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WHITE PAPER

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FAQs for Recent FTC Actions Against Employer/Employee Non-Compete Clauses

In early January 2023, the Federal Trade Commission ("FTC") proposed an unprecedented rule banning most employer/employee non-compete clauses. As detailed below, the rule is not likely to take effect for at least eight months, and possibly longer (if ever), given the likelihood of challenges to the FTC's authority to issue the rule. More significant for the immediate future, the FTC also filed and settled cases against three companies and two individuals, alleging that employer/employee non-compete restrictions violated Section 5 of the FTC Act.

In this *White Paper*, we: (i) summarize the proposed ban and the FTC's recent cases; (ii) identify how businesses can minimize their risk of an FTC investigation; and (iii) provide guidance for businesses about how to react (and not overreact) to the uncertainty that the FTC's recent actions have created.

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WHAT HAPPENED?

The FTC announced a proposed regulation ("Non-Compete Rule") that, if implemented, would ban most employer/employee non-compete clauses nationwide, superseding state laws that are less restrictive than the FTC rule. Under the proposed rule, an employer would violate § 5 of the FTC Act, which prohibits "unfair methods of competition," if it:

- enters or attempts to enter a prohibited non-compete clause with an employee,
- maintains an existing prohibited non-compete clause, or
- represents that an employee is subject to a non-compete without a good-faith belief that the non-compete is lawful.

As drafted, the Non-Compete Rule would apply to almost all employers and workers. The broad definition of "worker" covers both employees and independent contractors, and other workers whether or not classified as employees, including externs, interns, volunteers, apprentices, or sole proprietors who provide a service to a client or customer. Once adopted, the draft Non-Compete Rule would require employers, within 180 days of the final rule's publication, to inform each employee subject to a prohibited non-compete that the employer has rescinded the non-compete.

The FTC claims that non-compete clauses prevent workers from pursuing better jobs, higher pay, or improved working conditions. It further claims that approximately 20% of workers—30 million—have a non-compete clause with their employer. Despite mixed economic evidence on the effect of non-compete clauses on compensation, the FTC also claims that the Non-Compete Rule would increase workers' wages by $250 billion to $296 billion per year.

Historically, courts and U.S. antitrust enforcers would have evaluated non-compete clauses under the rule of reason, which evaluates a restriction's net effect on competition, balancing the harms and benefits. That analysis considers marketplace facts, the benefits or justification for the non-compete, and its reasonableness with respect to its scope (employee coverage and content of the restriction), geography, and duration. The FTC's Notice of Proposed Rulemaking ("NPRM") rejects that analysis, instead building on the FTC's recent Policy Statement (*See* this November 2022 *White Paper*), promising expansive use of § 5 of the FTC Act to challenge conduct that, in the FTC's view, is an unfair method of competition.

WEREN'T THERE FTC COMPLAINTS AND SETTLEMENTS THE DAY BEFORE THE FTC RULE WAS ANNOUNCED? WHAT WERE THEY, AND ARE THEY RELATED TO THE RULEMAKING?

The FTC released the proposed rule a day after it filed and settled allegations that three companies and two individuals violated § 5 of the FTC Act by imposing and enforcing anticompetitive employer/employee non-competes.[1] One FTC complaint alleged that Prudential Security used individual lawsuits to enforce non-competes, which required low-wage security guards to pay a $100,000 penalty if violated. The FTC also alleged that Prudential continued to require employees to sign non-competes even after a state court determined the restrictions were unreasonable and unenforceable under Michigan law.

The FTC's other complaints alleged that O-I, Inc.'s non-competes prohibited working for a U.S. competitor for one year following employment, while Ardagh's non-competes prohibited working for a North American competitor for two years. O-I and Ardagh are competitors in the manufacture and sale of glass containers used for food and beverage packaging in the United States.[2] The parties' employer/employee non-competes covered a range of job titles, including glass production, engineering, and management positions.

The companies and individual owners settled with the FTC, which ordered the parties to stop using non-compete agreements, end enforcement of existing non-competes, and notify affected employees that the non-competes no longer restrict their employment options.

In stinging dissents, FTC Commissioner Christine S. Wilson argued that the FTC's complaints offered no evidence of anticompetitive effects in any relevant market and only "conclusory" assertions that legitimate objectives could have been achieved through less restrictive means. She noted the complaints failed to address "the business justification and procompetitive benefit of employer-provided training." She also observed that the parties may have elected quick settlements with the FTC to avoid lengthy and expensive investigations, and possibly litigation.

