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PROPOSED FEDERAL TRADE COMMISSION RULING MAY BAN MOST NON-COMPETE AGREEMENTS

BACKGROUND

On January 5, 2023, the Federal Trade Commission (FTC) proposes a rule banning companies from requiring its workers, such as employees, independent contractors, volunteers and interns, to sign non-compete agreements as a condition of their employment. The proposed rule would be added to a new subchapter J, consisting of part 910, to chapter I in title 16 of the Code of Federal Regulations, and notes that such agreements are an "unfair method of competition," noting that any clause that constitutes 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" is covered. The FTC has rationalized that non-compete agreements "block workers from freely switching jobs, depriving them of higher wages and better working conditions, and depriving businesses of a talent pool that they need to build and expand."

DETAILS

"Functional Test" and *De Facto* Non-Compete Clauses

The FTC's proposed rule sets forth a vaguely described "functional test" to apply to determine whether a contractual provision is a prohibited non-compete clause. It also specifically discusses the banning of any contractual term that operates as a "*de facto* non-compete clause" in its effect, including two examples cited by the FTC:

- 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.

This second category could cause employers additional uncertainty regarding a variety of contractual provisions and executive compensation used by employers to retain employees including, but not limited to, retention bonuses, equity grants and other forms of incentive compensation that would be forfeited if an employee separates from the employer within a specified timeframe.

The FTC's proposed rule does not address whether a customer's or employee's non-solicitation provision would fall under the prohibited restrictive covenants. Further, supplementary materials by the FTC note that the "definition of non-compete clauses would generally not include other types of restrictive covenants—such as non-disclosure agreements (NDAs) and client or customer non-solicitation agreements—because these covenants generally do not prevent a worker from seeking or accepting employment with a person operating a business after the conclusion of the worker's employment with the employer." However, under the definition of "non-compete clause," the proposed rule provides: "such covenants would be considered non-compete clauses where they are so unusually broad in scope that they function as such." Thus, the rule does not appear to disturb litigation involving breaches of non-solicitation agreements and trade secret misappropriation on its face, but could invalidate restrictions that effectively discourage, dissuade or prevent an employee from leaving his or her company.

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Notice to Employees

One unique aspect of the proposed rule is the requirement that companies must send a notice of rescission to current and former employees within 45 days after the date of rescission. Former employers only need to be contacted if the employer readily has their contact information.

Sale of Business Exception

The proposed rule contains an extremely narrow sale-of-business exception that states that the rule will not apply to a non-compete clause that is entered

- by a person who is selling a business entity or otherwise disposing of all of the person's ownership interest in the business entity; or,
- by a person who is selling all or substantially all of a business entity's operating assets.

The Sale of Business exception applies only when the person restricted by the non-compete clause is an owner, member or partner holding at least a 25 percent ownership interest in the entity. Certain industries are excluded from the scope of the FTC's authority under Section 5 of the Federal Trade Commission Act, and thus presumably the rule would not apply to the following industries:

- banks;
- savings and loan institutions;
- federal credit unions;
- common carriers;
- air carriers and foreign air carriers; and,
- persons and businesses subject to the Packers and Stockyards Act, 1921 (subject to certain exceptions).

SUMMARY

The FTC's proposed rule is open for public comment for 60 days—until at least March 10, 2023. Members of the public may request that the FTC permit additional time for comments.

If the new rule goes into effect as presently proposed, litigants would be forced to dismiss lawsuits predicated on violations or breaches of non-compete agreements. This likely would lead to an uptick in trade secret misappropriation claims, in which an employer seeks an injunction to preclude an outgoing employee from further use of their former employer's trade secrets at their new place of employment. While claims of misappropriation typically have a higher threshold of proof than breaches of non-compete clauses due to the requirement that the employer show both (1) ownership of trade secrets and (2) actual (as opposed to hypothetical) misappropriation claims may become the most viable avenue for employers to prevent or discourage employees from departing for a competitor.

NEXT STEPS

In the interim, employers should continue to include confidentiality and non-disclosure provisions in employment agreements and—perhaps most significantly—identify with specificity the categories of information it considers to be trade secrets, and take stringent measures to protect those categories of information and keep secret in order to maintain a claim for misappropriation.

Nathan Pearman represents individuals, small businesses and large global corporations in complex litigation involving labor and employment matters, high-stakes commercial disputes, construction and real estate litigation, as well as trade secret litigation in both state and federal courts. He has handled a variety of restrictive covenant-based claims, including alleged breaches of non-solicitation and non-compete clauses, as well as an array of trade secret misappropriation matters.