



The FTC's Plan To Limit Noncompetes Could Pose an Array of Practical Problems

- A proposed FTC rule would prohibit most noncompete agreements and federalize an area that has traditionally been left to state law.
- While some states already prohibit many types of noncompetes, the FTC rule would go much further, requiring companies to cancel existing noncompetes.
- Legal challenges to the proposed rule are expected, but new state laws governing noncompetes will continue to pose challenges for employers no matter the fate of the FTC rule.
- Employers should prepare for the possibility that the FTC rule will be adopted, or that more states will take a page from the FTC playbook and restrict noncompetes — establishing alternative, permissible restrictions on former employees, for instance.

As part of its declared focus on fostering competition in the labor market, the Federal Trade Commission (FTC) has proposed to ban most noncompetition agreements, or noncompetes, restricting the activities of former employees. Noncompetes can be a useful tool for employers to safeguard their confidential information, trade secrets and goodwill from unfair competition by former employees. This area has traditionally been governed by state law, and the FTC's proposal has provoked criticism. If the commission moves forward with a ban of noncompetes, that will almost certainly face legal challenges.

But the FTC is not alone in viewing noncompetes with suspicion. Several states have also moved to limit noncompetes in recent years, and other states could decide to follow the FTC's lead.

The Current Law of Noncompetes Is a Patchwork of State Laws

State laws governing post-employment noncompetes vary widely. A few states, notably California, generally prohibit post-employment noncompetes. California does have several exceptions, however, including an important one for individuals selling their interests in a business.

Other states, such as Delaware and New York, allow post-employment noncompetes, but they generally require that such agreements be reasonable in duration, geographic scope and the kinds of competition they prohibit. For example, in 2022, Delaware's Court of Chancery declined to enforce a noncompete in connection with the sale of a business that it found was too broad in terms of geography and the types of

competition it prohibited. Moreover, the court declined to “blue pencil” or rewrite the noncompete in order to make it enforceable, invalidating it in its entirety. This decision marked a shift in Delaware’s approach to noncompetes and it is especially important since many noncompetes signed in connection with transactions are governed by Delaware law.

Many state legislatures have taken steps to limit post-employment noncompetes in recent years. For example:

- Several jurisdictions – including Colorado, the District of Columbia, Illinois, Oregon and Washington – now limit noncompetes to those who earn more than a certain amount each year. These salary thresholds can reach six figures — as high as \$150,000 in the District of Columbia.
- Massachusetts has gone even further and requires former employees to be paid during any noncompete period.

The FTC’s Restrictions on Noncompetes Would Be Broader Than Most State Laws

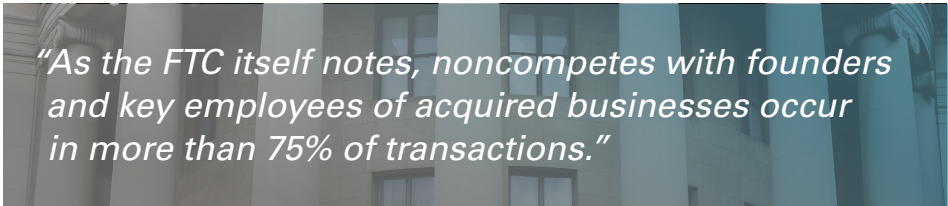
- The FTC’s proposed rule would bar even noncompetes that are reasonable under existing state law.
- The rule would declare noncompetes to be a form of “unfair competition.”

- The rules would prohibit entering into new post-employment noncompetes.
- They would require employers to rescind any existing noncompetes with current or former employees, and notify them of the rescission.

Other restrictive covenants that are often used to protect employees from unfair competition, such as confidentiality or non-solicitation agreements, would *not* be prohibited by the proposed rule. However, agreements that operate as *de facto* noncompetes would be.

In addition, the FTC would allow noncompetes as part of the sale of “all or substantially all” of a business’s assets where the seller owns 25% or more of a business being sold.

The FTC’s proposal is just one of a number of recent examples of federal antitrust regulators focusing on the intersection of competition and labor. The FTC has challenged noncompete clauses as “unfair methods of competition” in several cases that have been resolved through consent orders. The FTC and the Department of Justice (DOJ) have issued joint guidelines on the exchange of HR information on wages or benefits and its potential impact on competition in the labor markets, and the DOJ has aggressively pursued a number of criminal antitrust cases alleging “no-poach” agreements among firms competing in the labor markets.



