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Legal Sidebar

The FTC's Proposed Non-Compete Rule

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On January 5, 2023, the Federal Trade Commission (FTC) proposed a rule that would ban non-compete clauses in employment contracts. The proposal relies on the FTC's putative authority to issue rules defining "unfair methods of competition" (UMC) under Sections 5 and 6(g) of the Federal Trade Commission Act (FTC Act).

A final rule banning non-compete clauses would implicate unsettled legal questions. As a threshold matter, it is unclear whether the FTC has the authority to issue substantive UMC rules. While there is case law holding that the FTC possesses such authority, analysts have debated whether courts would reach the same conclusion if presented with that issue today. In addition, even if the FTC has UMC rulemaking power, a non-compete ban may raise questions about the scope of that authority.

This Legal Sidebar provides an overview of the FTC's non-compete proposal and these questions involving the agency's legal authority.

The Proposed Rule

The FTC's proposed rule would prohibit employers from entering into non-compete clauses with workers, maintaining existing non-compete clauses, or representing to workers that they are subject to a non-compete clause. Non-compete clauses would be defined as any contractual term that prevents a worker from obtaining employment with a person, or operating a business, after the conclusion of the worker's employment with the employer.

While non-compete clauses would generally not include other restrictive employment covenants, such as non-disclosure agreements and non-solicitation agreements, the proposed rule would treat these restrictions as functional non-compete clauses if they are so broad in scope that they effectively prevent workers from obtaining employment or operating a business.

Workers protected by the rule would include anyone who works for an employer, paid or unpaid, including independent contractors, interns, and executives. The proposed rule would apply to all persons or entities that hire or contract with workers, except for entities like banks, common carriers, and nonprofits that are exempt from the FTC's jurisdiction. The proposed rule would exempt, however, non-compete clauses between the buyer and seller of a business when the seller who is party to the clause had at least a 25% ownership interest in the business.

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The proposed rule would preempt any state laws conflicting with it. The FTC explained, however, that the proposal would establish a "regulatory floor, not a ceiling," thus allowing states to provide even greater protections to workers.

The FTC asserts the proposed rule is warranted based on research showing that non-compete clauses negatively affect competition in labor markets by suppressing labor mobility, resulting in lower wages for both workers subject to non-compete clauses (about one in five American workers according to FTC estimates) and those not subject to non-compete clauses. The FTC also relies on evidence showing that non-compete clauses reduce competition in product and service markets by, among other things, limiting former workers from creating new businesses and inhibiting workers from bringing innovative ideas to new companies.

The FTC acknowledged evidence that non-compete clauses lead employers to increase employee training and other forms of investment, and that these investments are the "primary justification" for non-compete clauses. Nevertheless, the FTC concluded that employers have less restrictive alternatives to protect their investments, such as trade secret law, non-disclosure agreements, or using fixed employment contracts to prevent workers from leaving shortly after receiving valuable training.

The FTC grounded its legal authority for the proposed rule in Sections 5 and 6(g) of the FTC Act. Section 5 prohibits "unfair methods of competition" (UMC), while Section 6(g) authorizes the Commission to "make rules and regulations for the purpose of carrying out the provisions of" the FTC Act.

The FTC's preliminary findings supporting the proposal differed for senior executives and workers who are not senior executives. The agency preliminarily concluded that non-compete clauses represent a UMC as applied to workers who are not senior executives for three independent reasons. First, the Commission concluded that such clauses are "restrictive conduct that negatively affects competitive conditions." Second, it determined that such clauses are "exploitative and coercive" at the time of contracting. Third, it concluded that such clauses are "exploitative and coercive" at the time of a worker's potential departure from an employer. In contrast, the FTC preliminarily determined that non-compete clauses binding senior executives represent a UMC based only on the first reason—that is, because such clauses represent "restrictive conduct that negatively affects competitive conditions."

As part of the rulemaking, the FTC sought comment on alternatives to the proposed rule. Specifically, the Commission asked for comments on whether it should (1) adopt a rebuttable presumption of unlawfulness rather than a categorical ban on non-compete clauses, and (2) create different standards for different categories of workers rather than a uniform rule for all workers.

As for the first alternative, the FTC recognized that a rebuttable presumption could have some advantages over a categorical ban in that it would accommodate particular situations where a non-compete clause does not raise competitive concerns. On the other hand, the Commission expressed concern that a rebuttable presumption would provide less certainty than a categorical ban and could lead to confusion among workers and employers as to whether a particular clause is forbidden.

