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Legal Sidebar

The Federal Trade Commission's Non-Compete Rule

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On April 23, 2024, the Federal Trade Commission (FTC) adopted a final rule prohibiting most employers from entering into or enforcing non-compete agreements with workers, subject to exceptions for the sale of a business and preexisting non-competes with senior executives. The rule implicates unsettled questions regarding the FTC's authority to promulgate substantive competition regulations. Multiple lawsuits challenging the rule have been filed in federal district court and others may follow. This Legal Sidebar provides an overview of the final rule (the "Non-Compete Rule") and related legal issues.

Background

Legal Background

The FTC relies on Sections 5 and 6(g) of the Federal Trade Commission Act (FTC Act) in promulgating the Non-Compete Rule. Section 5 prohibits "unfair methods of competition" (UMC) and empowers the FTC to enforce that prohibition through adjudication. Section 6 is titled "Additional powers of Commission." It confers a range of authorities, most of which involve investigations and the publication of reports. The provision also includes Section 6(g), which empowers the FTC to "from time to time classify corporations and . . . to make rules and regulations for the purpose of carrying out" the FTC Act.

Sections 5 and 6(g) were both part of the original FTC Act, which Congress enacted in 1914. In the decades following the statute's enactment, Congress adopted several laws granting the FTC rulemaking authority over discrete subjects, including the Wool Products Labeling Act, the Textile Fiber Products Identification Act, the Fur Products Labeling Act, the Flammable Fabrics Act, and the Fair Packaging and Labeling Act.

The FTC first asserted that Section 6(g) endows it with general substantive rulemaking power in 1962, and the agency adopted a number of trade regulation rules in the years that followed. Some of those rules defined certain conduct as both a UMC and an "unfair or deceptive act or practice" (UDAP)—a separate category of conduct prohibited by Section 5. Other rules relied only on the FTC's UDAP power. One rule relied solely on the FTC's competition authority, but was never enforced and has been repealed.

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In the 1970s, a trade association challenged the FTC's authority to issue substantive rules under Section 6(g) in *National Petroleum Refiners Association v. FTC*. The trade association argued that Section 6(g) authorized only procedural rules, emphasizing that the FTC had not asserted substantive rulemaking authority under Section 6(g) until 1962 and that FTC officials had occasionally denied the existence of such authority. The trade association also contended that Congress's enactment of several statutes granting the FTC specific rulemaking authorities implied that the FTC lacked general rulemaking authority.

The D.C. Circuit rejected those arguments. In affirming the FTC's power to issue legislative rules under Section 6(g), the court relied on appellate decisions construing similar statutes as authorizing substantive rulemaking; the advantages of rulemaking in effectuating the FTC Act's purposes; and the absence of any limiting language in the statutory text. The D.C. Circuit downplayed the fact that the FTC had not claimed general rulemaking authority until 1962, reasoning that the agency's earlier interpretation of its legal authority did not warrant judicial deference. The court also concluded that Congress may have provided the FTC with more specific rulemaking authorities based on "uncertainty, understandable caution, and a desire to avoid litigation," rather than a firm conviction that the FTC lacked general rulemaking authority.

Two years after the *National Petroleum Refiners* decision, Congress enacted the Magnuson-Moss Act, which imposed special procedural requirements for the FTC's UDAP rules and eliminated the FTC's authority to issue such rules under Section 6(g). Magnuson-Moss did not by its terms affect the FTC's authority to issue UMC rules: the statute included 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."

Despite this language in Magnuson-Moss, the FTC's putative authority to issue UMC rules has been dormant since the enactment of that statute. The Non-Compete Rule marks the first rule promulgated under Section 6(g) since the 1970s and the second rule ever that relies solely upon the FTC's competition authority. (As discussed, the FTC never enforced, and ultimately repealed, the only previous rule to rely solely upon that authority.)

A 1983 decision from the Seventh Circuit agreed with the D.C. Circuit's reasoning in *National Petroleum Refiners*, but no other federal circuit court has addressed the FTC's authority to issue legislative rules under Section 6(g). Whether the FTC possesses such authority remains unsettled; some commentators have argued that *National Petroleum Refiners* was wrongly decided and that it is unlikely that modern courts would reach the same conclusion.

