The FTC's Proposed Ban on Non-Competes - What Does It Mean?

By: Barry Cepelewicz, MD and Andrew Zwerling

Barry Cepelewicz, MD: Hello! My name is Barry Cepelewicz. I'm a partner at Garfunkel Wild, and I'm here with my partner, Andrew Zwerling to present today's podcast The FTC's Proposed Ban on Non-Competes - What Does it Mean?

Barry Cepelewicz, MD: The proposed rule I'm referring to is the one issued on January 5th, 2023 by the Federal Trade Commission that would prohibit employers from entering into non-competes with workers, including independent contractors.

Barry Cepelewicz, MD: Although the proposed rule has not been finalized, let alone implemented, and its viability will likely be challenged through litigation, the FTC's pronouncement has generated intense concern among employers over the future viability of their restrictive covenants and has already led employees to question whether their existing or future restrictive covenants are enforceable.

Barry Cepelewicz, MD: In this podcast, Andrew and I, both of whom for many years have dealt with issues concerning non-competes from both transactional and litigation perspectives, will discuss what the proposed rule entails, and what it may signify.

Barry Cepelewicz, MD: So for starters Andy, what exactly is the proposed rule?

Andrew Zwerling Yes, Barry, the proposed rule would categorically ban employers from using non-compete clauses with workers. It would define the term 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. The proposed rule would also clarify that whether a contractual provision is a non-compete clause would depend not on what the provision is called, but really how the provision functions. But it contains more. In addition to prohibiting employers from entering into non-compete clauses with workers starting on the rule's compliance date, the proposed rule would also require employers to rescind existing non-compete clauses no later than the rule's compliance date.

Andrew Zwerling The proposed rule would also require an employer rescinding a non-compete clause to provide notice to the worker that the worker's non-compete clause is no longer in effect. And that notice, under the proposed rule, would be required to be in writing in an individualized communication, and be sent to both current and former employees, who are subject to a non-compete. The proposed rule did note that the notice needs to be sent to former employees if their contact information is readily available.

Barry Cepelewicz, MD: Can you explain why the FTC issued the rule in the first place?

Andrew Zwerling Certainly, Barry. According to the FTC anyway, research has shown that the use of non-compete clauses by employers has negatively affected competition in labor markets with the consequences resulting in reduced wages for workers across the labor force, including workers not even bound by non-compete clauses. And that same research has shown, according to the FTC, that by suppressing labor mobility non-compete clauses have negatively affected competition and product and service markets, and in various ways including by reducing entrepreneurship and new business formations and also limiting the sharing of ideas, and thereby also limiting innovation.

Andrew Zwerling According to the FTC that same evidence shows that non-compete clauses bind approximately one in five American workers. We're talking about 30 million people or so, and the feeling of the FTC is that by preventing workers across the labor force from pursuing better opportunities that offer higher pay or better working conditions and by preventing employers from hiring qualified workers bound by these contracts, non-competes hurt both workers and also harm competition.

Andrew Zwerling The FTC found as another variable in the mix that non-compete clauses significantly reduce the wages of workers. When employers use non-compete clauses to restrict workers from moving freely, they then have the power to suppress wages and avoid having to compete to attract workers and based on existing evidence, non-compete clauses, it's felt, also reduce the wages of workers who aren't subject to non-competes by preventing jobs from opening in their industry and according to FTC estimates the proposed rule could increase workers' earnings across industries and job levels by anywhere between 250 billion dollars to 296 billion dollars annually.

Andrew Zwerling The FTC also examined state actions limiting non-competes, either globally or based on a variety of factors, including the workers' earnings and/or occupation and in Connecticut, just by way of one example, the non-compete for physicians can last up to one year post termination and can only involve a geographic radius up to 15 miles from the primary location where the physician provided services and cannot be enforced if the physician was terminated for no cause by the employer.

Andrew Zwerling And so the FTC used Connecticut and other jurisdictions as examples of how states were already in the process of limiting non-competes as part of its predicate for the proposed rule.

