BREAKING BARRIERS OR BREAKING BAD? THE FTC'S PROPOSED BAN ON NONCOMPETE AGREEMENTS IN EMPLOYMENT CONTRACTS

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On January 19, 2023, the Federal Trade Commission ("FTC") issued a Notice of Proposed Rulemaking ("NPRM") on noncompete agreements ("NCAs") in employment contracts,[1] proposing a rule that would ban virtually all NCAs. NCAs restrict employees' mobility to obtain other jobs upon termination of current employment. Typically, NCA restrictions apply to working with the employer's downstream competitors, within a specified geographic area and for a specified period of time.

We forego discussion of whether the FTC has such rulemaking authority—about which there is considerable doubt[2]—to focus on the proposed ban's likely economic effects. Assuming arguendo that the FTC has substantive rulemaking authority, we frame our analysis of the proposed NCA ban within the proper scope of the FTC's authority over economic transactions, which is circumscribed by the need to address the ultimate question of competitive effects. The FTC draws its statutory authority over economic activity primarily from Section 5 of the FTC Act, 15 U.S.C. § 45, which prohibits "unfair methods of competition" ("UMC"). The Supreme Court has ruled that the FTC's UMC authority encompasses the scope of the antitrust acts—the Sherman and Clayton Acts.[3] The Supreme Court has also ruled that the FTC's UMC authority extends *beyond the letter* of the antitrust acts while remaining *within their spirit*, to include economic activity

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[1] Non-Compete Clause Rule, 88 Fed. Reg. 3482 (proposed Jan. 5, 2023) (to be codified at 16 C.F.R. pt. 910). *See also* Camila Ringeling, Joshua D. Wright, Douglas H. Ginsburg, John M. Yun & Tad Lipsky, *Noncompete Clauses Used in Employment Contracts: Comment of the Global Antitrust Institute, Antonin Scalia Law School, George Mason University*, GEO. MASON UNIV. L. & ECON. RES. PAPER 20-04 (2020).

[2] *See generally* Thomas W. Merrill & Kathryn T. Watts, *Agency Rules with the Force of Law: The Original Convention*, 116 HARV. L. REV. 467 (2002) (demonstrating in 1914 both Congress and the courts followed a convention for differentiating between grants of legislative and procedural rule making authority and that the grant in Section 6 of the FTC Act was clearly the latter); Noah J. Phillips, *Against Antitrust Regulation*, AMERICAN ENTERPRISE INSTITUTE (2002), https://www.aei.org/research-products/report/against-antitrust-regulation/; *Comments of the American Bar Association Antitrust Law Section on Petition for Federal Trade Commission Rulemaking to Prohibit Worker Non-Compete Clauses*, AMERICAN BAR ASSOCIATION (Oct. 4, 2021), https://www.americanbar.org/news/abanews/aba-news-archives/2021/10/aba-antitrust-law-section-releases-comments-on-request-for-ftc-r/.

[3] *See* Fashion Originators' Guild of America v. Fed. Trade Comm'n, 312 U.S. 457 (1941).

that has "anticompetitive impact"[4] even if not strictly prohibited by the antitrust acts. We therefore analyze NCAs solely according to their potential competitive effects, recent FTC policy guidance to the contrary notwithstanding.[5] No matter how expansive the FTC's interpretation of an "unfair method" may be, a practice can be condemned as an unfair method of *competition* only if it has an effect of unreasonably restraining competition.

The bill of particulars against the FTC's proposed ban on noncompete agreements in employment contracts is threefold. First, the NPRM applies an incorrect legal standard that fails to rigorously grapple with competitive effects analysis as required by the Supreme Court. Instead, the NPRM superficially treats the "express terms" of mobility restrictions in NCAs as sufficient for condemning the practice, without recourse to any economic analysis. Second, the NPRM condemns NCAs on the grounds that the bargaining powers of employer and employee are unequal and therefore the agreement is unfair—again, without the requisite analysis of competitive effects. If unequal bargaining power were sufficient to condemn a market outcome, virtually all economic activity would come grinding to a halt. Third, and relatedly, the NPRM ignores the prospect of efficiency gains from NCAs. Given such prospects, a categorical ban is inappropriate. In this case a rule-of-reason analysis, which weighs a practice's anticompetitive effects against its procompetitive ones, is appropriate.