As for the second alternative, the FTC observed that state laws addressing non-compete clauses generally create different standards or exemptions based on workers' job functions or income. Still, the FTC preliminarily concluded that a uniform rule would be preferable, as it would create more certainty for workers.

Commissioner Christine Wilson dissented from the FTC's proposed rule. Commissioner Wilson argued that non-compete clauses are an inappropriate subject for rulemaking because their competitive effects are highly fact-specific and depend on the business justification for particular clauses.

Commissioner Wilson also criticized the Commission for initiating a rulemaking on a subject with which it had little enforcement experience, relying on academic literature containing mixed conclusions, and discounting the procompetitive business justifications of non-compete clauses.

Finally, Commissioner Wilson questioned the FTC's legal authority to adopt the proposed rule. She predicted that such a rule would be successfully challenged on the grounds that (1) the FTC has no authority to engage in UMC rulemaking, (2) the major questions doctrine precludes the FTC from adopting a non-compete ban without clear congressional authorization, and (3) Section 5 of the FTC Act represents an impermissible delegation of legislative authority if construed to authorize a non-compete ban. These legal arguments are discussed further below.

Legal Issues

Does the FTC Have Substantive UMC Rulemaking Authority?

As discussed, the FTC has grounded its assertion of UMC rulemaking power in Sections 5 and 6(g) of the FTC Act. The provisions contain broad language: Section 5 prohibits "unfair methods of competition," while Section 6(g) empowers the FTC to issue rules "for the purpose of carrying out" the FTC Act.

There is case law supporting the FTC's claim of rulemaking authority. In its 1973 decision in *National Petroleum Refiners Association v. FTC*, the D.C. Circuit held that Section 6(g) authorizes the FTC to promulgate substantive Section 5 rules defining "unfair or deceptive acts or practices" (UDAP) and UMC.

Two years later, Congress responded to *National Petroleum Refiners* in the Magnuson-Moss Act, which established special procedures for the FTC's UDAP rulemakings under a new Section 18 of the FTC Act. Magnuson-Moss did not, however, purport to alter the FTC's UMC rulemaking authority. The statute contains a provision disclaiming an intent to "affect any authority of the Commission to prescribe rules (including interpretive rules), and general statements of policy, with respect to unfair methods of competition in or affecting commerce."

While Magnuson-Moss did not by its terms affect the FTC's UMC rulemaking authority, the Commission has not made extensive use of that power. The FTC has promulgated one substantive antitrust rule—a 1968 regulation (preceding Magnuson-Moss) that involved price discrimination in the men's clothing industry, which the agency never enforced and later repealed.

Some commentators have argued that the absence of a robust historical pedigree for UMC rules—along with several principles of statutory construction—suggest that the FTC does not have substantive UMC rulemaking authority. Among other things, they contend that the D.C. Circuit's decision in *National Petroleum Refiners* gave short shrift to certain canons of interpretation that may have greater purchase with modern courts; that the structure of the FTC Act suggests Section 6(g) confers ministerial rather than substantive rulemaking authority; and that the major questions doctrine precludes the FTC from issuing rules involving issues of "vast economic and political significance" without "clear congressional authorization."

Proponents of UMC rulemaking have responded that the text of Section 6(g) does not identify any limitations on the rulemaking power it confers and that the major questions doctrine is primarily relevant to the scope of the FTC's rulemaking authority, rather than the threshold question of whether Section 6(g) allows the agency to promulgate substantive rules.

A separate Legal Sidebar provides a more detailed discussion of these issues.

Would the FTC's Non-Compete Proposal Exceed the Scope of the Commission's UMC Rulemaking Authority?

Some commentators have argued that the FTC's non-compete proposal would—if implemented as a final rule—exceed the scope of the Commission's UMC rulemaking authority, even if the agency has the authority to promulgate other types of UMC rules. The remainder of this Sidebar addresses two issues raised by such arguments: (1) the breadth of Section 5 of the FTC Act in relation to the Sherman Antitrust Act, and (2) the major questions doctrine.

Section 5 of the FTC Act and the Sherman Act

Under current law, non-competes can be challenged under state law or the Sherman Act, though the latter is generally not an attractive vehicle for such lawsuits for the reasons discussed below.

