

6 Things Cos. Should Do Following FTC Noncompete Proposal

By **Colton Long, Melissa McDonagh and James Witz** (January 12, 2023, 3:15 PM EST)

On Jan. 5, the Federal Trade Commission released a proposed rule that, if it becomes final, would ban all noncompete agreements with limited exceptions.

The rule would go into effect 60 days after it becomes final, but employers would have 180 days after publication of the final rule in the Federal Register to comply.

We expect several changes may be made — and to see potential challenges in court — before the FTC imposes a final rule. However, the required timeline for the proposed rule presents an opportunity for businesses to get ahead of the game.



Colton Long

Summary of the Proposed Rule

The rule defines a noncompete 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."

Notably, the proposed rule prescribes what it calls a "functional test for whether a contractual term is a non-compete clause." As a result, the rule goes beyond traditional noncompetes and sweeps under its coverage any contract provision the FTC determines serves as a de facto noncompete by effectively "prohibiting [a] worker from seeking or accepting employment with a person or operating a business" at the end of a worker's employment.



Melissa McDonagh

Under the functional test, the FTC states it could deem the following as prohibited de facto noncompetes. Overbroad:

- Nondisclosure agreements;
- Nonsolicit agreements; or
- Repayment agreements for training costs that are not reasonably related to costs an employer incurred for that training.



James Witz

Exempt from the rule are noncompete clauses involving:

- A seller of an entire business entity or all of the person's ownership interest in the business entity; and/or
- A seller of all, or substantially all, of the operating assets of a business entity, so long as the party restricted (the seller) is an owner, member or partner holding at least 25% ownership interest in the entity.

Importantly, existing noncompetes are affected under the proposed rule. The FTC's proposed rule seeks to apply retroactively, requiring employers to formally rescind — in writing — all noncompetes with current and former employees no later than the compliance date.

The proposed rule would supersede all state laws, regulations, orders and interpretations inconsistent with the proposed rule's requirements, unless state restrictions afford greater protections than those provided by the proposed rule.

Six Steps Businesses Can Take Now

As it currently stands, otherwise valid noncompete provisions that meet the strictures of their respective state's laws remain enforceable; a final rule is yet to be issued and will not be for some time. But the FTC's proposed rule nevertheless signals a new era in competition law in which the federal government is more actively taking aim at agreement provisions restricting a person's freedom of professional movement.

There are six steps we recommend businesses take now.

1. Take inventory of existing noncompete clauses in your business.

If the rule goes into effect in some form, businesses may need to reform and/or formally rescind certain noncompete covenants.

Review existing agreements to identify those containing noncompete covenants. It is not unusual to see noncompete covenants in offer letters, employment agreements, long-term incentive plans, equity agreements, separation agreements, severance plans, independent contractor agreements, and purchase and sale agreements.

2. Consider other alternatives and exercise commonsense caution.

There are other methods to secure a noncompete with key employees.

Companies should evaluate using alternative noncompete provisions that may be exempt from the final rule, such as paid notice or garden leave provisions or clawback and forfeiture-for-competition provisions in equity or long-term incentive agreements.

3. Advocate your position as a business.

The public has until March 10 to submit comments for the FTC's consideration. Indeed, the FTC has specifically requested comment on whether the ban should not apply to more senior executives.

We also expect that employers will strongly push back against the rule's retroactivity, which could

depend heavily negotiated agreements for which senior executives were paid significant compensation.

Consider how the proposed rule will impact your business. Organize with other businesses in your industry or lobbying organizations to submit public comments.

4. Look closely at business and employee nondisclosure agreements and policies.

Businesses should implement tailored, business-specific and jurisdictionally compliant nondisclosure agreements with employees, vendors and other business partners. If those agreements are already in place, businesses should take a close second look to ensure they adhere to the increasing body of strictures mandated by courts and state legislatures to avoid invalidation.

Noncompetes are most often used to protect a business's confidential information and trade secrets from being disclosed to a competitor — they provide a meaningful cooling-off period and decrease the likelihood that gleaned or stolen trade secrets will be of as high value when relationships end. Without noncompetes, businesses would have one less tool in the shed to protect themselves in this regard.

Review your nondisclosure agreements with employees and business partners. Ask:

- Do they protect and specifically delineate the right kinds of information for your business?
- Are they provided to the right personnel and business partners?
- Do they comply with the requirements of the state in which the employee or business partner is located?
- Do they provide for the right kinds of remedies in the event of a breach?
- Do you need to reconsider employment policies that reprimand employees for improperly divulging data or information without authorization?

5. Take advance steps to protect trade secrets and confidential information.

Again, in general, protection of confidential information and trade secrets is the key concern wrought by the FTC's proposed rule. But, there are several other methods for protecting a company's valuable data.

Ensure your business actually, truly limits access to confidential information and trade secrets to the right groups of personnel and partners.

- Do all employees have access to your business's research and development through a shared drive, for example?
- Are employees walled off from locations where physical or electronic data is used or leveraged by high-level employees?
- Are measures in place to flag exfiltrated data and information — be it through email, cloud accounts or external flash drives?
- Has a step-by-step data protection plan been implemented in the event of unauthorized data access?

6. Update and refine your customer and employee nonsolicitation provisions.

One other critical employer interest in utilizing noncompetes is to protect against former executives using their inside knowledge and goodwill with the company's customers and employees to decimate their employee and customers relationships.

It is thus critical that employers have well-drafted and enforceable customer and employee nonsolicitation provisions in place, which are unlikely to be affected by the FTC's proposed ban on noncompete provisions. Such provisions should be separate from noncompete provisions so that they will not be affected by the proposed ban if it goes into effect.

Colton Long is a shareholder at Littler Mendelson PC.

Melissa McDonagh is a shareholder and co-chair of the unfair competition and trade secrets practice group at the firm.

James Witz is a shareholder and co-chair of the unfair competition and trade secrets practice group at the firm.

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