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FTC Takes Historic Action Against the Enforcement of Non-Compete Agreements

On January 5, the Federal Trade Commission (FTC) took historic action relating to the enforcement of non-compete agreements when it announced a proposed rule that would prohibit all employers in the United States from entering into or enforcing non-compete agreements, with very limited exceptions. If the proposed rule becomes effective, employers not only will be prohibited from entering into new non-compete agreements with their workers but also will have an affirmative obligation to cancel existing non-compete agreements and notify workers that they are not subject to non-compete agreements. The proposed rule applies categorically to all workers, without regard to a worker's earnings or job function. It will, however, allow employers to continue utilizing agreements that prohibit solicitation of customers and those that prohibit disclosure of confidential or trade secret information, so long as the agreement does not 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." Unless it is rescinded or modified, the proposed rule will become effective this March, although revisions and delays are expected.

The FTC's Proposed Nationwide Rule Banning All Non-Compete Agreements

State law typically has regulated the use and enforceability of non-compete agreements, resulting in different rules across the 50 states. State law evolved over time through a combination of common law and legislation. The differences among the states vary greatly. Some states, like California, North Dakota and Oklahoma, essentially ban all non-compete agreements. Some states prohibit them for certain types of workers or pay levels, while other states generally enforce them subject to reasonableness in time and geographical scope and underlying legitimate interests. Using its powers under federal antitrust laws, the FTC published a proposed rule that would ban almost all non-competes in the employment context in all 50 states, trumping decades of state law.

Overview of the Proposed Rule

The proposed rule defines a non-compete clause as "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating business, after the conclusion of the worker's employment with the employer." An employer is defined as "any natural person, partnership, corporation, association, or other legal entity, including any person acting under color or authority of State law" that hires or contracts with a worker to work for the employer. A worker is defined as any "natural person who works, whether paid or unpaid, for an employer," including independent contractors, interns, volunteers, apprentices, and sole proprietors who provide service to a client or customer.

The proposed rule would prohibit an employer from entering into a non-compete clause with a worker and maintaining with a worker a non-compete clause. Employers with existing non-compete agreements with workers must rescind those clauses before the compliance date and refrain from entering into a new non-compete clause starting on the compliance date. Finally, employers have an obligation to provide notice to all current and former employees that non-compete clauses previously agreed to are no longer in effect and may not be enforced against the worker.

Non-Disclosure and Non-Solicit Agreements

Anticipating that employers will ask how they can protect their investments, the FTC identifies several ways in which an employer can protect its customer relationships and valuable information. For example, in the notice of proposed rulemaking, the FTC discusses the Uniform Trade Secret Act, which prohibits an employee's misappropriation or use of trade secret information; the federal Defend Trade Secrets Act, which established a civil cause of action for trade secret misappropriation; and the Economic Espionage Act, which makes it a federal crime to steal a trade secret for a foreign entity or "anyone other than the owner" of the trade secret. The proposed rule also provides that non-disclosure agreements and customer non-solicitation agreements, when used properly, will not be prohibited. The proposed rule sets forth a functional test to determine whether an agreement constitutes a non-compete clause. The test requires consideration of whether a contractual provision "has 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." The proposed rule also sets forth examples of overbroad non-disclosure and non-solicitation agreements, including a non-disclosure agreement between an employer and a worker that is so broad that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer. Another overbroad agreement is one that requires a worker to pay the employer for training costs if the worker's employment terminates within a specific time period and the required repayment is not reasonably related to the costs the employer incurred by training the worker.

Exceptions to the Proposed Rule

Section 910.3 of the proposed rule does provide a limited exception to the rule: non-competes are permitted between the seller and the buyer of a business, so long as "the person restricted by the non-compete clause is a substantial owner of, or substantial member or substantial partner in, the business entity at the time the person enters into the non-compete clause." The proposed rule also only applies to workers and does not apply to non-compete clauses between two businesses where neither is a worker, such as agreements between franchisors and franchisees.

Impact on State Law

Section 910.4 of the proposed rule states that the rule will supersede all state laws, regulations and orders that are inconsistent with the rule's requirements discussed above. States would still be allowed to impose their own non-compete restrictions so long as the restrictions provide greater protection to workers than the protection provided by the proposed rule.

Existing Non-Competes

So, what happens to existing non-competes if this rule becomes final? According to Section 910.2(b) of the proposed rule, employers that entered into non-competes with workers prior to the rule's compliance date must rescind the non-compete by no later than the compliance date. The proposed rule would become effective 180 days after publication of the final rule. To rescind the non-compete, employers must provide formal written notice to existing and former employees subject to non-competes. The proposed rule provides a model written notice that employers would be able to use to comply with the notice requirement.