I. Noncompete Agreements Differ Fundamentally From No-Poach Agreements

A close analogue to the FTC's proposed categorical ban on NCAs is the antitrust rule of per se illegality. A practice that is treated as per se illegal in antitrust law can be condemned simply on a finding that the practice exists, without regard to its competitive effects. The paradigmatic example of a per se illegal practice is horizontal price-fixing,[6] in which rival firms agree not to compete on the prices of the products they sell. A symmetric point applies in competition to procure inputs. No-poach agreements, which involve a form of market division by employers who agree not to compete for one another's employees, are closely related in their anticompetitive effects to price-fixing and are likewise per se illegal.

NCAs differ fundamentally from no-poach agreements, however.[7] Whereas no-poach agreements are horizontal agreements not to compete, NCAs are vertical agreements—contracts

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[4] *See* Fed. Trade Comm'n v. Sperry & Hutchinson Co., 405 U.S. 233, 246 (1972).

[5] *See* "Policy Statement Regarding the Scope of Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act," Fed. Trade Comm'n File No. P221202 (Nov. 10, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/P221202Section5PolicyStatement.pdf; "Dissenting Statement of Commissioner Christine S. Wilson," Fed. Trade Comm'n File No. P221202 (Nov. 10, 2022) ("the Policy Statement announces that the Commission has the authority summarily to condemn essentially any business conduct it finds distasteful."), https://www.ftc.gov/system/files/ftc_gov/pdf/P221202Section5PolicyWilsonDissentStmt.pdf.

[6] *See e.g.*, United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 218 (1940) ("[F]or over forty years [the Supreme Court] consistently and without deviation adhered to the principle that price-fixing agreements are unlawful per se under the Sherman Act and that no showing of so-called competitive abuses or evils which those agreements were designed to eliminate or alleviate may be interposed as a defense."). We use "horizontal" in the antitrust sense to refer to relationships between firms at the same level of a supply chain, firms that typically compete with one another in making downstream sales or upstream purchases.

[7] *See generally* Bruce H. Kobayashi, *Antitrust, Non-Competition, and No-Poach Agreements in Digital Industries*, THE GLOBAL ANTITRUST INSTITUTE REPORT ON THE DIGITAL ECONOMY 20 (2020).

between employer and employee—that do not necessarily restrict competition unreasonably, either for workers upstream or in downstream product markets.[8] Vertical agreements are commonly analyzed under the rule of reason, which requires a finding of anticompetitive effect for a practice to be condemned.

II. PER SE CHARACTERIZATION TURNS ON THE ABSENCE OF ANY PROSPECT FOR EFFICIENCIES

In their history of the evolution of the per se rule and rule of reason, Rooney, Fleming and Polizzano conclude that "in contemporary per se cases, the [Supreme] Court has limited its application to restraints whose context exposes *nothing but* a 'naked' agreement on price or output."[9] The demonstrable prospect of efficiencies flowing from NCAs, which we sketch below, puts these restraints squarely in the realm of rule of reason analysis.

In *Broadcast Music*, a case that involved an accusation of horizontal price-fixing among performance rights holders, the Supreme Court described the standard for deeming a practice per se illegal as seeking to determine:

> whether the effect and, here because it tends to show effect, the purpose of the practice are to threaten the proper operation of our predominantly free-market economy—that is, whether the practice facially appears to be one that would *always or almost always* tend to restrict competition and decrease output, and in what portion of the market . . . .[10]

The Supreme Court's always-or-almost-always anticompetitive standard for applying the per se rule is rooted in sound economics, as we discuss presently.

