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Practice Update

The Potential Challenges and Pitfalls of the Proposed Rule Banning Non-Compete Agreements

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As previously advised, the Federal Trade Commission ("FTC") released a proposed rule (the proposed "Rule"), which, if adopted, essentially would ban all non-compete agreements, with very limited exceptions. In addition to the overbreadth of the proposed Rule's application, as described in more detail below, many glaring issues exist that likely may prevent the proposed Rule from being promulgated in its current iteration. *See* summary of proposed Rule provided last week.

Potential Challenges

Should the FTC proceed with enacting the proposed Rule impacting non-compete clauses in this manner, it likely will face legal challenges regarding its statutory authority. The U.S. Chamber of Commerce (the "Chamber of Commerce") already has released a statement, recognizing the proposed Rule as "blatantly unlawful" and that "[a]ttempting to ban noncompete clauses in all employment circumstances overturns well-established state laws which have long governed their use and ignores the fact that, when appropriately used, noncompete agreements are an important tool in fostering innovation and preserving competition." Further, the Chamber of Commerce previously published a response to the FTC's "Solicitation for Public

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Comments on Contract Terms that May Harm Competition." Within its response, the Chamber of Commerce noted that the text, structure, and history of the Federal Trade Commission Act of 1914 (the "FTC Act"), as well as 2021 Supreme Court guidance, all recognize that the FTC lacks statutory authority to promulgate an unfair methods of competition rule banning or severely restricting non-competes, explaining that "nothing in the [FTC] Act's text expressly gives the FTC rulemaking authority to prohibit business practices that the FTC deems an unfair method of competition." According to the FTC, under the FTC Act, the FTC is "empowered, among other things, to [] prevent unfair methods of competition...[and] prescribe rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices..." *See* 15 U.S.C. §§ 41-58. However, in *AMG Capital Management v. FTC*, the Supreme Court unanimously rejected the FTC's claim that it could assert broad remedial powers without an express grant of authority from Congress. *See AMG Capital Management v. FTC*, 141 S. Ct. 1341, 1349 (2021).

In addition, many states have adopted restrictive covenant and trade secret laws, which have withstood decades of judicial review, to regulate to whom they can be applied and the permissible circumstances in which they can be enforced. Many states with restrictive covenant laws provide for "blue pencil" provisions, allowing a state court to modify or delete overly broad restrictive covenants in an enforcement action. The FTC's attempt to espouse a broad, binding rule to ban non-competes could be viewed as unnecessary federal preemption, since such rule making would undermine state efforts to determine beneficial and reasonable non-compete clauses within their own jurisdiction.

Accordingly, we expect legal challenges will arise, should the FTC proceed with its proposed methods of competition rulemaking in its current form.

Proposed Rule's Pitfalls

With respect to the proposed Rule's exception for sellers of businesses, as drafted, there exists confusion as to the extent that corporate transactions would be impacted. The FTC does not clearly indicate whether non-competes will be permitted (i) for individuals selling their ownership interest in a business entity regardless of percentage owned; in addition to (ii) the owners of a business selling the business entity's assets, where the owner has at least a 25% ownership interest in the entity. There exists ambiguity and potential to disrupt transactions while de-valuing businesses, whereby the buyers of a business will be unable to guarantee that they will not face immediate competition from the sellers of such business. For example, the buyer may not be able to bind executives from creating a competing business with proprietary information or client information as soon as the deal closes, along with hiring the sold business' employees (none of whom will be subject to a non-compete), if the ownership interests of each executive or owning individual was under 25%. No doubt, the proposed Rule will affect a company's valuation in buying a business where they are unable to guarantee that the executives cannot be bound from creating a competing business with its proprietary information as soon as the deal closes.

Additionally, the proposed Rule arguably weakens protection of trade secrets and proprietary information, which could lead to increased litigation. The proposed Rule covers almost all workers, beyond minimum wage and unskilled workers, bringing C-suite level executives under the almost total ban on non-competes. The definitions section specifies that the Rule is intended to cover employees, independent contractors, externs, interns, volunteers, apprentices, and sole proprietors. Although the proposed Rule requires rescission of existing non-compete clauses, no provisions were set forth in the proposed Rule defining the parameters for current and former workers to repay the compensation that was

exchanged for such clauses. For example, separation and settlement agreements that provided payment to workers in exchange for restrictive covenants would make such agreements lose some of their value. It is unclear whether the worker must refund the employer the compensation received as consideration. It would also be impossible in some cases to ascertain how much compensation was related to the rescinded restrictive covenants and since, in most cases, the worker is no longer employed, offsetting future compensation would not work to affect the rescission. Similarly, the FTC has not explained what enforcement mechanism an employer could utilize to receive repayment of the consideration from the current or former worker. Ambiguity exists regarding whether recission of payment then means other provisions in settlement or separation agreements would be tolled pending repayment. The proposed Rule also could stop companies from requiring workers to reimburse them for certain kinds of training if they leave before a certain period of time. The training repayment could be banned if it "is not reasonably related to the costs the employer incurred for training the worker." *See* proposed Rule, §910.1(b)(2)(ii). Repayment also could implicate tax issues, since there is no indication of whether the worker will get a tax benefit for the taxes previously paid by the worker with respect to the refunded compensation, or whether the employer has to report refunded compensation as income.

Moreover, non-disclosure agreements also could be banned, based on the vague definition that compares such clauses as a functional equivalent to a non-compete. The proposed Rule provides examples of clauses that similarly would be impermissible, in tandem with banning non-compete clauses, explaining that non-disclosure covenants "would be considered non-compete clauses where they are so unusually broad in scope that they function as such." However, the FTC does not explain what would be considered an "unusually broad" non-disclosure clause, leaving open to interpretation what is

impermissibly broad, and thus, leaving businesses to guess as to what would pass muster under the proposed Rule. Further, for workers still employed or engaged (employees and independent contractors), a worker could threaten an employer with divulgence of protected information, as leverage to increase compensation.

Looking Forward

As noted, the proposed Rule will be subject to a 60-day public comment period. We expect that, at the conclusion of the public comment period, there likely will be substantial revisions to the proposed Rule. Akerman will closely monitor the developments.