Barry Cepelewicz, MD: Now are all forms of restrictive employment covenants barred by the proposed rule?

Andrew Zwerling No, not at all, Barry. You know, that was the initial impression that people had, but it's a general rule. The definition of a non-compete clause would generally not emphasize **not** include, other types of restrictive employment covenants, such as non-disclosure agreements, otherwise known as NDA's, and client to a customer or a patient non-solicitation agreements because, as the FTC has concluded, these other covenants generally do not prevent the worker from seeking or accepting employment with a person, or even operating a business after the conclusion of the worker's employment with the employer. However, the FTC did caution that if the NDA or non-solicitation agreement is so broad in scope that it would essentially act as a non-compete, it could then be treated as a non-compete for purposes of the rule.

Andrew Zwerling Similarly, contractual provisions that cause a bonus, equity grant, or compensation to be forfeited if the employee separates from the employer, can potentially be impacted as a result.

Barry Cepelewicz, MD: Now, what types of workers are covered by the proposed rule?

Andrew Zwerling It's very broad in scope, Barry, the proposed rule would clarify that the term "worker" includes an employee and individuals who are classified as an independent contractor, extern, intern, volunteer, apprentice, or a sole proprietor who provides a service to a client or a customer.

Barry Cepelewicz, MD: Now, what happens if state law permits restrictive covenants?

Andrew Zwerling The proposed rule really will carry a broad and all-encompassing impact. It would contain an express preemption provision, and by that it means that it would supersede any state statute, regulation, order, or interpretation to the extent that such statute, regulation, order, or interpretation is inconsistent with the rule.

Andrew Zwerling On the other hand, the proposed rule further provides that a state statute, regulation, order, or interpretation is not inconsistent with the provisions of the proposed rule if the protection such state statute, regulation, order, interpretation, affords any worker is greater than the protection provided under the rule.

Barry Cepelewicz, MD: Are there any exceptions to the proposed rule?

Andrew Zwerling Yes, the proposed rule would include a very narrow exception for non-compete clauses between the seller and a buyer of a business. This exception, however, would only be available where the party restricted by the non-compete clause is an owner, member, or partner, holding at least a 25% ownership interest in a business entity at the time such person entered into the not-compete clause. And limiting the exception to substantial owners, substantial members, and substantial partners, would ensure that the exception is only available where the seller's stake

in the business is large enough that a non-compete course may be necessary to protect the value of the business acquired by the buyer. The FTC proposed a threshold of 25% ownership interest for a particular reason.

Andrew Zwerling The FTC felt that, and believes, that the exception should be available where, for example, a few entrepreneurs sharing ownership interest in a startup, sell their firm, because in such a scenario a non-compete clause may be necessary to protect the value of the business acquired by the buyer.

Andrew Zwerling For this reason a threshold of, for example 51% may be too high. However, the FTC believes the exception should not be available where the ownership interest in question is so small the transfer of ownership interest would not be necessary to protect the value of the business acquired by the buyer.

Andrew Zwerling In terms of this particular exception it was justified by the FTC because it found that many states who presently limit non-competes still permit their use in the sale of a business and the FTC explained that the 25% threshold, in the FTC's view, strikes an appropriate balance between a threshold that may be too high, which would exclude many scenarios in which a non-compete clause may be necessary to protect the value of the business acquired by the buyer and a threshold that may be too low, and therefore would allow the exception to apply more broadly than is needed to protect such an interest.

Andrew Zwerling The FTC also expressed that establishing a specific threshold would thereby create greater clarity to the public, and also facilitate compliance with the rule.

Barry Cepelewicz, MD: So are any alternatives to the proposed rule possible from the FTC's perspective?

Andrew Zwerling Yes, Barry, there are. In fact, the FTC and again the proposed rule, we're talking a 200 page length in terms of the document, came to a lot of information, has articulated several alternatives to the proposed rule for which it is seeking comments. That said, however, that in pointing out these alternatives, the FTC also made it explicit that it favored the categorical ban.