Commissioner Wilson further observed that the glass-company settlements, which listed job titles for which the

companies would be prohibited from using non-competes, excluded senior executives and research and development employees. Beyond that implicit acknowledgement that there are benefits to non-competes—protecting a company's competitively sensitive secrets and strategies—the settlements provide little practical guidance to businesses about when an employer/employee non-compete agreement might violate the federal antitrust laws (if indeed they do). Notably, the FTC's settlements are not legally binding precedent, and it remains an open question how such challenges would fare in court. However, the three consents are the clearest indication of the policy the FTC will implement unless and until it adopts the Non-Compete Rule in final form.

DOES THIS MEAN ALL EMPLOYEE NON-COMPETES ARE UNLAWFUL ONCE THE RULE IS IMPLEMENTED?

Under the Non-Compete Rule, most employer/employee non-compete clauses would be unlawful. However, the Non-Compete Rule would have four exceptions:

1. **Employers that are exempt from the FTC Act**, as the FTC has no power to regulate those employers. Certain banks, savings and loan institutions, federal credit unions, air carriers, livestock-related businesses, and nonprofits will be exempt from the Non-Compete Rule.
2. **State or local governments and government-affiliated private entities**, to the extent they are considered "state actors" under the law.
3. **Non-compete clauses between a buyer and a seller of a business**, where the person selling the business is a "substantial" owner, member, or partner in the business being sold. The Non-Compete Rule defines "substantial" to mean a person holding at least a 25% ownership interest in the target business. Such clauses must still pass muster under federal and state antitrust laws.
4. **Non-compete agreements between franchisors and franchisees that restrict franchisees**, although the Non-Compete Rule will still cover any employer/employee non-competes between franchisors or franchisees and their respective employees.

Unlike many state laws, which include exceptions for highly compensated, executive, and managerial employees, the FTC's proposed ban contains no exemptions for high-level employees or those with unique, specialized skills or knowledge. The NPRM requests comments about whether the final rule should have an exemption for senior executives or apply a rebuttable unlawfulness presumption to non-compete clauses between employers and senior executives (as compared to the ban for other workers). A senior executive exemption would be consistent with the FTC's recent *O-I* and *Ardagh* non-compete cases, noted above, in which the FTC did not include senior executives (or R&D employees) in a list of job titles for which O-I and Ardagh were prohibited from having non-competes. Although the FTC was not explicit, we assume it is thinking about treating senior executives differently because they are most likely to have competitively sensitive information that could harm the company. Unlike for other workers, the FTC states that non-competes for senior executives are "unlikely to be exploitive or coercive."

However, the FTC claims that there are "compelling reasons" to ban senior executive non-competes because such clauses negatively affect business formation, innovation, and competitors hiring highly skilled workers. To that end, the FTC even argues that a ban on non-compete clauses for highly skilled workers and senior executives may benefit consumers even more than prohibiting non-compete clauses for other workers. Therefore, even if the FTC adopts an exemption for senior executives, it is likely to be narrow.

DOES THE NON-COMPETE RULE AFFECT CUSTOMER NON-SOLICIT CLAUSES OR OTHER RESTRICTIVE COVENANTS?

As drafted, "the definition of non-compete clause would generally not include other types of restrictive employment covenants—such as non-disclosure agreements ("NDAs") and client or customer non-solicitation agreements.…" The FTC, however, also noted in the NPRM that it may consider such covenants to be prohibited non-compete clauses where "they are so unusually broad in scope that they function as such." That analysis will turn, in part, on the competitive dynamics in a given industry. For example, if a customer non-solicitation agreement applies to sales employees that sell into a downstream market with very few customers, the FTC may argue that a customer non-solicit is a de facto non-compete. Similarly, the FTC could view a very broad non-recruit agreement applied to an in-house recruiter (e.g., a limitation prohibiting the employee from being able to effectively recruit talent in his or her particular industry) as potentially also running afoul of the FTC's rules.

WHEN DOES THE NON-COMPETE RULE GO INTO EFFECT?

The FTC has opened the 60-day public comment period, which ends March 20. Following the public comment period, the FTC will review and address comments before adopting the final rule. If the FTC makes significant changes to the rule, it may have to issue a revised rule for public comment.