State laws governing non-competes vary. A few states categorically ban non-competes, some prohibit them for specific categories of employees, and others subject them to reasonableness review.

Under the Sherman Act, by contrast, challenges to non-compete clauses are evaluated using a standard called the Rule of Reason, which requires plaintiffs to show that the defendant possesses market power and that the specific conduct at issue harmed competition. Under this test, lawsuits targeting non-compete clauses are seldom successful. In some cases, for example, courts have rejected antitrust challenges to non-compete clauses because plaintiffs failed to allege that the clauses had market-wide anticompetitive effects, as opposed to negative effects on the individuals bound by the clauses.

Accordingly, a key question in assessing the FTC's authority to ban non-compete clauses is the extent to which Section 5 of the FTC Act extends beyond the Sherman Act's prohibitions. While courts have recognized that Section 5 is broader than the Sherman Act, the precise scope of its extra coverage—often called the FTC's "standalone" Section 5 authority—is unsettled.

As discussed, the FTC's proposal offers multiple theories in support of its preliminary conclusion that non-compete clauses represent a UMC under Section 5.

One theory involves the contention that non-compete clauses constitute "restrictive conduct that negatively affects competitive conditions." The Commission argues that non-compete clauses have such effects "in the aggregate," noting that the effect of individual clauses may be "marginal" or "impossible to discern statistically." The rule would thus not require proof of competitive harm in individual cases, nor would it demand proof of specific indicia of harm (*e.g.*, proof that an employer has labor market power). Additionally, the rule would not allow employers to justify particular clauses with evidence of procompetitive benefits.

It remains to be seen whether courts would be receptive to this type of potential paradigm shift in antitrust enforcement. While the history of antitrust is filled with examples of bright-line rules—and some types of conduct remain *per se* illegal today—the consistent trend has been toward flexible standards that require courts to evaluate the details of specific challenged conduct.

In Sherman Act cases, modern courts have tended to conclude that *per se* illegality is appropriate "only after considerable experience" evaluating a specific practice. The FTC does not have such experience challenging or regulating non-compete clauses. The limited Section 5 case law involving such clauses also endorses a fact-specific approach. In a 1963 decision, the Seventh Circuit rejected the FTC's allegation that a business-to-business non-compete clause violated Section 5. In doing so, the court explained that non-compete clauses "are legal unless they are unreasonable as to time or geographic scope" and declined to conclude that such clauses represent *per se* Section 5 violations. The FTC's authority to implement a categorical prohibition of non-competes may thus depend on the extent to which its Section 5 rulemaking authority reaches beyond the standards that govern judicial recognition of new *per se* offenses.

The FTC's second theory justifying its conclusion that non-competes represent a UMC—that such clauses are "exploitative and coercive" as applied to non-senior-executive workers—may raise similar issues. In elaborating on this theory, the FTC distinguished between exploitation and coercion at the time an employment contract is signed and exploitation and coercion at the time of a worker's potential departure from an employer.

Non-compete clauses are "exploitative and coercive" at the time of contracting, the FTC argues, because they take advantage of unequal bargaining power between employers and workers. Such clauses are "exploitative and coercive" at a worker's prospective departure, the agency claims, because they "force a worker to either stay in a job they want to leave or choose an alternative that likely impacts their livelihood."

It is unclear how a court would evaluate these arguments. In its analysis of Section 5, the FTC references decisions from the 1960s affirming the FTC's findings of Section 5 violations where defendants used economic power in one market to harm competition in another market. Another decision the Commission cites involved a marketing scheme that exploited the inability of children to protect themselves. Whether the concepts of "exploitation" and "coercion" employed in these cases would be sufficient to support a broad non-compete ban remains uncertain.

The FTC's distinction between exploitation and coercion *at the time of contracting* and exploitation and coercion *when a worker seeks to leave a job* may also be a point of contention. The FTC frames these as "independent" theories of unfairness, suggesting that the agency has preliminarily concluded that non-compete clauses may be "exploitative and coercive" when a worker seeks to leave a job even if they are not "exploitative and coercive" when workers agree to them.

That claim may raise issues that are broadly similar to those that arise in connection with antitrust aftermarkets—markets for goods used together with a durable product, but where the goods are purchased after consumers have purchased the durable product (*e.g.*, printer ink, razor blades). These types of goods have generated questions regarding the circumstances in which a firm that lacks market power in a primary equipment market can nevertheless harm competition in a related aftermarket. While the Supreme Court has held that such harm is possible, recent case law has taken a narrow approach in applying the doctrine—especially when aftermarket terms are clearly set forth in a primary market contract. In those circumstances, courts have reasoned, consumers can incorporate aftermarket restrictions into their decisions in the competitive primary market.

