

January 10, 2023

FTC Proposes Rule Prohibiting Non-Compete Clauses for Workers

On January 5, 2023, by a 3-1 vote, the Federal Trade Commission (FTC) issued a [notice of proposed rulemaking](#) that, if promulgated and upheld, would dramatically overhaul the law governing non-competition covenants across the United States by prohibiting employers from entering into, and requiring employers to rescind existing, non-compete clauses with workers (including employees and individual independent contractors). The regulation of non-competes historically has been the province of states, many of which have recently amended or are in the process of reviewing and amending their laws on the subject. This notice of proposed rulemaking follows the FTC's [January 4 announcement of enforcement actions](#) against three companies for imposing non-compete restrictions on workers that the FTC contends violate Section 5 of the Federal Trade Commission Act (FTCA). The FTC estimates that 30 million existing non-compete agreements, covering an estimated 20% of American workers, would be illegal if the proposed rule were to become effective.

The Proposed Rule. Under the proposed rule, entering into or maintaining a non-compete with a worker constitutes an unfair method of competition in violation of the FTCA. The term “worker” is defined broadly as natural persons who work, whether paid or unpaid, for an employer; it includes senior executives, highly paid and highly skilled workers, though the FTC has specifically requested comments as to whether different standards should apply to these types of workers and, if so, how such categories and standards should be defined. The ban would extend to non-disclosure agreements and non-solicitation covenants that effectively function as non-competes, and to any requirements that workers repay training costs not “reasonably related” to the costs incurred by the employer. The proposed rule would expressly preempt state law to the extent inconsistent with the rule, though any state law that provides greater protection to workers than under the rule would not be deemed to be inconsistent.

Limited Exemptions. Importantly, the proposed rule exempts non-competes entered into between business entities, including in the sale of a business or in connection with a joint venture. In addition, the proposed rule would exempt non-compete clauses entered into with a person who (1) is selling a business entity, disposing of all of the person’s ownership interest in the business entity or selling all or substantially all of a business entity’s operating assets and (2) is a substantial owner, member, or partner (defined as holding at least a 25% interest in the business entity).

Comment Period; Effective Date. The public may comment on the proposed rule for 60 days following publication in the Federal Register. Once the rule is finalized, it would become effective 60 days following publication of the final rule in the Federal Register, and employers would have 180 days after publication to comply with the final rule.

Potential Challenges. Questions have already been raised as to whether the FTC has overstepped its regulatory authority, including by the U.S. Chamber of Commerce and FTC Commissioner Christine S. Wilson. Challengers contend that the FTC lacks the authority to define what constitutes “unfair methods of competition” through rulemaking, and that the proposed rule constitutes, under the Supreme Court’s recent jurisprudence, a “major question”

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requiring clear congressional authorization that has not been granted to the FTC. The proposed rule may also be challenged under the non-delegation doctrine, which prevents Congress from delegating its legislative power to another branch of government, including independent agencies such as the FTC.

Key Implications.

*Employment Arrangements.* Employers should review existing employment arrangements and policies and consider alternative ways to protect their trade secrets and goodwill in the event that the proposed rule becomes effective, including ensuring that current confidentiality and trade secrets clauses are up to date and cover or are entered into with all necessary workers. In negotiating new or upcoming employment arrangements, employers should also consider whether changes to compensation design are appropriate in order to incentivize retention and loyalty, such as retention awards and/or longer vesting periods.

*Sale of Business.* In M&A transactions, it is not uncommon for acquirors to enter into non-compete agreements with the seller's key employees. While the notice of proposed rulemaking acknowledges the importance and fairness of non-compete agreements in this context, limiting exempt non-competes to workers who own 25% or more of the acquired business renders the exemption virtually nonexistent for workers of publicly traded companies and many other large businesses. Should the proposed rule become effective, acquirors of businesses from sellers for whom non-competes are not permitted may wish to consider alternative methods of protecting goodwill, such as entering into employment or consulting arrangements with key individuals, delaying payment of consideration to align post-closing incentives, or exploring alternative structures such as joint ventures or commercial partnerships.

*Section 280G.* A strategy used to mitigate or avoid the impact of Section 280G of the Internal Revenue Code, the golden parachute excise tax, is to reduce the "parachute payments" by the amount of reasonable compensation paid to an individual for refraining to perform services under a valid non-compete agreement. The current proposed rule would render this strategy unavailable with respect to all but major shareholders, significantly restricting Section 280G mitigation strategies.

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Non-competition covenants have long been viewed by courts and legislatures as a potential restraint on trade, with enforceability varying widely by jurisdiction. Although any new FTC rule is unlikely to become effective for several months or longer, the FTC's efforts to curtail non-competes, whether through Section 5 rulemaking or otherwise, constitute a dramatic change to this area of law that warrant close and immediate attention by companies.

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