The Non-Compete Rule's prohibitions are slated to take effect 180 days after the FTC publishes the final rule. At the conclusion of the 180-day period, companies must have released workers from existing non-competes and would be prohibited from entering into new non-compete clauses. Thus, employers will have at least eight months—and potentially longer—before they need to make changes to non-compete clauses that would violate the Non-Compete Rule.

HOW WILL THE FTC'S PROPOSED RULE AFFECT NON-COMPETES IN M&A?

The Non-Compete Rule would not apply to agreements between companies to sell a business. Instead, it prohibits 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 limit the ability to use non-competes with some employees in the M&A context. As noted above, the Non-Compete Rule has an exception for a non-compete that restricts a person selling a business or substantially all of a business's assets, provided the person has a 25% ownership interest in a business entity. The narrowness of that exception would limit a buyer's ability to obtain a non-compete in the following hypotheticals:

- **Selling General Partners.** Acquisition of a business owned by a general partnership in which some or all of the owners have a less than 25% interest.
- **Founder.** Acquisition of a business involving a founder who owns less than 25% of a business and who will depart or retire post-closing.
- **Departing Senior Executives.** Acquisition of a business in which the senior executives will depart prior to closing, if those senior executives have less than a 25% interest (unless the seller has a valid non-compete and the FTC allows a senior executive exemption).

WHAT WOULD HAPPEN IF A COMPANY WERE TO VIOLATE THE NON-COMPETE RULE?

Once the Non-Compete Rule is in effect, if a company maintains existing non-competes or enters new non-compete clauses, the FTC may attempt to obtain an order requiring the company to comply with the Non-Compete Rule. If the FTC were to obtain a final order and the company subsequently failed to comply, the FTC may argue that the company is subject to monetary penalties of $46,517, as adjusted, per violation per day.[3] Some commentators have argued that the FTC Act does not authorize the FTC to remedy violations of rulemaking pursuant to Section 6(g). That question may be the subject of future litigation between the FTC and private parties.

WHAT SHOULD MY BUSINESS DO RIGHT NOW? DO WE HAVE OBLIGATIONS TO TERMINATE NON-COMPETES BEFORE THE FTC FINALIZES THE RULE?

There are three considerations: (i) the Non-Compete Rule, (ii) the FTC's recent § 5 cases announced the day before the Rule, and (iii) existing state and federal laws.

The Non-Compete Rule

As noted above, the Non-Compete Rule is not likely to take effect for at least eight months, and potentially longer. Once it goes into effect, there almost certainly will be an immediate challenge to the FTC's rulemaking authority, and a reviewing court could well enjoin enforcement pending the outcome, which will take time to work through the federal courts. To the extent that there is a change in administration in 2024 that results in a more centrist, mainstream Commission, the Non-Compete Rule could be withdrawn or the FTC could choose not to issue a final rule. Even if the rule takes effect "quickly" and there is no injunction, the 180-day grace period will provide some time to prepare for compliance.

The FTC's Recent § 5 Cases

However, in the meantime, businesses should consider whether and how to react to the FTC's settlements in *Prudential*, *O-I*, and *Ardagh*. A company's approach will depend upon its need for non-competes, the justification, risk tolerance, and,

perhaps, desire to fight if the FTC comes calling. Subject to state law restrictions, companies should consider the following five rules of thumb to minimize risk:

1. **Tailor the Geographic Scope to the Reasonable Need for the Non-Compete.** O-I's non-compete covered the United States, Ardagh's covered North America, and Prudential's covered 100 miles.
2. **Tailor the Duration to the Reasonable Need to Protect Confidential Information.** If your confidential information becomes stale quickly, consider a shorter non-compete. Alternatively, confidential information with a longer shelf-life may justify a longer non-compete.
3. **Tailor the Scope to the Legitimate Need to Protect the Company and/or Its Confidential Information.** For example, it may not be necessary to prohibit an employee from working for a competitor if that employee will work in a competitor's business unit that does not compete against your company, or that would not allow the employee to use your company's confidential information.
4. **Be Reasonable and Make Judicious Use of Non-Competes: Do You Need Them for Lower-Level Employees?** In all three cases, the FTC cited large numbers of employees that had non-competes. In Prudential, the FTC focused on the fact that many of the non-competes covered low- or minimum-wage earners (security guards), applied a 100-mile radius to those workers, and included $100,000 liquidated damages clauses. As noted above, the O-I and Ardagh settlements excluded senior executives (the FTC is considering such an exception in the Non-Compete Rule) and R&D employees. Of course, there may be instances in which low-wage earners have access to a company's key confidential information that justifies a non-compete.
5. **Consider Alternatives to Non-Competes.** The FTC's complaints allege that the legitimate objectives of non-competes can be achieved through "significantly less restrictive means"—for example, through confidentiality agreements. Companies should consider whether NDAs, customer non-solicit agreements, or other similar agreements could protect the company's interests, as long as they are not de facto non-compete clauses.

