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Can Non-Disclosure Agreements Survive the Federal Trade Commission's Proposed Rule to Ban Non-Compete Agreements?

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On January 5, 2023, the Federal Trade Commission (FTC) issued a Notice of Proposed Rule, that if enacted, would categorically ban nearly all non-compete agreements, with a very limited exception for non-compete agreements in the sale of a business.[1] According to the FTC, the proposed rule would allow workers to liberally pursue employment opportunities and encourage entrepreneurship and innovation. Although the proposed rule may benefit low-wage workers, there is also a major impact on businesses and their ability to protect confidential information.

If it takes effect, the proposed rule will require employers to rescind all existing non-compete agreements.

By way of background, a non-compete agreement is an agreement between an employer and its employee that prevents the employee from competing with the employer by working for a competitor, usually in a similar or related role, or starting a competing business within a certain geographical area and for a specific period after employment terminates. If the employee were to breach the agreement, they may be liable for money damages and injunctive relief.

This proposed rule comes as a substantial change to the current system for governing non-compete clauses. Currently, the regulation of non-compete agreements is left to the states, which all vary in how they enforce. For some years non-compete agreements have been subject to varying state law restrictions, and in the case of California, for example, outright banishment, except in the context of the sale of a company. Other states like Alabama, Connecticut, Delaware, Maryland, Tennessee, and Texas have set restrictions for certain professions such as doctors and other medical professionals. [2] Some states have wage thresholds for non-compete agreements. For instance, in Oregon employees are only subject to non-compete agreements if they earn $100,533 and in Colorado if they earn more than $112,500.[3] Yet despite these restrictions, the FTC has sought to impose a nationwide ban on all forms of worker non-compete agreements.

ALTERNATIVES TO NON-COMPETE AGREEMENTS

The FTC proposed rule would also bleed outside the arena of non-competes that effectively

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function like a non-compete if they meet the FTC's Proposed Rule description of "de facto non-compete." One of these types of agreements is confidentiality clauses and non-disclosure agreements (collectively, NDAs).

If it takes effect, the proposed rule will require employers to rescind all existing non-compete agreements.

NDAs focus on restricting the use of information that has been disclosed to an employee, rather than a restriction on the employee's future job position. NDAs do not restrict future employment by their plain terms, and unlike non-compete agreements, are not targeted at competition in a given industry for a given field of use in that industry and are geographically specific and time based. An NDA, however, in certain states can be perpetual for qualified trade secrets and are not geographically limited. This is because trade secrets are protected by the Uniform Trade Secrets Act (UTSA), which has been adopted by nearly all states and the Defend Trade Secrets Act (DTSA), a uniform statutory scheme that creates federal causes of action for trade secret misappropriation. Under the UTSA and the DTSA, trade secrets cannot be misappropriated,[4] which means they cannot be used or disclosed without consent.[5] Owners may seek injunctive relief and damages if their trade secret is misappropriated.[6] They may also seek emergency injunctive relief, like temporary restraining orders and preliminary injunctions, which are critical because the value of the trade secret diminishes once the trade secret has been disclosed.

While the FTC provides examples of overly broad NDA's that would qualify as *de facto* non-competes, the courts have also evaluated NDAs as if they were restrictive covenants like non-competes in cases such as *TLS Mgmt & Marketing Servs. V. Rodriguez-Toledo*.[7]

If all three factors exist, then the nondisclosure agreement is overly broad, and therefore, unenforceable.

In *TLS Mgmt & Marketing Servs.*, Rodriguez-Toledo argued that the nondisclosure agreement his company signed for TLS failed to comply with *Arthur Young & Co. v. Vega III,* a case where the "Puerto Rico Supreme Court held certain noncompete clauses invalid as contrary to public policy."[8] According to Rodriguez-Toledo, the nondisclosure agreement had same effect as a noncompete clause, which "infinitely precluded [them] from utilizing their skills and knowledge to work in any such areas concerning the accounting profession."[9] In contrast, TLS argued that *Arthur Young* was inapplicable because "a "confidentiality clause" is not a "non-compete clause."[10] The First Circuit sided with Rodrigo-Toledo, finding that "overly broad nondisclosure agreements, while not specifically prohibiting an employee from entering into competition with the former employer, raise the same policy concerns about restraining competition as noncompete clauses."[11] The court went through three factors to consider when deciding whether a nondisclosure agreement is overly broad:

(1) Whether it restricts general knowledge;

(2) Whether it restricts public information that is not confidential; and

(3) Whether it restricts information provided by a third-party source.[12]

