thoroughly explaining their concerns, including potential costs and adverse effects.

Legal Challenges to the Rule Are Likely Once It Is Finalized

The proposed rule represents a significant expansion of the FTC's regulatory reach in two respects: First, the Commission had not previously held non-compete agreements to be unfair methods of competition under the Federal Trade Commission Act, until its recently-announced settlements. Second, substantial doubt exists that the FTC possesses rulemaking authority in this area.?[17] As Gibson Dunn partners have explained and Commissioner Christine S. Wilson notes in her statement dissenting to the Notice of Proposed Rulemaking, any final rule is likely subject to several potentially significant legal challenges. Commissioner Wilson notes three concerns:

1. **Congress did not intend to grant authority** to promulgate substantive competition rules under the FTC Act provisions on which the FTC purports to rely to promulgate the proposed rule.?[18]

2. The rule may exceed the limits imposed by the Supreme Court's **major questions**? doctrine.[19]

3. The rule may exceed the limits imposed by the Supreme

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Court's **non-delegation** doctrine.?[20]

Takeaways

This new proposed rule is part of a larger trend toward more vigorous federal regulation of the employment relationship, including by the FTC, National Labor Relations Board, and Department of Labor (DOL), as we have noted in previous Client Alerts addressing the FTC's approach to no-poach and non-solicit agreements, the DOL's rulemaking on who qualifies as an independent contractor under the FLSA, and the FTC's broader vision of its authority to address unfair methods of competition under Section 5.

Gibson Dunn attorneys are closely monitoring these developments and available to discuss these issues as applied to your particular business or assist in preparing a public comment for submission on this proposed rule.

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[1] Non-Compete Clause Rulemaking, Fed. Trade Comm'n (Jan. 5, 2023). The Commission vote to publish the Notice of Proposed Rulemaking was 3-1 along party lines. Chair Khan and Commissioners Slaughter and Bedoya released a joint statement. *See* Joint Statement, Fed. Trade Comm'n (Jan. 5, 2023). Commissioner Wilson dissented. *See* Dissenting Statement of Commissioner Christine S. Wilson, Fed. Trade Comm'n (Jan. 5, 2023) (objecting because the proposed rule fails to consider factual context, the fact that "the need for fact-specific inquiry aligns with hundreds of years of precedent," and the business justifications for such clauses).

[2] Notice of Proposed Rulemaking, Fed. Trade Comm'n (last visited Jan. 5, 2023) (outlining the text of the rule as will be published in the Federal Register at 16 CFR Part 910). Notably, prior FTC workshops on this subject focused on low-wage employees, but this proposed rule goes beyond that scope. Workshops, *Making Competition Work: Promoting Competition in Labor Markets*, Fed. Trade Comm'n (Dec. 6–7, 2021).

[3] Id. at 1.

[4] Press Release, *FTC Cracks Down on Companies That Impose Harmful Noncompete Restrictions on Thousands of Workers*, Fed. Trade Comm'n, (Jan. 4, 2023). *See also* Client Alert, *FTC Announces Broader Vision of Its Section 5 Authority to Address Unfair Methods of Competition*, Gibson, Dunn & Crutcher LLP (Nov. 14, 2022) (noting that "this development at a minimum adds uncertainty for businesses that heightens the need for vigilance in how they operate").

[5] Notice of Proposed Rulemaking at 215 (§ 910.2(a)).

[6] *Id.* at 4.

[7] Id. at 214 (§ 910.1(b)(2)).

[8] Id. (§ 910.1(b)(2)(i)-(ii)).

[9] Id.

[10] Id. at 214–15 (§ 910.1(f)).

[11] Id. at 215–17 (§ 910.2(b)(1)-(2)).

[12] Id. at 217 (§ 910.2(b)(3)).

[13] Id. at 131 (§ 910.3). *See also id.* at 128–131 (explaining the scope of § 910.3).

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[14] Id. at 131.

[15] Cal. Bus. & Prof. Code § 16601.

[16] Notice of Proposed Rulemaking at 217 (§ 910.4).

[17] *See* Svetlana Gans & Eugene Scalia, *The FTC Heads for Legal Trouble*, W.S.J. (Aug. 8, 2022) (Gibson Dunn partners explaining why "FTC regulation of employment noncompete agreements would run headlong into the major questions doctrine" and other issues with the FTC's approach).

[18] Dissenting Statement of Commissioner Christine S. Wilson, Fed. Trade Comm'n, at 10–11 (Jan. 5, 2023) (discussing Sections 5 and 6(g) of the FTC Act and how the FTC's authority should be interpreted in light of the Magnuson-Moss Act).

[19] Id. at 11–12 (discussing *West Virginia v. EPA*, 142 S. Ct. 2587 (2022) and its implications).

[20] Id. at 12–13, 12 n.61 (noting recent writing from most of the Supreme Court's justices that would indicate a willingness to reconsider and broaden the scope of the Supreme Court's non-delegation doctrine) (citing *Gundy v. United States,* 139 S. Ct. 2116, 2131 (2019) (Alito, J. concurring) (stating with respect to the nondelegation doctrine that "[i]f a majority of this Court were willing to reconsider the approach we have taken for the past 84 years, I would support that effort"); *Gundy*, 139 S. Ct. at 2131 (Gorsuch, J., dissenting, joined by Chief Justice Roberts and Justice Thomas) (expressing desire to "revisit" the Court's approach to the nondelegation doctrine); *Paul v. United States*, 140 S. Ct. 342, 342 (2019) (statement of Kavanaugh, J, respecting the denial of certiorari); Amy Coney Barrett, *Suspension and Delegation*, 99 Cornell L. Rev. 251, 318 (2014)).

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding the issues discussed in this update. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Administrative Law and Regulatory Group, Antitrust and Competition, Labor and Employment, and Trade Secrets practice groups, or the following practice leaders:

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