Employers implementing new restrictive covenants and NDAs should consider structures that provide for maximum enforceability, i.e., including severability provisions. Employers who provide consideration for non-compete agreements also should take into account the uncertainty of future enforcement in designing such programs. Employers choosing to rely on reasonable non-disclosure and trade secret agreements should pay special attention to defining confidential and trade secret information. In addition, employers may wish to increase communications to employees regarding trade secret information, review controls on confidential and trade secret information, and implement enhanced tracking of access to trade secrets. Finally, to prepare for future trade secret litigation, employers should review processes for departing employees, including retention of departing employee electronic devices.

To be clear, those rules of thumb are not a panacea against an FTC inquiry, nor are all potential changes absolutely required. To the contrary, the Non-Compete Rule makes clear that the FTC thinks most non-competes should be banned. However, they should serve as a practical guide for companies to minimize risk of FTC enforcement under federal law, during the uncertainty ahead.

State and Federal Laws

State laws on employer/employee non-competes vary, but a number of states follow a common law reasonableness test. Generally, courts will balance the following three factors to determine enforceability: (i) whether the restriction is broader than necessary for the protection of a legitimate business interest; (ii) the effect of the restriction on the employee; and (iii) whether the restriction is in the public interest.[4] The reasonableness analysis includes many of the rules of thumb above, including the scope, geography, and duration of the restriction.[5] Three states—California, North Dakota, and Oklahoma—prohibit employer/employee non-competes in almost all cases, and a number of states (e.g., Illinois, Maine, and New Hampshire) have or are considering a ban on non-competes with "low wage employees," as defined in their respective statutes.

Absent the FTC's controversial use of § 5 of the FTC Act, as detailed above, under federal antitrust law, the rule of reason would apply to most employer/employee non-competes.

The Bottom Line

For some companies—those with few non-competes beyond senior executives, highly skilled employees, or other employees with access to particularly sensitive information—there may be little to change in the near-term, assuming the

non-competes are otherwise reasonable. For other companies, there may not be a reasonable or inexpensive way to know which employees even have non-competes or whether the FTC might consider the myriad other employment agreement terms to be a de facto non-compete. In those cases, companies should consider a high-level review of past and existing practices, including whether the company aggressively enforces non-competes, and weigh whether changes are necessary going forward. The FTC, which is the only federal or state agency with authority to enforce the FTC Act, will not (and cannot) investigate or take action against every company employing the allegedly 20% of American workers with non-competes.

The takeaways from the three § 5 cases are that there is more risk of FTC § 5 enforcement if:

- A company has expansive non-competes for low-level employees, there is no procompetitive justification (e.g., the employee has confidential business information), and the company aggressively and regularly enforces those non-competes;
- A company operates in a highly concentrated industry in which competitors also use employer/employee non-competes; and
- A company has an active M&A pipeline. We expect that the FTC also might try to use its HSR Act merger investigations, known as Second Requests, to find non-competes.

Those unlucky companies that are hit with an FTC non-compete investigation will have to consider whether to settle with the FTC or fight an investigation, or potentially litigation.

CAN I SEND A CEASE-AND-DESIST LETTER, INITIATE LITIGATION, AND/OR CONTINUE ENFORCING A NON-COMPETE AGREEMENT NOW?

Subject to the considerations above from the FTC's *Prudential*, *O-I*, and *Ardagh* cases, yes, assuming the non-compete in question is legal under state law. However, employers should be aware that, if adopted, the Non-Compete Rule would invalidate existing non-compete clauses after the 180-day grace period. Employers initiating litigation at this juncture should pay special attention to pleading claims in addition to those arising under a non-compete, such as under the Defend Trade Secrets Act or state trade secrets law.

IS THERE ANY WAY TO CHALLENGE WHAT THE FTC HAS DONE?