If all three factors exist, then the nondisclosure agreement is overly broad, and therefore, unenforceable.[13] In Rodriguez-Toledo's case, all three factors existed in the nondisclosure agreement TLS made him sign. The agreement broadly defined "Confidential Information" as:

> 1.2.1. All information[] . . . regarding ("TLS") business methods and procedures, clients or prospective clients, agent lists, marketing channels and relationships, marketing methods, costs, prices, products, formulas, compositions, methods, systems, procedures, prospective and executed contracts and other business arrangements, proposals and project plans, and ("TLS") Affiliates;
>
> 1.2.2. . . . any other information provided to [Rodríguez] by ("TLS") or ("TLS") Affiliates by or in connection with proposing or delivering ("TLS Services") . . .;

> 1.2.3. The identities of agents, contractors, consultants, sales representatives, sales associates, subsidiaries, strategic partners, licensors, licensees, customers, prospective customers, suppliers, or other service providers or sources of supply including firms in which a ("TLS") Principal may have an ownership interest . . .;
>
> 1.2.4. . . . any other information that [Rodríguez] may obtain knowledge [sic] during his/her tenure while working at ("TLS")[.][14]

The court found that the "astounding breadth and lack of any meaningful limitation restricted Rodríguez's freedom to compete. The nondisclosure agreement "exceed[ed] the real need to protect [TLS] from . . . competition," essentially tied TLS's clients to its services, and "excessively and unjustifiably restrict[ed] . . . the general public's freedom of choice."[15] The agreement sought to protect information that was public and "general knowledge not particular to TLS's business."[16] Additionally, the agreement sought to protect information that was acquired from "third parties, such as TLS's former clients."[17]

Some forms of NDAs are sufficiently broad that they could theoretically prohibit an employee from working for specific employers in a specific role. For example, in certain jurisdictions, a prior employer can prevent the employment of an individual at the prior employer's competitor if they can demonstrate that their former employee would utilize its trade secrets simply by virtue of the fact that their new duties would inevitably result in their disclosure. Known as the "inevitable disclosure doctrine" a number of states continue to uphold this form of NDA as viable.

An open issue is whether the proposed FTC rule supersedes the inevitable disclosure doctrine since the proposed rule supersedes contrary laws and an NDA that restricts competition likely falls into the broad definition of a functionally equivalent non-compete under proposed rule 910.1. While this is obviously a theoretical issue at this stage, good arguments exist that a well-crafted NDA that is subject to the inevitable disclosure doctrine could be distinguished from a non-compete agreement.

One of the leading cases on inevitable disclosure *PepsiCo, Inc. v. Redmond*, acknowledged the tension between the protection of a company's trade secrets and an employee's ability to move to a different job.[18] *PepsiCo* noted that "[t]his tension is particularly exacerbated when a plaintiff sues to prevent not the actual misappropriation of trade secrets but the mere threat that it will occur."[19] Nonetheless, the Seventh Circuit panel upheld the district court's injunction finding that "PepsiCo presented substantial evidence at the preliminary injunction hearing that Redmond possessed extensive and intimate knowledge about PCNA's strategic goals for 1995 in sports drinks and new age drinks."[20] The Seventh Circuit further concluded that unless Redmond possessed an uncanny ability to compartmentalize information, he would necessarily be making decisions about Gatorade and Snapple by relying on his knowledge of PCNA's trade secrets. "It is not the "general skills and knowledge acquired during his [Redmond's] tenure with" PepsiCo that PepsiCo seeks to keep from falling into Quaker's hands, but rather "the particularized plans or processes developed by [PCNA] and disclosed to him while the employer-employee relationship existed, which are unknown to others in the industry, and which give the employer an advantage over his competitors."[21]

The *Pepsico* court went to lengths to demarcate a distinction between the sweeping restrictiveness of a non-compete versus the fact specific connection between a certain type of trade secret in the form of a company's strategic goals, and the hiring away and eventual disclosure of a high-level employee whose employment was based in large part on his knowledge of just such a strategy. It would therefore be hard to conclude that the NDA at issue in *PepsiCo* operated along functionally in the same lines as a non-compete provision, even though both types of agreement had the same end result.

PepsiCo also provides some useful arguments that can generally help differentiate its claim of trade secret misappropriation from being functionally equivalent to a breach of a non-compete provision. First, the court examined the circumstances that qualified PepsiCo's strategic document as a trade secret both in terms of the measures PepsiCo undertook to keep the strategy a secret, and the economic importance of this strategy to PepsiCo's business. Second, the court examined the circumstances regarding Redmond's departure from PepsiCo and his truthfulness with his former employer regarding the nature of his new job and his role and responsibilities. Third, the nature of Redmond's employers' business and his job responsibilities were a central factor in the court's opinion that there was likely to be an inevitable disclosure.