The Antitrust Reform Movement and UMC Rulemaking

The past several years have witnessed renewed interest in antitrust law and policy. Much of this interest has been driven by concerns that the antitrust laws have been underenforced and that current doctrine is overly permissive. Since the 1970s, the Supreme Court has reduced the number of *per se* rules that define specific conduct as anticompetitive without inquiries into market dynamics and harms in particular cases. In doing so, the Court has expanded the scope of the "rule of reason"—a standard that, in its current form, typically involves a burden-shifting framework that requires such inquiries.

Empirical studies have found that the vast majority—as much as 97%—of complaints evaluated under the rule of reason are dismissed at the first stage of this burden-shifting process, leading some commentators to argue that the rule of reason is, in practice, a rule of *per se* legality. Others have criticized the costs and slow pace of antitrust litigation, which they attribute in part to the detailed analysis required by current law. Alongside the extension of the rule of reason, the Supreme Court has relaxed several aspects of monopolization doctrine, limiting the ways in which antitrust law restricts the unilateral conduct of dominant firms.

Advocates of more aggressive antitrust enforcement have supported UMC rulemaking as a means of counteracting these developments. In 2020, Lina Khan (who now serves as FTC Chair) and Rohit Chopra (an FTC Commissioner at the time) co-authored an article in which they contended that exclusive reliance on case-by-case adjudication under the rule of reason had produced "a system of enforcement that generates ambiguity, unduly drains resources from enforcers, and deprives individuals and firms of any real opportunity to democratically participate in the process." They thus argued that the FTC should supplement antitrust adjudication with UMC rules, which could promote legal clarity, lower enforcement costs, and allow the public to participate in the formulation of competition policy. Other academic work from proponents of antitrust reform has likewise urged enforcers and courts to "eschew the open-ended rule of reason" in favor of simpler presumptions and bright-line rules.

In July 2021, President Biden joined these calls for UMC rulemaking. In an executive order on competition policy, President Biden encouraged the FTC to exercise its "statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

Others have identified additional issues that the FTC may seek to address if its UMC rulemaking power is upheld. A coalition of advocacy groups has filed a petition for rulemaking urging the FTC to prohibit exclusive dealing by dominant firms. Commentators have also suggested that the FTC may propose rules targeting reverse-payment settlements in the pharmaceutical industry (often called "pay-for-delay" agreements), predatory pricing, and manufacturer repair restrictions.

The FTC's authority to issue such rules—and the Non-Compete Rule—depends not only on whether Section 6(g) authorizes legislative rulemaking, but also on the scope of Section 5's prohibition of UMC. The Supreme Court has repeatedly said that Section 5 is broader than the Sherman Act and the Clayton Act (the other core federal antitrust laws). However, the scope of this additional coverage—often called the FTC's "standalone" Section 5 authority—is unsettled.

Under previous leadership, the FTC took a narrow view of its standalone Section 5 authority. In a 2015 policy statement, the FTC indicated that decisions to bring standalone Section 5 actions would be guided by considerations of consumer welfare; that the FTC would evaluate challenged conduct under "a framework similar to the rule of reason"; and that the FTC was less likely to bring a standalone Section 5 action if enforcement of the Sherman Act or Clayton Act was sufficient to address the relevant competitive harm.

The FTC rescinded this policy statement in 2021 and issued a new Section 5 policy statement the following year. In the 2022 policy statement, the FTC identified two criteria it will consider in evaluating whether a "method of competition" is "unfair." First, the FTC indicated that "unfair" conduct "may be coercive, exploitative, collusive, abusive, deceptive, predatory, or involve the use of economic power of a similar nature," and "may also be otherwise restrictive or exclusionary." Second, the FTC explained that such conduct "must tend to negatively affect competitive conditions"—for example, by foreclosing or impairing the opportunities of market participants, reducing competition between rivals, limiting choice, or otherwise harming consumers. The 2022 policy statement indicated that this second inquiry will not turn on whether conduct directly causes harm in particular cases, but instead will focus on whether conduct "has a tendency to generate negative consequences."

The FTC framed its 2022 policy statement as a return to the original purposes of the FTC Act. Former Commissioner Christine Wilson dissented from the statement, arguing that it departed from antitrust's traditional focus on consumer welfare and did not provide clear guidance to businesses on how to structure their conduct to avoid violating the law.