If a court applied similar reasoning to the FTC's theories regarding non-compete clauses, it may be skeptical of the claim that such clauses can be "exploitative and coercive" when a worker seeks to leave a job if they are not "exploitative and coercive" at the time of contracting. In that case, the FTC's theory that non-competes are "exploitative and coercive" at the time of contracting would be the linchpin of its exploitation-and-coercion arguments.

To support that theory, the FTC's proposal appeals to inequalities in bargaining power between employers and workers. In particular, the Commission contends that most workers depend on income from their jobs to meet basic needs; that employers "generally" have "considerable" market power based on factors like concentrated labor markets and job search costs; and that outsourcing and declines in union membership have further eroded the negotiating positions of workers. The FTC also argues that workers face inequalities in bargaining power when negotiating employment terms because employers are repeat players in such negotiations, workers typically do not seek the assistance of counsel in reviewing employment contracts, and workers likely exhibit cognitive biases that interfere with their ability to appropriately evaluate employment terms.

These arguments implicate some of the issues discussed above. Even if a court was to credit the FTC's empirical claims about the level of competition and bargaining inequality in many labor markets, a rule that applies to all labor markets without admitting any affirmative defenses may invite judicial skepticism, based on the trends that have characterized modern antitrust.

While the FTC's proposed rule thus stands in some tension with aspects of prevailing antitrust doctrine, another principle may support the agency's efforts: *Chevron* deference. When *Chevron* applies, courts defer to an agency's reasonable interpretation of an ambiguous statute that the agency is charged with administering. Some commentators have argued that the FTC would be eligible for *Chevron* deference when promulgating UMC rules. Others, however, have noted that the Supreme Court has qualified the availability of *Chevron* deference in several recent decisions, including decisions involving the major questions doctrine.

The Major Questions Doctrine

As noted, the Supreme Court has relied on the major questions doctrine to reject claims of regulatory authority involving issues of "vast economic and political significance" when an agency has been unable to establish "clear congressional authorization" for the relevant power.

As discussed in this Sidebar, the Court recently applied this doctrine in *West Virginia v. EPA*, holding that the Environmental Protection Agency exceeded its authority under Section 111(d) of the Clean Air Act by promulgating emission guidelines for power plants that were based in part on shifting electric energy generation from higher-emitting sources to lower-emitting ones.

It is possible a reviewing court would conclude that a non-compete clause ban implicates "major questions" and thus requires explicit congressional authorization. Given the prevalence of non-compete clauses, a ban may have a significant economic impact. The FTC's proposal estimates that roughly 30 million workers are subject to a non-compete clause and that the proposed rule would increase workers' earnings by $250 billion to $296 billion a year. The proposed rule would also arguably have significant political impact—for example, by preempting state laws that currently govern non-competes. In one recent case, the Supreme Court justified its application of the major questions doctrine in part based on the fact that a federal regulation implicated the landlord-tenant relationship and thereby "intrude[d] into an area that is the particular domain of state law." Because non-compete clauses have traditionally been regulated primarily at the state level, similar reasoning might support the application of the major questions doctrine to a non-compete ban.

If a court determined that a non-compete ban implicated "major questions," the FTC would need to establish clear congressional authorization for such a rule, which may be a difficult task in light of the potential ambiguities involving Section 5's scope.

For its part, the FTC has denied that its authority is uncertain. Three Commissioners have contended that the FTC's proposal is grounded in "clear statutory authority" to identify and address UMC.

Considerations for Congress

The FTC's authority to prohibit non-compete clauses is primarily an issue of statutory interpretation. Congress could thus attempt to clarify the agency's authority via statute.

Congress could also regulate non-competes directly. In the 117th Congress, the Workforce Mobility Act (S. 483 and H.R. 1367) would have prohibited non-competes, subject to exceptions for the sale of a business or the dissolution of a partnership. S. 2375, the Freedom to Compete Act, would have adopted a narrower approach and banned non-competes for certain low-wage workers.

Deregulatory action is also possible. Congress could, for example, enact preemptive legislation authorizing non-compete clauses that meet certain conditions.

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