Another important case regarding the inevitable disclosure doctrine is *Bimbo Bakeries v. Botticella*.

Another important case regarding the inevitable disclosure doctrine is *Bimbo Bakeries v. Botticella,* which also acknowledged the importance of balancing the public interest in upholding the "inviolability of trade secrets" versus the interest of employers being free to hire whom they please and their employees being free to work for whom they please.[22] "Of these latter two interests, Pennsylvania courts consider the right of the employee to be more significant."[23]

Despite weighing in favor of an employee's freedom of movement, the Third Circuit concluded that Botticella's behavior went beyond acceptable limits. In other words, Botticella's copying files from Bimbo during his final days of employment, was sufficiently questionable that the issuance of a broad preliminary injunction was warranted since the use of Bimbo's trade secrets during employment with the new employer [Hostess] "rests on a solid evidentiary basis, namely, Botticella's "not disclosing to Bimbo his acceptance of a job offer from a direct competitor, remaining in a position to receive Bimbo's confidential information and, in fact, receiving such information after committing to the Hostess job, and copying Bimbo's trade secret information from his work laptop onto external storage devices."[24]

Similar to the circumstances in *PepsiCo*, three identifiable arguments are evident in the *Bimbo Bakeries* case which differentiates it from an attempted enforcement of an overly broad NDA like in *TLS Mgmt & Marketing Servs.*: Bimbo's information copied by Botticella were highly valuable trade secrets involving the costs, recipes and marketing strategies of Bimbo, the behavior of Botticella demonstrated a lack of truthfulness, and Botticella was entering an identical senior position of responsibility with his new employer.

While non-competes are governed by individual state laws, most states consider common factors to determine whether a non-compete agreement is reasonable. For instance, many states consider whether the employer has a legitimate interest in protecting the non-compete agreement,[25] the geographic scope of the restriction,[26] the duration of the restriction,[27] whether the type of work being restricted differs from what they are doing for the employer,[28] and whether the employer is providing additional compensation or benefits in exchange.[29] Generally, courts are concerned about whether the employer's interest in protecting the use of its confidential information, its customer relationships, and specialized training and goodwill, is outweighed by any hardships to the employee or the public.[30]

SO WHAT COMES NEXT?

In light of the FTC's proposed rule, employers should begin to take a closer look at their current policies on how they protect their business from disclosure of trade secrets. If non-competes no longer are enforceable, it is likely that there will be a shift in focus towards litigation surrounding trade secrets and breaches of NDAs. To survive these types of challenges, businesses need to be able to demonstrate that their trade secrets were in fact confidential information and that the business took reasonable measures to protect that information from disclosure. If the proposed rule is enacted, employers will have one hundred eighty days after the date of publication to comply. However, even if the FTC's proposed rule is not enacted, employers need to have strong enforceable trade secret provisions in place to appropriately protect their confidential information.

In light of the FTC's proposed rule, employers should begin to take a closer look at their current policies on how they protect their business from disclosure of trade secrets.

Here are some actions your business may consider to best protect trade secrets:

- Identify what type of information within your business is not "generally known"[31] to others who are knowledgeable about the subject matter, and should, therefore, be confidential. To the extent possible, specify such information in the NDA definition of "confidential information", to avoid outcomes such as the *TLS* case. A trade secret is business information protected from disclosure such as, customer lists, formulations, recipes, source code, business plans, strategic plans, and business financial information.[32]

- Have employees sign NDAs but avoid overly broad agreements to stay free from the FTC's "de facto" non-complete clause. To the extent possible, limit disclosures only to those employees on a need-to-know basis. The NDA should clearly identify and describe the trade secret information being protected. Make sure the standard carve-out clauses for publicly known information are included.

- Closely consider the issue of expiration dates for confidential information and possibly differentiate those sunset dates from trade secret information in the NDA. In certain states trade secrets even have a perpetual term, so an end date may unduly limit your company's protection term for qualifying information. Indeed, some courts have held that setting an expiration date demonstrates that reasonable efforts[33] were not taken to maintain secrecy and therefore "eternal vigilance" cannot be proven.[34]

- Place restrictions on what type of information employees have access to at work and may be able to download, take home, or share with others.

- Establish a strong cyber security program, in addition to protecting sensitive information by passwords and multifactor authentication, to guard your sensitive data from hackers and/or internal leaks.

- Set in place procedures for departing employees.