The Non-Compete Rule

The Rule's Details

The Non-Compete Rule broadly tracks a proposed rule that the FTC released in January 2023, which was summarized in a previous Legal Sidebar.

The final rule makes it a UMC to enter into or enforce a non-compete clause with any worker who is not a senior executive. The rule also prohibits employers from entering into non-competes with senior executives after the rule's effective date, but allows employers to enforce preexisting non-competes with senior executives. The rule defines the term "senior executive" to mean a worker who occupied a "policy-making position" and received total compensation of at least $151,164 in the preceding year.

The rule's prohibitions are subject to an exception for non-compete clauses entered into pursuant to a bona fide sale of a business entity, a person's ownership interest in a business entity, or all or substantially all of a business entity's operating assets.

The rule defines the term "non-compete clause" to mean a term or condition of employment that "prohibits," "penalizes," or "functions to prevent" a worker from seeking or accepting work with a different person after the conclusion of the employment that includes the term or condition. The rule explains that this definition encompasses "de facto" or "functional" non-competes—for example, "forfeiture-for-competition" clauses that extinguish an employer's obligation to pay promised compensation or benefits if a worker accepts another job. The rule does not, however, categorically prohibit non-disclosure agreements (NDAs) or non-solicitation agreements.

The rule defines the term "worker" to include employees and independent contractors. That term does not include franchisees in the context of a franchisor-franchisee relationship, but does include employees of a franchisor or franchisee.

Employers that fall outside of the FTC's jurisdiction under the FTC Act are not subject to the rule. These employers include certain banks, savings and loan institutions, federal credit unions, common carriers, air carriers, and "persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act." Entities that are not "organized to carry on business for [their] own profit or that of [their] members" are also excluded from the FTC Act's coverage. The rule explains that simply claiming non-profit status under the tax code is not sufficient to qualify for this exclusion. Instead, the FTC evaluates the economic realities of an entity's activities to determine whether the exclusion applies.

The Non-Compete Rule requires employers to provide "clear and conspicuous notice" to workers subject to prohibited non-compete clauses that the clauses "will not be, and cannot legally be" enforced.

The FTC's Justification for the Rule

In adopting the rule, the FTC found that the use of non-compete clauses constitutes a UMC on several grounds. First, the FTC found that the use of non-competes constitutes a UMC because it qualifies as "restrictive and exclusionary conduct that tends to negatively affect competitive conditions" in labor markets and product and service markets. Here, the FTC indicated that non-competes are facially "restrictive" because they restrict workers' opportunities after they leave a job. Non-competes are also "exclusionary," the FTC found, because they impair the opportunities of rival firms to hire workers.

Second, the FTC determined that the use of non-competes for workers other than senior executives constitutes a UMC because it qualifies as "exploitative and coercive conduct that tends to negatively affect competitive conditions" in labor markets and product and service markets. The FTC based its findings of exploitation and coercion on its assessment that non-competes with workers other than senior

executives (1) are almost always unilaterally imposed by employers without negotiation, and (2) "trap workers in jobs or force them to otherwise bear significant harms and costs."

As noted, the FTC also found that non-competes "tend to negatively affect competitive conditions" in labor markets and product and service markets. With respect to labor markets, the FTC found that non-competes for workers other than senior executives inhibit labor mobility, suppress workers' earnings, and reduce job quality. With respect to product and service markets, the FTC found that non-competes for workers other than senior executives inhibit new business formation, suppress innovation, may increase concentration and consumer prices, and may reduce product and service quality and consumer choice. (While the FTC reached more limited findings regarding the competitive effects of non-competes with senior executives, it concluded that such clauses also "tend to negatively affect competitive conditions" in labor markets and product and service markets for some of the aforementioned reasons.)

The FTC considered several justifications for non-compete clauses, but concluded that they did not alter its finding that the use of such clauses constitutes a UMC. In particular, the FTC considered the arguments that non-competes incentivize employer investments in human capital and help safeguard trade secrets. Ultimately, the FTC found that employers have less restrictive ways to secure these benefits, including trade secret law, NDAs, fixed-duration contracts, and offering better pay or working conditions.