In the near term, any interested parties may submit comments through the Regulations.gov portal. The FTC has invited comments on any issues raised by the NPRM, and these comments could discuss, for example, the important justifications for non-compete clauses or other reasons the NPRM should not be adopted as the final rule. The FTC will consider these comments in formulating the final rule and must respond to any that raise important arguments.

Once the FTC publishes the final rule, aggrieved parties, such as businesses that use non-compete clauses, will have standing to challenge the rule in court. Challengers also may seek to delay the rule from going into effect before legal proceedings are resolved. Absent such a stay, as noted above, businesses would need to come into compliance within 180 days after publication of the final rule.

Challengers will be able to raise a variety of arguments to attack the rule. Some of these will depend on the contours of the final rule and the analysis that the FTC offers to support it. For example, challengers should consider whether there are any important public comments that the FTC has failed to adequately discuss. Challengers should also consider other reasons the rule may be arbitrary and capricious, such as whether a rule that invalidates existing non-compete clauses may impermissibly upset contractual expectations.

But there are at least three arguments that any challenger should be able to raise.

- The FTC lacks authority to promulgate any rule under the part of the FTC Act it has invoked. As Commissioner Wilson explained in her dissent from the Non-Compete Rule, the FTC previously acknowledged that it has no authority to regulate competition practices through rulemaking, and the statutory and regulatory history of the FTC suggests that its former position is correct.[6] Moreover, the FTC's authority over "unfair methods of competition" is arguably circumscribed by antitrust principles, and, as Commissioner Wilson has explained elsewhere, does not allow it to regulate merely "business conduct it finds distasteful."

- To the extent the FTC's statutory authority is a close question, rulemaking is unavailable under the major questions doctrine. Under that doctrine, courts must reject new and surprising interpretations of an ambiguous statute where the interpretive question is of "major" importance. As the scope of that doctrine makes clear, whether the FTC can make substantive rules concerning competition policy has enormous implications, as does the substantive content of the Non-Compete Rule—something the FTC itself argues.
- The FTC Act may violate the nondelegation doctrine, which bars Congress from transferring too much authority to the President, if it empowers the FTC to make substantive rules about competition policy. Although this doctrine is rarely invoked by courts, the relevant provision of the FTC Act is very similar to a statute that the Supreme Court deemed an unconstitutional delegation in *ALA Schechter Poultry Corp. v. United States*.[7] The Court in that decision distinguished the FTC Act provision on the ground that the FTC is an adjudicatory agency, but that rationale collapses if the FTC is engaging in rulemaking, as it is attempting to do here. Litigation about the final rule may thus clarify not only the continuing legality of non-compete clauses but also the extent of the FTC's power to regulate businesses operating in the United States.

CAN EMPLOYEES SUE TO ENFORCE THE NON-COMPETE RULE? WILL AN FTC CASE UNDER § 5 LEAD TO FOLLOW-ON LITIGATION?

The Non-Compete Rule does not include a private right of action. Nonetheless, we anticipate that the proposed rule could give rise to employment actions grounded in public policy and declaratory judgment actions to invalidate non-compete agreements. The Non-Compete Rule also would pose a substantial hurdle to employers enforcing non-compete agreements.

There is no private right of action under § 5, but some state unfair competition laws that parallel the general language of § 5, such as Massachusetts's, include a private right of action. Many of the FTC's § 5 cases in recent decades involved conduct that fell short of satisfying the agreement element in a Sherman Act § 1 case, e.g., signaling or invitations to collude. Some argued that private follow-on litigation was therefore not likely to arise from FTC § 5 enforcement. However, the FTC's allegations may encourage plaintiffs to file Sherman Act § 1 (conspiracies in restraint of trade) or Sherman Act § 2 (monopolization, attempted monopolization) cases under the right facts, relying on the FTC's § 5 allegations. However, as Commissioner Wilson notes in her dissents, the FTC's complaints in the *Prudential*, *O-I*, and *Ardagh* cases offer "no evidence of anticompetitive effect in any relevant market," which would be required to satisfy federal pleading requirements. A plaintiff also will face challenges in satisfying the injury-in-fact and antitrust injury pleading requirements.

WHAT'S IMMEDIATELY NEXT?