III. BALANCING ERROR COSTS AGAINST ADMINISTRATIVE COSTS IN PER SE CHARACTERIZATION

Once a practice has been properly characterized as "always or almost always" restricting competition unreasonably, the practice can in principle be condemned summarily, without further consideration of effects, thereby economizing on costs incurred by the court system and litigating parties.[11] In contrast, if a practice is found to be sometimes harmful and sometimes not,

[8] We use "vertical" in the antitrust sense to refer to relationships between firms at different levels of a supply chain, one being upstream supplying products or services to the other downstream. Such buyer-seller relationships do not involve competition, unless there is also some horizontal connection between them. Here we refer to employment contracts reached bilaterally, without wage-fixing among rival employers.

[9] *See* William H. Rooney, Timothy G. Fleming & Michelle A. Polizzano, *Tracing the Evolving Scope of the Rule of Reason and the Per Se Rule*, 2021 COLUM. BUS. L. REV. 1, 10 (2021) (emphasis in the original).

[10] Broadcast Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 19–20 (1979) (emphasis added) (citation omitted).

[11] *See* Arizona v. Maricopa Cnty. Med. Soc., 457 U.S. 332, 344 (1982) ("For the sake of business certainty and litigation efficiency, we have tolerated the invalidation of some agreements that a full-blown inquiry might have proved to be reasonable.").

the balance of costs favors expenditure of effort on a case-by-case basis to seek a well-informed result under the rule of reason.[12]

For decades, the Supreme Court has typically required an extensive inquiry before characterizing a practice as meriting per se treatment. In *Broadcast Music*, the Supreme Court noted that "easy labels do not always supply ready answers"[13] and rejected a "literal" or categorical approach to per se characterization.[14] The Supreme Court's careful deliberation in assessing whether a practice merits (continued) per se treatment is also based on sound economics, trading off error costs against enforcement costs.

In a dynamic context, per se rules carry the risk of substantial, long-lasting error costs. As compared with rule of reason analyses undertaken on a case-by-case basis, which allow for new information to be incorporated into the decision-making processes of antitrust agencies and courts, per se characterization can have especially high false-positive error costs. By its nature, per se characterization locks analysis in place for future cases. Consequently, it can take (and has taken) decades for false per se characterizations to be reversed as economic understanding of the rationale for the practice and empirical evidence on its effects has evolved.[15]

In principle, the present value of expected losses of per se characterization from false-positive errors stretching long into the future should be balanced against the expected gains from reducing the cost of litigating competitive effects evidence on a case-by-case basis and increasing business certainty. Given the strong lock-in effect of per se characterization, the balance favors careful deliberation and narrow application of the per se rule on an always-or-almost-always standard.

IV. THE FTC APPLIES AN INCORRECT STANDARD FOR PER SE CHARACTERIZATION

The NPRM departs radically from the level of careful analysis prescribed by the Supreme Court, opting instead for a simplistic standard that the Supreme Court recognized to be economically incorrect more than a century ago. The NPRM's fundamental condemnation of NCAs is based on the idea that "[n]on-compete clauses limit competition *by their express terms*" (emphasis added).[16] The problem with this theory is that it proves too much. As Justice Brandeis noted for a unanimous Supreme Court more than a century ago in *Chicago Board of Trade*:

> Every agreement concerning trade . . . restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.[17]

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[12] *See, e.g.*, ANDREW I. GAVIL, ET AL., ANTITRUST LAW IN PERSPECTIVE 252–56 (4th ed. 2021). Notably, efficient and accurate decision making is facilitated by the Court's clear mandate that antitrust analysis extend no further than appropriate to determine the competitive impact of the specific practice being analyzed.

[13] *Broadcast Music*, 441 U.S. at 9.

[14] *Id*. *See generally* Rooney et al., *supra* note 9.

[15] *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977); Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007); Illinois Tool Works, Inc. v. Independent Ink, Inc., 547 U.S. 28 (2006).

[16] Non-Compete Clause Rule, *supra* note 1, at 2.

[17] Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

Thus, the mere fact that NCAs restrict worker mobility, "by their express terms," is insufficient to infer a lessening of competition, either in labor markets or in downstream markets for products and services.

The first expressed limitation on the application of the per se rule appears in *Northern Pacific Railroad*,[18] which found it necessary to consider potential anticompetitive and procompetitive effects to determine whether a practice belongs to the class of "practices which, because of their pernicious effect on competition and lack of any redeeming value"[19] merit per se illegality. *Northern Pacific Railroad*'s "lack of any redeeming value" refers to a practice lacking any prospect for efficiencies.