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The FTC Restrictions Could Complicate the Purchase of Businesses

The FTC’s 25% ownership threshold would reduce the flexibility that buyers now have when negotiating to protect the goodwill of a business they are acquiring. By contrast, California and New York do not put a specific threshold on the percentage of ownership required to make a noncompete enforceable. By limiting the sale-of-business exception to substantial owners, the FTC rule would limit the protection the buyer of a business can obtain where an individual seller is responsible for a meaningful portion of a business’s goodwill but owns less than 25% of its equity.

The rule would also limit buyers’ ability to enter into noncompetes with key employees who are not owners or fall below the 25% threshold.

As the FTC itself notes, noncompetes with founders and key employees of acquired businesses occur in more than 75% of transactions. Limiting noncompetes with these key individuals would increase uncertainty among buyers about their ability

to protect their investment in the acquired business, and that may affect the transaction value.

Legal Challenges to the FTC’s Rule Are Likely

The FTC’s proposed rule was published on January 19, 2023, and the comment period ran through April 19, 2023, with over 26,000 comments submitted. If adopted by the commission, the rule could go into effect as soon as October 16, 2023.

Legal challenges to the proposed rule, if enacted, are likely. The FTC approved the rule in a 3–1 vote with Commissioner Christine S. Wilson dissenting. She said that the proposed rule is susceptible to legal challenges on various grounds, including that Congress never authorized the FTC to restrict noncompetes and that it conflicts with Supreme Court precedent on administrative law. Wilson, who stepped down from the FTC in March 2023, also argued that the rule would ban conduct that is currently allowed in 47 states and that has been permitted by courts interpreting federal antitrust laws.

Interest groups have also weighed in. The U.S. Chamber of Commerce has called the proposed rule “blatantly unlawful” and an attack on “well-established state laws,” and has said it is prepared to go to court if the rule is adopted.

Suits to block the rule would likely be filed when the measure is approved, well ahead of the effective date.

Companies Can Prepare Now for the Possibility of New Constraints on Noncompetes

If the FTC's proposed rule is finalized and survives legal challenges, employers will face the difficult task of rescinding their existing post-employment noncompetes and notifying affected workers of the rescissions in accordance with the regulation. Whether employers must do so while the issue is being litigated will depend on whether a court issues an injunction against the proposal while the case is pending.

Even if the FTC's proposal is struck down by legal challenges, state laws that narrow the scope and/or application of allowable noncompetes will remain. Some states may follow the FTC's lead and implement new or additional restrictions on noncompetes.

To prepare for these scenarios, employers will need to take an inventory of every noncompete to which they are a party — a potentially time-consuming process.

Employers can take proactive steps to protect themselves from allegations of unfair competition no matter the outcome of the FTC's proposal:

- Frequently review all existing restrictive covenants for compliance with applicable state law. Usually, the relevant law is that of the state where the employee regularly works. The law of the state where the employer is headquartered or otherwise located should be considered, as well.
- Consider what alternative restrictions are permitted to protect the employer's interests — requiring, for example, that employees sign broad agreements to protect trade secrets and other confidential information (with necessary carveouts for any disclosures that employees are permitted to make under applicable state or federal law).
- Where permitted, consider non-solicitation agreements with employees that bar them from recruiting customers or other employees (keeping in mind that such agreements are usually only enforceable where they are deemed to be reasonable under state law).
- In negotiating transactions, be mindful of any limitations on noncompetes that may apply. The value of a company may be reduced if the former owners or key employees are free to compete with it after a sale.

Restrictions on Noncompetition Agreements Vary Widely by Jurisdiction

While no means exhaustive, recent proposed and enacted laws regarding post-employment noncompetes at the federal and state level include:

| Federal | |
|--|---|
| FTC proposal | Broad prohibition with narrow exception for sale of a business, limited to those selling >25% stake. |
| States | |
| California | Long-standing broad prohibition, but with an exception for certain sales of a business. |
| Colorado, District of Columbia, Illinois, Oregon and Washington | Laws enacted between 2020 and 2022 restrict noncompetes to employees making salaries over a certain threshold, ranging from \$75,000 to \$250,000, depending on the jurisdiction and the employee's profession. |
| Massachusetts | Former employees must be paid during noncompete period, which can last no longer than one year in most circumstances. |

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