Andrew Zwerling In terms of the alternatives, one proposed alternative, for which the FTC can comment would be to replace the categorical ban with a rebuttable presumption.

Andrew Zwerling This approach it would be presumptively unlawful for an employer to use a non-compete clause, however, the use of a non-compete clause would be permitted in a scenario where the employer can meet a certain evidentiary burden based on a standard that would be articulated in the rule.

Andrew Zwerling The rationale behind this approach would be that prohibiting employers from using non-compete clauses as an appropriate default rule in light of the adverse effects on competition referred to above. However, there may be specific sets of facts under which the use **may** be justified, so it would be appropriate to permit employers to use them in those cases where they can meet, whatever that evidentiary threshold may be.

Andrew Zwerling The rebuttable presumption approach would also be similar in many respects to the current common law governing non-compete clauses.

Andrew Zwerling In most states, as you and I know, Connecticut, New Jersey, non-compete clauses are disfavored, but are permitted if an employer can identify a legitimate business interest, and if the non-compete cause is reasonable with respect geographic area, duration, and the scope of activity prohibited.

Andrew Zwerling Similarly under the rebuttable presumption approach non-compete clauses would be presumptively unlawful, but would be permitted under certain circumstances.

Andrew Zwerling One important question, I should add related to the rebuttable presumption approach, is what the test for rebutting the presumption should be.

Andrew Zwerling The Commission has expressed in that lengthy document, preliminarily beliefs that if it were to adopt a rebuttable presumption and a final rule, it would adopt a test that is more restrictive than the current common law standard that I just mentioned. Otherwise the rule in the FTC's mind would be no more restrictive than current law, and the objective of the rule to remedy the adverse effects, the competition referred to above, would not be achieved.

Andrew Zwerling Another alternative that was articulated, would be to apply different rules to different categories of workers based on a worker's job function or occupation, or earnings, or some combination of factors.

Andrew Zwerling There are 3 main ways a rule can differentiate among workers. First, a rule could apply different standards to workers based on the worker’s job functions or occupation.

Andrew Zwerling For example, a rule could apply more lenient standards to non-compete clauses for senior executives, or could exempt them from coverage altogether. The FTC identified 4 classes of workers that “merit special attention”: high tech workers, physicians, workers who are paid on an hourly basis, and chief executive officers.

Andrew Zwerling Second, a rule could apply different standards to workers based on some combination of job functions, occupations that are workers’ earnings. By way of example, the rule could apply more lenient standards to workers who qualify for the FLSA exemptions for executives and learned professionals.

Andrew Zwerling Workers qualify for these FLSA exemptions, the Fail Labor Standards Act exemptions, which exempt the worker from minimum wage and overtime pay rules, if they earn above a certain amount and perform certain types of job duties.

Andrew Zwerling Well, third, a rule could simply apply different standards based on the workers’ earnings, and to reiterate with respect to all these alternatives, the FTC has requested comment.

Barry Cepelewicz, MD: So, Andy, we're right now at the proposed rule stage. We still have a long way to go. As someone who has litigated non-competes now for quite a while, what would you advise employers to be doing in the interim?

Andrew Zwerling And that's a question that we've been getting with a fair amount of frequency from employers that I know you've experienced, Barry, so is what have I. What do we do in the face of this? Well, although the proposed rule doesn't require an immediate action by employers, or change current law at this time, employers should be aware of a continuing legislative trend at the state level restricting non-competes.

Andrew Zwerling In response to this trend, and in anticipation of a potential sea change, if the FTC proposed rule will ever become final, employers should carefully evaluate the scope of the need for non-competes with their employees, especially with blue collar and other non-executive employees and in states that have imposed greater restrictions on enforceability of non-competes.

