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Non-Competes No More? Recent FTC Proposed Order May Prove Fatal to Employers Non-Compete Clauses, article by Katherine S. Catlos, Esq., and Regan M. Heslop , Esq., 1-30-2023

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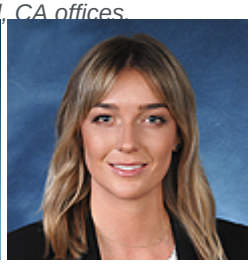

A recent Notice of Proposed Rulemaking (NPRM) from the Federal Trade Commission (FTC) could affect employers and their ability to impose non-compete clauses on their employees. Introduced on January 5, 2023, the Proposed Rule would take effect 180 days after the FTC publishes a final rule and would supersede all state laws that are less restrictive.

Considerations for California Employers:

As an important note, non-compete agreements have been unenforceable in California since January 1, 2017, except in limited circumstances. They are permissible in the narrow context of (1) selling a business, (2) partnerships, and (3) LLCs. Though other states permit "reasonable" non-compete agreements in employment contracts, California law forbids using "choice-of-law provisions" to have such clauses enforced by other jurisdictions.

A major consideration for employers is the protection of trade secrets. In California, employers cannot utilize non-compete clauses to do so. However, California employers need not fear as California Business & Professional Code § 16600 does not preclude courts from enjoining employees where their conduct is independently wrongful under the trade secret laws (e.g., Trade Secrets Act and/or Unfair Competition Law).

What Does the Proposed Rule Say?

The Proposed Rule has adopted a sweeping definition of "non-compete clauses," which could pose problems for employers. The prohibition would not only cover clearly stated non-compete clauses, but also extend to "de facto" non-compete clauses as well – meaning other contractual provisions which have the same effect of prohibiting workers from seeking or accepting employment or operating a business after the end of their current employment would be prohibited. Accordingly, the Proposed Rule may apply to broadly drafted or vague "non-disclosure" restrictions and "repayment-of-training-costs" provisions. The Proposed Rule could also possibly implicate non-solicitation clauses, depending on the surrounding facts.

Generally, the FTC's Proposed Rule would prohibit employers from using non-compete clauses. Specifically, the FTC's new rule would make it illegal for an employer to:

- **enter into or attempt to enter into a non-compete with a worker;**
- **maintain a non-compete with a worker; or**
- **represent to a worker, under certain circumstances, that the worker is subject to a noncompete.**

The Proposed Rule would apply to independent contractors and anyone who works for an employer, whether paid or unpaid - this includes interns and volunteers, too.

Recission and Recission Notice:

Employers will also be required to rescind existing non-competes and actively inform workers that they are no longer in effect. However, it's important to note that any provisions which were negotiated in exchange for an existing non-compete (for example, a severance provision) would remain intact.

The Proposed Rule requires employers to send out notice of the rescission to both current and former employees within 45 days after the date of recission. With the Proposed Rule taking effect 180 days after its final publication, it appears that the deadline to send such rescission notices would be 225 days following such final publication. For former employees, employers must send notices only to those workers whose contact information the employer has readily available. § 910.2(b)(2)(B).

The notice must be sent "in an individualized communication … on paper or in a digital format such as … an email or text message." § 910.2(b)(2)(A). The content of the notice must "communicate[] to the worker that the worker's non-compete clause is no longer in effect and may not be enforced against the worker." § 910.2(b)(2)(C). The Proposed Rule has provided employers with model language for the notice, however, they are not required to use it.

Sale of Business Exception:

The Proposed Rule will not apply to non-compete clauses that are entered into:

- 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.

However, this exception only applies when the person restricted by the non-compete clause, at the time the person enters into the clause, is an owner, member, or partner holding at least a 25 percent ownership interest in the entity.

This exception is similar to California's sale of business exception. In California, non-compete agreements are permitted and may be enforced under three narrow statutory exceptions if they are executed in conjunction with the dissolution or sale of a business entity by:

- Business owners (Cal. Bus. & Prof. Code § 16601).
- Members of limited liability companies (Cal. Bus & Prof. Code § 16602.5).
- Partners in partnerships (Cal. Bus & Prof. Code § 16602).

The major difference is that the Proposed Rule requires the person subject to the non-compete to be holding at least a 25 percent ownership interest in the entity, while California has no such requirement.

Determining "De Facto Non-Compete Clauses":

The Proposed Rule defines a prohibited 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 a business, after the conclusion of the worker's employment with the employer." § 910.1(b)(1).

In determining whether a contractual provision is a prohibited non-compete clause, the rule will apply a "functional test." § 910.1(b)(2). It also expressly covers any contractual term that operates as a "de facto non-compete clause" in its effect.

The Proposed Rule gives two examples of such "de facto non-compete clauses":

- "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." § 910.1(b)(2)(i).
- "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 period, where the required payment is not reasonably related to the costs the employer incurred for training the worker." § 910.1(b)(2)(ii).

Importantly, the proposed rule does not discuss whether a non-solicitation provision would be considered a prohibited de facto non-compete clause. However, the FTC's supplementary materials state that "the definition of non-compete clause 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."

Which Businesses Are Excluded:

Section 5 of the Federal Trade Commission Act (which is the source of the FTC's power to disseminate the Proposed Rule) does 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).

What's Next for Employers:

If the Proposed Rule is adopted as it stands, there will undoubtedly be disputes over whether NDAs, non-solicitation provisions, or other restrictions an employer might use will qualify under the FTC's "functional test." Employers using broad non-disclosure or non-solicitation provisions could face significant uncertainty as to the validity of those post-employment obligations by both the FTC and the courts.

Moreover, a major sticking point for employers concerns the FTC's second example of a "de facto" non-compete clause – repayment of training costs. Issues may arise over the variety of contractual provisions and executive compensation that employers use to retain employees. Examples include retention bonuses, equity grants, and other forms of incentive compensation that would be forfeited if an employee separates from the employer within a specified period of time.

Accordingly, employers should reevaluate their non-compete agreements and other restrictive covenants to see how this Proposed Rule may impact their workforce. As always, restrictive covenants should be drafted narrowly to protect the legitimate business interests of the employer, such as trade secrets, confidential information, or customer goodwill. Such restrictions should be no broader than necessary to protect those interests, and must be reasonable in terms of geography, duration, and scope of activities prohibited. Finally, these covenants should generally not be used with lower-level employees absent legitimate reasons to do so.

As a final note, employers should also consider reaching out to their elected officials to discuss concerns they may have regarding the Proposed Rule. This is especially important as the FTC is considering alternatives to the current language that could be less restrictive and they have expressly requested that employers weigh in on these issues. It is anticipated that any final publication of the rule will be challenged in court, leaving its fate likely to fall to elected officials in Congress.