In claiming authority to issue substantive rules under Section 6(g), the FTC pointed to the provision's plain meaning and the D.C. Circuit's decision in *National Petroleum Refiners*. The FTC also argued that Congress implicitly ratified the D.C. Circuit's decision in both the Magnuson-Moss Act and the Federal Trade Commission Improvements Act of 1980. As discussed, Magnuson-Moss included 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." The 1980 statute imposed procedural requirements that the FTC must follow in issuing any "rule." It defined the term "rule" to include rules promulgated under Section 6 or Magnuson-Moss. The statute excluded from that definition "interpretive rules, rules involving Commission management or personnel, general statements of policy, or rules relating to Commission organization, procedure, or practice." The FTC argues that this exclusion confirms its authority to issue rules under Section 6 that are *not* merely "interpretive rules, rules involving Commission management or personnel, general statements of policy, or rules relating to Commission organization, procedure, or practice."

Two FTC Commissioners voted against the Non-Compete Rule, explaining in oral statements that they believe the rule exceeds the FTC's legal authority.

Legal Challenges

At least three lawsuits challenging the Non-Compete Rule have been filed in federal district court. The lawsuits challenge the rule on a variety of grounds, summarized below.

- **Lack of Substantive Rulemaking Authority.** Three lawsuits contend that the FTC does not have substantive competition rulemaking authority. They argue that the history and structure of the FTC Act demonstrate that Section 6(g) authorizes only procedural rules. One of the lawsuits also asserts that the "major questions doctrine"—which requires that agencies have "clear congressional authorization" to adopt rules involving issues of "vast economic and political significance"—confirms that the FTC lacks UMC rulemaking power.
- **Unlawful Interpretation of "Unfair Methods of Competition."** Three lawsuits claim that, even if the FTC does have authority to issue UMC rules, the Non-Compete Rule exceeds that authority. Here, all three complaints invoke the major questions doctrine. One of the lawsuits also contends that a categorical prohibition of non-competes is

inconsistent with the FTC's longstanding view that Section 5 calls for fact-specific analysis of agreements that are not *per se* illegal.

- **Non-Delegation Doctrine.** Three complaints allege that, to the extent that Section 5 could be interpreted to authorize a categorical prohibition of non-competes, it violates the non-delegation doctrine, which requires Congress to provide agencies with an "intelligible principle" in delegating legislative authority.
- **Unlawful Retroactivity.** One of the lawsuits argues that, by invalidating preexisting non-compete clauses for workers other than senior executives, the Non-Compete Rule is impermissibly retroactive. In particular, the suit claims that the FTC Act does not authorize retroactive rulemaking and that, even if it did, the Non-Compete Rule's retroactive effect would "raise serious questions under the Fifth Amendment of the U.S. Constitution."
- **"Arbitrary and Capricious" Rulemaking.** Two of the complaints allege that the Non-Compete Rule is "arbitrary and capricious" and thus violates the Administrative Procedure Act (APA). One lawsuit claims that (1) the record before the FTC did not justify a categorical non-compete ban, and (2) the FTC failed to adequately consider alternative proposals, such as a rebuttable presumption of illegality or a rule that exempts all preexisting non-competes. Another complaint alleges that the rule's invalidation of preexisting non-competes for workers other than senior executives violates the APA by unreasonably overriding the settled expectations of parties to such agreements.
- **The FTC's Structure.** Two of the lawsuits argue that the FTC Act violates Article II of the Constitution by preventing the President from removing FTC Commissioners for reasons other than "inefficiency, neglect of duty, or malfeasance in office." (The complaints acknowledge that this claim is foreclosed by applicable circuit precedent, but preserve the argument for further appellate review.)

Considerations for Congress

Several of the issues discussed above are questions of statutory interpretation that Congress has the power to clarify. For example, Congress could clarify whether the FTC possesses general competition rulemaking authority.

Congress also has the authority to pass legislation addressing non-compete clauses. In the 118th Congress, the Workforce Mobility Act (S. 220 and H.R. 731) would prohibit non-competes, subject to exceptions for the sale of a business or the dissolution of a partnership. S. 379, the Freedom to Compete Act, would adopt a narrower approach and ban non-compete clauses in employment contracts that are subject to the wage and overtime requirements of the Fair Labor Standards Act. Congress also has the option of leaving existing law unchanged.

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