The FTC has opened the 60-day public comment period, which ends March 20. Interested parties may submit comments here. Given the attention (and reaction) to the FTC's announcements, Congress may consider holding hearings, and, to the extent there is a negative reaction from business and/or the public, Congress may consider steps to dissuade the FTC from implementing the Non-Compete Rule.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

ANTITRUST & COMPETITION LAW

Craig A. Waldman
Washington
+1.202.879.3877
cwaldman@jonesday.com

Michelle K. Fischer
Cleveland
+1.216.586.7096
mfischer@jonesday.com

Michael A. Gleason
Washington
+1.202.879.4648
magleason@jonesday.com

Peter A. Julian
San Francisco
+1.415.875.5864
pjulian@jonesday.com

Jeremy P. Morrison
Washington
+1.202.879.3751
jmorrison@jonesday.com

LABOR & EMPLOYMENT

Matthew W. Lampe
New York
+1.212.326.8338
mwlampe@jonesday.com

Elizabeth B. McRee
Chicago
+1.312.269.4374
emcree@jonesday.com

Terri L. Chase
Miami / New York
+1.305.714.9722 / +1.212.326.8386
tlchase@jonesday.com

Brent D. Knight
Chicago
+1.312.269.4290
bdknight@jonesday.com

Kristin Berger Parker
Minneapolis
+1.612.217.8847
kparker@jonesday.com

Steven M. Zadravecz
Irvine / Los Angeles
+1.949.553.7508 / +1.213.243.2195
szadracecz@jonesday.com

ISSUES & APPEALS

James Burnham
Washington
+1.202.879.5429
jburnham@jonesday.com

Hashim M. Mooppan
Washington
+1.202.879.3744
hmmooppan@jonesday.com

GOVERNMENT REGULATION

Donald F. McGahn II
Washington
+1.202.879.3939
dmcgahn@jonesday.com

Brett A. Shumate
Washington
+1.202.879.3835
bshumate@jonesday.com

Alexis Zhang, an associate in the Washington Office, contributed to the drafting of this White Paper.

ENDNOTES

1 *In the Matter of O-I Glass, Inc.; In the matter of Ardagh Group, et al.; In the matter of Prudential Security, et al.*

2 The FTC does not allege that O-I and Ardagh coordinated their use of non-compete clauses.

3 While some have suggested the FTC may be able to seek civil penalties through its Penalty Offense Authority, it is unlikely such relief is available to activities under competition law. Under the FTC's Penalty Offense Authority, the FTC must prove a company knew its conduct was "unfair or deceptive in violation of the FTC Act," and the FTC must have issued a written decision that such conduct is unfair or deceptive. Once the FTC has met those conditions, it may send a Notice of Penalty Offense to companies it believes are engaging in such conduct. If a company receives such a notice and continues the conduct, it may face civil penalties of up to $46,517, as adjusted, per violation per day. As with the FTC's authority to issue a competition policy rulemaking (discussed on pages 5 and 6), there are strong arguments that the Notice of Penalty Offense enforcement mechanism is unavailable to the FTC outside of consumer protection.

4 *See* 6 Williston on Contracts § 13:4 (4th ed.).

5 Restatement (Second) Contracts § 188 cmt. d (explaining that the enforceability of a non-compete agreement depends in part on the reasonableness of the restriction on activity, geographic area, and duration).

6 As far back as 1980, the American Bar Association ("ABA") Section of Antitrust Law observed, "It clearly would be anomalous if the FTC could adopt an antitrust rule based simply on a notice and comment proceeding under the Administrative Procedure Act, while being required to follow the procedural guards Congress mandated for rules in the consumer protection area." ABA Section of Antitrust Law, Report of the Section Concerning Federal Trade Commission Structures, Powers, and Procedures 340 (1980). In 2020, the ABA submitted comments to the FTC in response to a call for comments for a public workshop on employer/employee non-competes. In that submission, the ABA stated that it "remains skeptical of the Commission's authority under Section 6(g) of the Federal Trade Commission Act to promulgate antitrust rules—in this case, one banning or limiting the use of non-compete clauses in employment agreements as an unfair method of competition. Antitrust problems are in general too fact-specific and context-specific to lend themselves to a broad sweeping rule." ABA Section of Antitrust Law, Comments of the Antitrust Law Section of the American Bar Association in Connection with the Federal Trade Commission Workshop on "Non-Competes in the Workplace: Examining Antitrust and Consumer Protection Issues" 58 (2020).

7 295 U.S. 495 (1935).