Insight

Proposed FTC Rule Banning Noncompete Agreements Oversteps Agency Authority

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Executive Summary

- Following an executive order from President Biden, the Federal Trade Commission (FTC) proposed a rule barring employers from entering noncompete agreements with employees, as well as nullifying existing agreements, claiming these employment contracts represented an unfair method of competition.
- The rule is expected to be challenged on several legal grounds, including whether the FTC has the legal authority to engage in rulemaking with respect to unfair methods of competition and the major questions doctrine, recently strengthened by the Supreme Court in *West Virginia v. EPA*.
- The newly minted Congress should ensure adequate oversight of the FTC's latest attempt to push the bounds of its enforcement authority beyond the agency's traditional and legal purview.

Introduction

President Biden's executive order (EO) on Promoting Competition in the American Economy included a directive for the Chair of the Federal Trade Commission (FTC) to use the agency's rulemaking authority to "curtail the unfair use of non-compete clauses…that may unfairly limit worker mobility." This order set in motion a series of events at the FTC.

Under the direction of FTC Chair Lina Khan, the agency methodically laid the groundwork for what would become the proposed rule preventing employers from entering noncompete agreements with employees and nullifying existing agreements. In 2021, an FTC memorandum to staff and a Statement of Regulatory Priorities made clear that the agency intended to target noncompete agreements using unfair methods of competition rulemaking. In November 2022, an FTC policy statement outlined an expanded interpretation of the agency's authority to challenge unfair methods of competition under Section 5 of the FTC Act.

The FTC then proposed a rule, published January 5, 2023, which asserted that "noncompetes constitute an unfair method of competition and therefore violate Section 5 of the Federal Trade Commission Act."

While the FTC proposed rule does explore some of the market frictions that result from noncompete agreements, prior American Action Forum (AAF) research concluded that federal and state legislation could adequately curtail these inefficiencies. Additional AAF research claimed the FTC's expanded interpretation of its Section 5 authority is legally vulnerable. Furthermore, the proposed rule will likely be challenged on several grounds, including the major questions doctrine, recently strengthened by the Supreme Court in *West Virginia v. EPA*.

This proposed rule signals that the FTC will continue to push the bounds of its competition rulemaking

authority, which may trigger Congress to challenge such action.

Overview of the Proposed Rule and Noncompete Agreements

Noncompete agreements are contracts between employer and employee signed at the onset of employment. These contracts prohibit the employee from working for a competitor, starting a competing business, developing competing products or services, and hiring former colleagues, among other restrictions. Often, these contracts include a geographic component and are valid for a specific amount of time.

Alleging that noncompete clauses represent an unfair method of competition, the FTC's proposed rule would "generally prohibit employers from using noncompete clauses…. The proposed rule would apply to independent contractors and anyone who works for an employer, whether paid or unpaid. It would also require employers to rescind existing noncompetes and actively inform workers that they are no longer in effect." An exception to an outright ban on noncompete agreements is carved out between the "seller and buyer of a business," but the FTC warned that "non-compete clauses covered by this exception would remain subject to federal antitrust law as well as all other applicable law."

Using the findings from various studies, the FTC estimated that banning noncompete agreements "could increase wages by nearly $300 billion per year and expand career opportunities for about 30 million Americans."

Groundwork Supporting the Proposed Rule

President Biden issued an EO on Promoting Competition in the American Economy in July 2021 that ushered in the administration's whole-of-government approach to boost competition, lower prices, increase wages, and spur innovation in the economy.

The EO included a directive "To address agreements that may unduly limit workers' ability to change jobs, the Chair of the FTC is encouraged to consider working with the rest of the Commission to exercise the FTC's 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."

Leveraging the EO directive, the FTC mobilized and laid the groundwork for what would become its proposed rule on noncompete agreements. First, FTC Chair Khan issued a memorandum to staff in September 2021 that outlined the "Vision and Priorities of the FTC." In this memo, Khan noted "certain contract terms…constitute unfair methods of competition" generally, and noncompete agreements specifically. Compounding the evidence that the FTC was planning to act on noncompete agreements was the 2021 Statement of Regulatory Priorities in which the agency proclaimed that a "case-by-case approach to promoting competition, while necessary, has proved insufficient…. Accordingly, the Commission…will consider developing…unfair-methods-of-competition rulemakings…." As a final step, the FTC considerably expanded what it perceived as its authority to challenge unfair methods of competition under Section 5 of the FTC Act, the same section of the act used to justify the proposed rule.

Questionable Rulemaking Authority and the Major Questions Doctrine

FTC Commissioner Christine S. Wilson issued a dissenting statement in response to the proposed rule. Wilson stated that the "Commission's competition rulemaking authority itself certainly will be challenged," asserting that "the Commission lacks the authority to engage in 'unfair methods of competition' rulemaking…the major

questions doctrine addressed in *West Virginia v. EPA* applies, and the Commission lacks clear congressional authorization to undertake this initiative; and…assuming the agency does possess the authority to engage in this rulemaking, it is an impermissible delegation of legislative authority under the non-delegation doctrine."