According to the Fact Sheet published by the FTC, the FTC finds that non-competes "significantly reduce workers' wages" and "stifle new businesses and new ideas." The FTC further provided that the proposed rule would "increase workers' earnings by nearly $300 billion per year," "save consumers up to $148 billion annually on health care costs," and "double the number of companies founded by a former worker in the same industry." In part to support the proposed rule, the FTC cited industry research and suggested that other methods of protecting investments, including protection of trade secrets and confidential information, may have led to the success of large tech companies in California because of increased labor mobility.

What Is Next?

The FTC's proposed rule is now subject to public commentary and potentially further refinement by the FTC. The commission is seeking comments on its preliminary findings that support the proposed rule and on the proposed rule itself and provides a

60-day period to receive comments. Once the rule becomes effective, employers will have 180 days to comply. If the proposed rule becomes effective, it will likely face legal challenges regarding whether the FTC has the authority to regulate non-compete agreements in this way. The U.S. Chamber of Commerce senior vice president for international regulatory affairs and antitrust released a statement claiming that "actions by the Federal Trade Commission to outright ban non-compete clauses in all employer contracts is blatantly unlawful." The public will have the opportunity to submit comments on the proposed rule for 60 days after the *Federal Register* publishes the proposed rule. Then, the FTC will review the comments and may make changes in a final rule. As discussed above, the proposed rule would go into effect 60 days after it becomes final, and employers would have 180 days after the final rule is published in the *Federal Register* to comply with the rule.

The FTC's Recent Actions Against Several Companies

Just one day before announcing the proposed rule, on January 4, the FTC announced that it took unprecedented action when it found that companies Prudential Security and Prudential Command Inc., O-I Glass Inc., and Ardagh Group S.A. engaged their workers in illegal non-competes, and as a result, ordered the companies to cease issuing or enforcing non-competes against their employees. The FTC found that the non-competes used by these companies constituted unfair competition and violated Section 5 of the FTC Act, which prohibits "unfair or deceptive acts or practices in or affecting commerce."

The FTC found that Michigan-based companies Prudential Security Inc. and Prudential Command Inc. and their owners took advantage of security guard employees by requiring those employees to sign non-competes that prohibited them from working for any competing business within a 100-mile radius of their job site with Prudential for two years post-employment. The security guards subject to the non-competes at issue earned close to minimum wage. The FTC reported that Prudential's non-compete agreement also required employees to pay $100,000 as a penalty for any violations of the non-compete.

O-I Glass Inc. and Ardagh Group S.A., as well as the latter's subsidiaries, are large food and beverage container manufacturers. The FTC found that O-I Glass' non-competes banned its employees from working for, owning or being involved in any way with any business in the United States that sells similar products or provides similar services without the prior written consent of O-I Glass. The non-competes were effective for one year post-employment. Ardagh's non-competes banned employees from performing the same services as or services substantially similar to services they performed at Ardagh at any business in the United States, Canada or Mexico that is involved with or supports the sale, design, development, manufacture or production of glass containers in competition with Ardagh. These non-competes were effective for two years post-employment.

In addition to banning these companies' ability to issue or enforce non-competes, the FTC ordered that the companies notify all affected employees that they are no longer bound by the non-compete agreements, and the companies must provide a "clear and conspicuous notice" to new employees informing such employees that they may seek or accept a job with any company or person, run their own business, or compete with them at any time following their employment.

The FTC voted 3-1 to issue the administrative complaints and to accept the consent agreements. The agreements will be subject to public comment for 30 days, after which the FTC will decide whether to make the proposed consent orders final.

Takeaways

The FTC's proposed rule reflects both a trend by various states to limit employers' use of non-competes and the FTC's stated goal of promoting competition. Although it is likely that this rule will be challenged in the courts, there may be a period of uncertainty until a final determination is issued. It is also possible that given the likely legal challenges ahead, the FTC will publish a revised rule that would be more limited than the current broad proposed rule, as several states have done with their own state non-compete laws. In the meantime, the FTC may continue to take action against companies with non-competes. Employers are encouraged to review their non-compete agreements to ensure that they comply with state law and are narrowly tailored to achieve the goal of the non-compete agreement. Employers should contact counsel with any questions they have about their non-competes and to develop strategies to protect their businesses.

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