Sylvania revived the rule-of-reason approach for assessing vertical restraints,[20] which *Schwinn* had rejected ten years earlier,[21] and further clarified that the analysis must be based on demonstrable economic effects rather than formalistic line-drawing.[22] *Schwinn* had drawn a formalistic distinction based on the passage of title (e.g., in bicycles): "[A]ll restrictions were held to be *per se* illegal where title had passed, and all were evaluated and sustained under the rule of reason where it had not."[23] Yet the *Schwinn* "Court's opinion provides no analytical support for these contrasting positions. Nor is there even an assertion in the opinion that the competitive impact of vertical restrictions is significantly affected by the form of the transaction."[24]

Sylvania deals with location restrictions imposed on franchisee retailers. The Supreme Court focused on the demonstrable economic effects of these restrictions, rejecting the formalistic line-drawing of *Schwinn*. If the location restrictions on *independent* retailers in *Sylvania* merit rule of reason treatment, so too do the mobility restrictions on *employees* in NCAs. There is no good reason to conclude that contractual restrictions on employees are inherently more problematic than those on independent contractors. If anything, the opposite is the case, given the importance of especially close coordination between employer and employees to achieving a firm's efficiency goals.[25] The FTC's proposed approach to NCAs, however, seeks a return to *Schwinn*'s defunct formalistic line-drawing.

The NPRM's proposed categorical ban on NCAs, effectively treating these practices as per se illegal, is thus not tenable under *Sylvania*'s demonstrable-economic-effects standard. The economic rationale for rule-of-reason treatment is, if anything, stronger for NCAs with employees than for location restrictions on franchisees.

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[18] Northern Pac. R. Co. v. United States, 356 U. S. 1 (1958).

[19] *Id*. at 5.

[20] *See* Sylvania, *supra* note 15.

[21] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

[22] *Sylvania*, *supra* note 15, at 59 n.89.

[23] *Id*. at 52.

[24] *Id*. at 54.

[25] For example, during the Hollywood Studio Era (circa 1930-1948) many actors, including top-grossing stars, worked as studio employees signed to exclusive, fixed-wage contracts. This organizational form gave the major studios the incentive and ability to cast actors experimentally to discover star talent. After the end of the studio era and the unraveling of this contractual system, experimental casting and talent discovery fell. *See generally* F. Andrew Hanssen & Alexander Raskovich, *Does Vertical Integration Spur Investment? Casting Actors to Discover Stars During the Hollywood Studio Era*, 63 J.L. & ECON. 631 (2020).

Absent collusion (e.g., naked wage fixing or no-poach agreements),[26] NCAs are vertical restraints—between employer and employee—that merit legal treatment comparable to that of other vertical restraints. NCAs should be analyzed under the rule of reason so long as they have "any redeeming value," any non-negligible prospect for efficiencies. There are bases in economic theory for NCA efficiencies and evidentiary support in the empirical economics literature for such efficiencies.[27]

V. NCAs OFFER MULTIPLE PROSPECTS FOR EFFICIENCY GAINS

NCAs can promote efficiency in a variety of ways: by encouraging employers to provide more general training to employees to improve their productivity, protecting proprietary knowledge and thereby encouraging more investment in innovation, and providing employers with more effective tools to rein in employee shirking.

First, an important source of potential NCA efficiency is the spur that mobility restrictions give to the employer to provide employees with training in general skills. Rubin and Shedd find that "restrictive covenants [in employment contracts] were and are necessary in some circumstances to lead to efficient amounts of investment in human capital."[28] In particular, such circumstances arise in imperfect labor markets with frictions, where employer-sponsored human capital investment is general, having value outside the firm, and would be lost to the employer upon employee separation, as Acemoglu has formally shown.[29] There is some empirical support for this intuitive point. Garmaise finds that NCAs spur greater employer-sponsored training,[30] as does Starr.[31]