Section 5 and Section 6(g) are the sections of the FTC Act relevant to this question. Section 5 declares "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce" unlawful. Also included in the same subchapter is Section 6(g), which gives the FTC the ability to "make rules and regulations for the purposed of carrying out the provisions of this subchapter."

Chair Khan, along with the majority of commissioners, relied on the 1973 U.S. Court of Appeals for the D.C. Circuit's interpretation of Section 6(g) in the *National Petroleum Refiners Association v. FTC* decision for legal precedent. The court determined that Section 6(g) granted the commission rulemaking authority to implement Section 5. This ruling departed from the long-held belief that Section 6(g) "was believed to provide authority only for the Commission to adopt the Commission's procedural rules," as explained by Commissioner Wilson.

In response to the *Petroleum Refiners* decision, Congress adopted the Magnuson-Moss Act — Federal Trade Commission Improvement Act of 1975. The act, as described by AAF, "imposed some additional rulemaking steps on the agency beyond those typical of the common informal rulemaking described in the Administrative Procedure Act." By 1980, however, Congress recognized that the FTC had "exceeded congressional intent…[and] enacted additional steps for the agency to follow to prevent the issuing of excessive rules…." These rules applied specifically to "unfair or deceptive acts or practices in or affecting commerce." Unfair methods of competition was not specified.

While suspicious of the FTC's interpretation, Randolph J. May and Andrew K. Magloughlin postulated that it was the combination of the *Petroleum Refiners* decision and Magnuson-Moss that provided the FTC majority with its legal argument for the proposed rule. They observed that "FTC Chair Khan believes that, in adopting the Magnuson-Moss procedures, Congress has implicitly codified *Petroleum Refiners'* holding that the FTC has authority to issue [unfair methods of competition] rules. She argues that legislative history for the 1975 amendments show that Congress rejected a version of the bill that applied Magnuson-Moss procedures to all FTC rulemaking, rather than just unfair or deceptive acts rulemaking."

George Washington University law Professor Richard J. Pierce Jr. disagreed with the FTC's conclusion. Pierce "doubt[s] that the Supreme Court would uphold the 1973 D.C. Circuit opinion, but the D.C. Circuit used a method of statutory interpretation that no modern court uses and that is inconsistent with the methods of statutory interpretation that the Supreme Court uses today." He also questions whether the "Supreme court would interpret the 1975 statutory amendment to distinguish between 'unfair acts' and 'unfair methods of competition' for the purposes of the procedures that the FTC is required to use to issue rules to implement Section 5."

Another likely legal roadblock to the proposed rule is the recently decided Supreme Court decision concerning the major questions doctrine in *West Virginia v. EPA* (prior AAF analysis explains the decision). Wilson is confident that "agency action will trigger the application of the major questions doctrine if the agency claims, among other things the power to (1) resolve a matter of great political significance, (2) regulate a significant portion of the American economy, or (3) intrude in an area that is the particular domain of state law." The proposed rule likely violates all three. Wilson highlighted congressional consideration and rejection of bills "significantly limiting or banning non-competes on numerous occasions," and said that the proposed rule was "a strong indication that the Commission is trying to 'work around' the legislative process to resolve a question of political significance." The proposed rule, which the FTC claims would result in $300 billion per year in

increased wages, would regulate a significant portion of the American economy and an estimated 30 million workers. Finally, states generally set the rules governing noncompete agreements. Citing research within the proposed rule, Commissioner Wilson noted that "47 states permit non-competes in some capacity, while three states have chosen to prohibit them entirely, and state legislatures have been active in this area recently."

In her dissenting statement, Wilson also warned the FTC of a potential challenge to the rule under the non-delegation doctrine, which is the view that Congress cannot delegate "its legislative power to another branch of government, including independent agencies." Citing various Supreme Court cases, Wilson argued that the proposed rule was ripe for legal challenges based on the non-delegation doctrine.

The proposed rule will certainly face legal challenges on several fronts, and the outcomes of these cases will either embolden or halt FTC rulemaking with respect to unfair methods of competition.

Conclusion

The FTC's proposed rule preventing employers from entering noncompete agreements with employees and nullifying existing agreements is likely to face legal challenges on several fronts. In particular, the recent Supreme Court decision involving the major questions doctrine in *West Virginia v. EPA* and whether the FTC has the legal authority to engage in rulemaking with respect to unfair methods of competition leaves any final rule vulnerable to legal challenges.

Congress should be vigilant in its oversight of an FTC that is increasing pushing the bounds of its enforcement authority beyond the agency's traditional and legal purview.