- Businesses should regularly audit and assess the status of their confidential information and who has access to it.

- Consider using complementary forms of intellectual property protection such as trade secret copyright registrations, or patent protection to cover aspects of your company's related intellectual assets that may not be impacted by the FTC's proposed rule.

Although the proposed rule is not yet a final rule, companies should stay vigilant and proactive to ensure that policies and procedures are in place to protect their most valuable information.

Notes

1. Non-Compete Clause Rulemaking, Fed. Trade Comm'n (Jan. 5, 2023).
2. Lawrence Peikes & Michael J. Kasdan, Limitations and Best Practices for Using Non-Competition to Protect Company Trade Secrets, National Law Review, Vol. XIII, No. 61 (2023).
3. Dawn Mertineit & Seyfarth Shaw, Non-Compete Regulation Should Be Left to the States, Not the FTC, Bloomberg Law, Feb. 3, 2023, https://news.bloomberglaw.com/us-law-week/non-compete-regulation-should-be-left-to-the-states-not-the-ftc.
4. UTSA § 1(2) (1985).
5. See id.
6. See id. at § 2(a).
7. 2020 WL 4187246 (1st Cir. July 21, 2020).
8. See id. at *56-58.(noting that in Arthur Young, the Puerto Rico Supreme Court held "that a contract's "prohibition cannot be extended beyond what is necessary to protect the former employer's legitimate interests" while "unjustifiably restricting the employee's freedom of contract and the general public's freedom of choice.").
9. See id.
10. See id.
11. See id. at *57.
12. See id. at *59.
13. See id. at *59-61 (concluding that the "astounding breadth and lack of any meaning limitation [in Rodriguez's nondisclosure agreement] restricted Rodriguez's freedom to compete" and that similar overly broad agreements have uniformly been held unenforceable).
14. See id. at 59 (reiterating the district court's admission that "it [wa]s undisputable that the confidentiality clause is broad.").
15. See id. at 59-60.
16. See id. at 59 (noting that TLS did not exclude information that was available to the public and that TLS's operating agreement could be found online).
17. See id.

18. 54 F.3d 1262 (7th Cir. 1995).
19. See id. at 1268.
20. See id. at 1269.
21. Ibid. at 1269.
22. 613 F.3d 102 (3d Cir. 2010).
23. See id. at 119.
24. Id. at 118.
25. CVS Pharmacy, Inc. v. Lavin, 951 F.3d 50, 55 (1st Cir. 2020) (noting that under Rhode Island law, a non-compete must be "designed to protect a "legitimate interest" of the employer."); Instant Tech. LLC v. DeFazio, 793 F.3d 748, 750 (7th Cir. 2015) (stating that in Illinois, a non-compete agreement is only valid if there isa legitimate business interest.); PharMethod, Inc. v. Caserta, 382 F. App'x 214, 220 (3d Cir. 2010) (emphasizing that under Pennsylvania law, a restrictive covenant must be necessary to former employer's legitimate business interest.).
26. Turnell v. CentiMark Corp., 796 F.3d 656, 662-665 (7th Cir. 2015) (stating that Pennsylvania courts will enforce non-compete agreements that are reasonably limited in geographic extent.).
27. See id. at 663 (noting that restrictions must be "reasonably limited to duration").
28. R.I. Gen. Laws § 5-37-33 (Prohibiting non-competes that restrict the ability of a physician to practice medicine).
29. Mayer Hoffman McCann, P.C. v. Barton, 614 F.3d 893, 902 (8th Cir. 2010) (indicating that agreeing to additional compensation in exchange to singing the non-compete constitutes valid consideration. (citing Superior Gearbox Co. v. Edwards, 869 S.W.2d 239 (Mo. Ct.App.1993)).
30. See generally, Maw v. Adv. Clinical Comms., Inc., 846 A.2d 604 (N.J. 2004); Brentlinger Enters. v. Curran, 752 N.E.2d 994 (Ohio Ct. App. 2001).
31. UTSA § 1 (1985) (Commissioners' cmt.) ("If the principal entity that could obtain economic benefit from the information is aware of it, there is no trade secret.").
32. ConFold Pac., Inc. v. Polaris Indus., 433 F.3d 952, 959 (7th Cir. 2006) (citations omitted).
33. Silicon Image Inc v Analogk Semiconductor Inc, No. 07-96073, 2007 U.S. Dist. Lexis 96073, at *46-51 (N.D. Cal. Dec. 20, 2007).
34. DB Riley Inc v AB Engineering Corp, 977 F Supp 84, 91 (D Mass, 1997).