Andrew Zwerling One should also keep in mind, that the proposed rule is, by definition, a proposed rule and it remains to be seen whether it will even be issued in its current form, or even in modified form. Importantly, on that note, the proposed rule faced some pretty stiff opposition from the time it was announced.

Andrew Zwerling For example, upon the FTC's Announcement to the proposed rule, FTC Commissioner Christine Wilson issued a dissenting statement opposing the proposed rule. The same day it was announced, the US Chamber of Commerce declared the proposed rule blatantly unlawful. Additionally, most commentators predict that any final rule by the FTC on the subject will be challenged in court. I think one can reasonably expect a fierce challenge to it.

Andrew Zwerling That said, however, recognizing the growing disfavor of restrictive covenants by the FTC and the courts, the employers must take great care in ensuring that restrictive covenants are: a) necessary; and b) no broader than necessary to protect the employer's legitimate interests.

Andrew Zwerling By way of example, restrictive covenants will generally be forced against a physician so long as it is reasonably limited time, geographic area, and scope. Secondly, it's not harmful to the public or unduly burdensome. And three serves the legitimate purpose of protecting the former employee, or associate from unfair competition. These 3 factors are those that the court will focus on in assessing the enforceability of a restrictive covenant against the physician.

Andrew Zwerling And I believe that you can take those same variables as an employer in any context and apply them to ensure that you stay in your lane with respect to making the restrictive covenant or non-compete no broader than necessary.

Andrew Zwerling I've done a bit of talking so far today. At this point, Barry. What I'm going to do is flip it around on you as a transactional lawyer of many years, as someone who has drafted these particular provisions for many different types of entities and employers.

Andrew Zwerling In your mind, how should a non-compete be drafted, at this juncture, to optimize enforceability to manage the risk that some court in the interim before the proposed rule process plays out? I'm an employer, what should I do to maximize the chances that the restrictive covenant I think I need will be enforced?

Barry Cepelewicz, MD: Well, I think first of all, to answer that probably could be a podcast in and of itself but, to be brief, I think the advice that we would give to employers now would be the same advice we've been giving employers for quite a long time. To go back on what you just left off, Andy, the 3 prongs or the factors that you had mentioned, serving a legitimate purpose, being reasonably limited in time, geographic area, and scope, and not being harmful to the public or unduly burdensome. Those are things that we've always spoken to employers about.

Barry Cepelewicz, MD: So to take those 3 factors, in that order. To begin with, with regard to the requirement that the restrictive covenants serve a legitimate interest of the employer, courts have long recognized the inherit interest of a medical practice in maintaining its patient base and numerous cases recognize that medical practices' interest in maintaining its patients is a legitimate interest worthy of protection by a covenant not to compete even where the practice is a profit-generating venture.

Barry Cepelewicz, MD: Courts also have recognized that the loss of patients and referral sources may cause irreparable injury that is not readily compensated in monetary damages, and that medical practices also have a legitimate interest in safeguarding the reputation and goodwill it has cultivated.

Barry Cepelewicz, MD: Going to the next factor where you had mentioned that the non-compete, you know, must be reasonable in duration, geographic area, and scope let's take those 3 and address them relatively quickly.

Barry Cepelewicz, MD: First, the time duration must be reasonable. And so, when drafting these types of provisions, we always advise the employers that they must take care to ensure that the prohibition is reasonable in duration, and, generally speaking, one to three years post-termination is the timeframe. Whether we pick one, two, or three years depends on the practice, depends on the physician, on the specialty. There are many factors here that we think about before we come up with either one year, two year, or three year, post termination restriction.

Barry Cepelewicz, MD: Second, the provision must be reasonable in its geographic or restricted area. Now the reasonableness of a non-compete geographic area is generally determined by the employer's activity and what is necessary to protect the legitimate interest of the employer.