Second, NCAs protect proprietary knowledge and trade secrets from misappropriation. The misappropriation problem is likely to be especially acute "when monitoring [of knowledge transfer] and the enforcement of trade secrets law is costly."[32] A nondisclosure clause might in principle prevent a departing employee from revealing trade secrets to a new employer, but

[26] *See* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDANCE FOR HUMAN RESOURCE PROFESSIONALS (2016), https://www.justice.gov/atr/file/903511/download. Moreover, an employee bound by a non-solicitation agreement (prohibiting a departing worker from soliciting the departure of other works), may be a potential competitor of the employer. For a discussion of potential competition issues, see John M. Yun, *Are We Dropping the Crystal Ball? Understanding Nascent & Potential Competition in Antitrust*, 104 MARQ. L. REV. 613 (2021).

[27] *See* Ringeling et al., *supra* note 1, at 4–10.

[28] Paul H. Rubin & Peter Shedd, *Human Capital and Covenants Not to Compete*, 10 J. LEGAL STUD. 93 (1981).

[29] Daron Acemoglu, *Training and Innovation in an Imperfect Labour Market*, 64 REV. ECON. STUD. 445 (1997) (diagnosing the underinvestment problem in a formal model but not discussing NCAs as a potential solution).

[30] *See* Mark J. Garmaise, *Ties that Truly Bind: Noncompetition Agreements, Executive Compensation, and Firm Investment*, 27 J. L., ECON., & ORG. 376, 403 (2011). This study also finds evidence that NCAs lessen worker investment in skills, and that this effect dominates. A negative net effect on aggregate investment levels does not necessarily imply a loss of efficiency, however. An employer has an incentive to provide training that has a firm-specific component or slant, to improve the worker's productivity within the firm. A worker has the contrary incentive to invest in training that is more general, to improve the worker's outside options. For an analysis of how closer vertical coordination can improve efficiency by reducing investment in outside options, see George Baker, Robert Gibbons, & Kevin J. Murphy, *Relational Contracts and the Theory of the Firm*, 117 Q.J. ECON. 39 (2002).

[31] Evan Starr, *Consider This: Training, Wages, and the Enforceability of Non-Compete Clauses*, 72 INDUS & LAB. REL. REV. 783, 799 (2019).

[32] Ringeling et al., *supra* note 1, at 5.

breach of the clause can be difficult to detect and costly to punish. In this case, the mobility restrictions of an NCA may be a more efficient form of trade secret protection, thereby encouraging greater investment in such intellectual property.

Third, NCAs also encourage closer coordination between the worker and firm in other beneficial ways. In their study of NCAs with corporate CEOs, Kini, Williams, & Yin find evidence that "turnover-performance sensitivity is stronger when CEOs have NCAs."[33] That is, termination for poor performance has more bite when a CEO's mobility is restricted, thereby encouraging greater CEO effort.

The foregoing NCA efficiency rationales militate for rule-of-reason treatment, contrary to the NPRM's fallacious argument that—without more—mobility restrictions suffice to condemn NCAs by their express terms.

VI. UNEQUAL BARGAINING POWER MAY BE "UNFAIR," BUT IT IS UNRELATED TO COMPETITION

The NPRM forwards a second fallacious argument in support of a categorical ban on NCAs, again without recourse to rigorous competitive effects analysis. The NPRM notes "concerns about unequal bargaining power between employers and workers[.]"[34] According to the FTC, the unequal bargaining power is, in and of itself, "unfair."[35] This rationale, however, is flawed. For such an imbalance to support condemnation of NCAs as an "unfair method of competition," critically, *competition* must be implicated. It is not.

The NPRM also asserts that employers are typically better negotiators than workers.[36] That may well be true, and employers may even be more patient or less risk-averse negotiators than workers. These are all factors determining the relative bargaining powers of the negotiating parties. Competition, however, has to do with bargaining *leverage* rather than bargaining *power*.[37]

Bargaining leverage refers to the strength of a bargaining party's outside option: the value of the next-best alternative if the party were to walk away from the bargaining table. The outside option relates to a bargaining party's *competitive* alternatives. The stronger a worker's outside option, the better will the worker's bargaining outcome tend to be, all else equal. Bargaining power, on the other hand, has to do with a bargainer's negotiating skill, patience, and risk-aversion. These factors also affect a worker's bargaining outcome, but are unrelated to competition.[38]

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[33] Omesh Kini, Ryan Williams, & Sirui Yin, *CEO Noncompete Agreements, Job Risk, and Compensation*, 34 REV. FIN. STUD. 4701, 4701 (2021).