Barry Cepelewicz, MD: Now, in a health care context, courts have upheld geographic restrictions as much as 30 miles from where the employee practiced. Critically, however, in assessing the reasonableness of the restricted area, courts also take into consideration the population density of the area in which the employer's practice is located. So, for example, in suburban or rural areas, a larger restricted area may be enforced. That's where you may see the 15-20 mile non-competes. But If you're in

Manhattan, for example, then the breadth of the geographic scope will be substantially smaller. Frequently we define the geographic area by a certain number of blocks north, south, east, and west of the office.

Barry Cepelewicz, MD: Another non-compete scenario one must be cautious of is when using a restrictive covenant that bars the employee from working within a certain geographic area from **all** of the offices of the medical practice, even of those sites where the employee never worked.

Barry Cepelewicz, MD: Now, as a general but not absolute rule, courts may take a dim view of such covenants, based on the notion that with respect to the office sites at which the physician never practiced, that physician would not be known to patients who visit those sites and would not therefore, be in a position to lure them away. And thus the employer may be deemed by the court of not having a legitimate interest to protect, and enforcing that restrictive covenant with respect to those sites.

Barry Cepelewicz, MD: Similarly, non-compete sometimes may include prohibiting the physician employee from working for specifically named competitors or requiring the employee to resign privileges at hospitals and other facilities serviced by the practice that are within the restricted area.

Barry Cepelewicz, MD: Again, all of these types of considerations must be addressed on a practice-by-practice, case-by-case scenario, because you don't have a one-size fit all of non-compete that applies to every practice of every specialty in every geographic location.

Barry Cepelewicz, MD: Third, the non-compete needs to be reasonable in defining what types of post-employment activities are prohibited. Employers should try to narrowly tailor the restrictions to include only the post-employment conduct that is reasonably necessary to protect that employer's legitimate interests, their legitimate business interests.

Barry Cepelewicz, MD: Thus, for example, if you have a restrictive covenant that prevents the employee from his position, from providing medical services, and a specialty that the employer never provided, well then, the court may conclude that there is really no legitimate interest of the employer to protect, and they hold that the restrictive covenant would be unenforceable.

Barry Cepelewicz, MD: Similarly, a non-compete that prohibits a specialist from totally practicing medicine as opposed to only prohibiting the specialist from practicing in that particular specialty could also be very closely scrutinized by the court and the court may come out adverse to the non-compete.

Barry Cepelewicz, MD: Finally, employers should be in a position to demonstrate that the restrictive covenant is not unduly burdensome or harmful to the public. In large part, this inquiry depends on the accessibility of positions providing similar services.

Barry Cepelewicz, MD: Now, courts have found typically that there is no evident harm brought to the public by enforcing a restrictive covenant where there are nearby physicians who

are available to treat patients. So, for example, if a court finds that there are other surgeons of the same specialty in that county or in that vicinity, then they find that it is not unduly burdensome or harmful to the public, or if there are other facilities, hospitals, or other types of surgical centers, or other types of health care facilities, where they can get the access to the same type of care, then the harm to the public probably would not be seen by a court. So again, this is something that we typically, unless you're in a very rural area, we typically don't see these problems in the urban locations where we have many of our clients who would like to have their non-competes enforced.

Barry Cepelewicz, MD: So I think again, that's sort of a very brief overview as what we need to consider. Again, as I mentioned earlier on when I started, this is advice that I've been giving to health care professionals who are owners, or who are employers, of practices, whether it's a small practice, or a super group, or any other type of facility. These are the types of factors we have to consider. And again, as I've mentioned, we have to consider each type of factor: how it applies, how it impacts the employer, the employee, so that in case it ever is challenged in a court, and we always have to be prepared for a challenge, we can demonstrate amply that we are protecting a legitimate business interest, we're not harming the public, and our non-compete is reasonable in all those different types of factors or scopes.

Barry Cepelewicz, MD: So I think Andy, we probably used our allotted time for this session. We all hope you've enjoyed this podcast. If you have any questions, please feel free to give Andy a call at 516.393.2580 or me, Barry Cepelewicz at 516.393.2579. Thank you very, very much.