[34] Non-Compete Clause Rule, *supra* note 1, at 2.

[35] *Id*. Unequal bargaining power is ubiquitous across the economy. If such "unfairness" sufficed to rationalize FTC enforcement, virtually all economic activity would be subject to condemnation.

[36] *Id.* at 83–84.

[37] *See* Aviv Nevo, Deputy Assistant Att'y General For Economics, Antitrust Division U.S. Dep't of Just., Remarks as Prepared for the Stanford Institute for Economic Policy Research and Cornerstone Research Conference on Antitrust in Highly Innovative Industries (Jan. 22, 2014).

[38] *See* Alexander Raskovich, *Ordered Bargaining*, 25 INT'L J. INDUS. ORG. 1126 (2007) (presenting a formal model that distinguishes the effects of competition and bargaining power on bargaining outcomes).

VII. PROSPECTS FOR NCA HARM DEPEND ON THE SPECIFICITY OF HUMAN CAPITAL

A rigorous competitive effects analysis of NCAs must contend with the fact that monopsony in labor is plausible only if the relevant labor is scarce in a meaningful sense. All else equal, workers with general skills (e.g., low-wage workers) tend to have broader employment options outside a given industry than do workers with narrower industry-specific skills, and thus are unlikely to be vulnerable to an exercise of monopsony power. The notion that low-wage workers are especially vulnerable to exercises of labor market power is contrary to the economics of human capital.[39] The opposite is the case: *industry-specific* human capital is an important precondition (but not a sufficient condition) for an exercise of labor market power to be profitable.

CONCLUSION

The FTC's NPRM on NCAs is based on bad economics and bad law. In effect, the FTC seeks to treat NCAs as illegal per se, ignoring the Supreme Court's rulings that such treatment is appropriate only for business practices that have no prospect of generating efficiencies, and also effectively ignoring the theoretical and empirical evidence that NCAs can often be efficient. The Supreme Court has ruled that, if a business practice can plausibly yield efficiencies, the appropriate approach is rule-of-reason analysis to determine whether the practice harms competition or promotes it.

Instead of following the Supreme Court's rulings, the FTC relies on two fallacious legal arguments to support its proposal to categorically condemn NCAs. The first is that, by their "express" terms, NCAs limit employee mobility and this alone suffices to condemn the practice. This simplistic legal theory was rejected by the Supreme Court more than a century ago when Justice Brandeis pointed out that every agreement on trade necessarily restrains--that to bind, to restrain is of a contract's very essence. It is rather a contract's effect on competition that matters.

For its second fallacious argument, the FTC asserts that NCAs inherently cause "unfair" and unequal bargaining power between employers and employees, running afoul of Section 5 of the FTC Act. According to this fanciful notion, virtually all economic activity would be subject to FTC regulation for being unfair. The Supreme Court has ruled that Section 5 of the FTC Act applies only to business practices that have anticompetitive impact. Put differently, it is not enough for a practice to be "unfair" to be an "unfair method of *competition*;" the practice must also adversely affect *competition*.

In response to public comments on the NPRM, and perhaps recognizing that NCAs which bind highly paid high-tech workers and CEOs may have a procompetitive rationale (or involve unattractive victims), the FTC may adopt a fallback position of banning only NCAs that apply to low-wage workers. But even if limited in application to low-wage workers, an NCA ban would likely have unintended consequences of harming workers and downstream consumers. In particular, such a ban would tend to undercut employer incentives to provide general training, risking entrenchment of workers who are at the bottom of the pay scale in perpetually low wages with poor prospects for advancement.

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[39] *See generally* GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS (2009).

In advancing this ill-conceived proposal, the FTC is breaking bad.