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THE COST OF KEEPING THINGS QUIET: CRACKDOWN ON CONFIDENTIALITY CLAUSES CALLS FOR EXPLICIT CARVE-OUTS

By Niles Pierson

In last February's Employment Law Commentary, we discussed best practices for drafting separation agreements.[1] Among the issues raised was a recent SEC enforcement action applying one of the Commission's rules in a novel way to clamp down on contracts seen as chilling whistleblowing activity.[2] In the year since we last touched this subject, the SEC has been more active than ever in enforcing Rule 21F-17, extracting substantial settlements from a number of companies for drafting contractual provisions that it construes as designed to muzzle whistleblowers.

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Shortly after the SEC began this new trend, the federal Defend Trade Secrets Act went into effect.[3] The statute largely protects proprietary secret information, but it contains a conspicuous provision immunizing whistleblowing activity.[4] It even goes so far as to penalize employers for failing to provide notice of this immunity by denying them potentially lucrative forms of relief.[5]

These two regulatory developments reflect growing concern that in the wake of Dodd Frank's expansion of whistleblower protections, businesses may have used confidentiality agreements to drive reporting inward or simply discourage it outright.[6] That being said, every business has legitimate interests in preventing disclosure of sensitive and proprietary information. Indeed, businesses would be remiss not to try to obtain some assurance that confidential information—including that of third parties—will remain secret.

Assuming the trend plotted by these developments is not interrupted by the transition of power in D.C., the line between what government considers reasonable privacy protections and obstructionist overreaches appears to be thinning. Accordingly, employers must rethink how they draft confidentiality agreements. In this update, we discuss how employers can craft confidentiality provisions with broad enough scope to protect their interests while staying clear of interfering with protected activities.

SEC RULE 21F-17

As recently as three days before President Trump's inauguration, a large asset manager settled with the SEC for $340,000 exclusively over charges that it required more than a thousand employees to sign waivers of any monetary awards for whistleblowing,[7] and just two days later, another company settled an action including similar charges, among others, for $500,000.[8] Indeed, one of the companies targeted by the SEC had unilaterally revised its agreements to remove the offending clauses in March before being contacted by the Commission, yet it was still charged.[9] The list of companies to have settled such claims includes Sandridge ($1.4 million),[10] BlueLinx ($265,000),[11] and HealthNet ($340,000),[12] but does not end there. Rule 21F-17 even played a role in a $415 million settlement in June[13] and a settlement for $6 million in September.[14] Other enforcement actions are still in the works.[15]

The SEC's decision to ramp up enforcement of Rule 21F-17 sends a strong message that companies under its jurisdiction need to start actively reviewing their contract drafting procedures to avoid any semblance of whistleblower obstruction. Originally promulgated in 2011, it took until 2015 for the SEC to announce its intentions to aggressively litigate Rule 21F-17 in a press release.[16] It then took its first action to enforce Rule 21F-17(a) against KBR Inc., which settled for $140,000.[17]

The regulation, codified at 17 C.F.R. § 240.21F-17(a) states:

> No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement... with respect to such communications.

In October 2016, the Office of Compliance Inspections and Examinations issued a Risk Alert[18] citing several of the recent actions and outlining much of the conduct that the SEC considers overreach:

1. requiring employees to represent that they haven't assisted in any investigations;

2. prohibiting any and all disclosures with no exception for communications with the Commission;

3. requiring employees to notify their employers or receive consent prior to disclosing information with no exception for Commission communications;

4. purporting to permit disclosures only as required by law without an exception for communications with the Commission.

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Other clauses have also been highlighted in the SEC's string of actions over the past year, such as unrestricted nondisparagement clauses, waivers of monetary rewards for participation in investigations, and any express or implicit threats of discipline or termination.

In most of the settlements, the SEC found the inclusion of a clause explicitly exempting communications with the Commission to be sufficient to satisfy Rule 21F-17; in several, it also required that special notice be given to those who had already signed confidentiality agreements. For example, one of the entities who settled with the SEC agreed to introduce yearly trainings on its "Global Policy for Reporting Illegal or Unethical Conduct," which now expressly informs employees of their right to blow the whistle.[19]

THE DEFEND TRADE SECRETS ACT

The Defend Trade Secrets Act went into effect last May.[20] Its core provision, 18 U.S.C. § 1832, provides federal protection for trade secrets in much the same fashion as the Uniform Trade Secret Acts adopted by most states. It includes robust protections that allow courts to award not only actual damages and unjust enrichment, but also exemplary damages and attorney's fees for willful and malicious violations.[21] The Act varies from the state laws, however, in that it both immunizes whistleblowing activity and induces employers to provide notice of this immunity.

The immunity provision preempts all other trade secret laws and permits indirect or direct disclosures to Federal, State, and local government, or disclosures to attorneys, for the purpose of reporting or investigating any violation of law.[22] It also protects disclosures that are made as part of court filings so long as those filings are made under seal.[23]

As stated in 18 U.S.C. 1833(b)(3)(A):

> An employer shall provide notice of the immunity set forth in this subsection in any contract or agreement with an employee that governs the use of a trade secret or other confidential information.

Fortunately, the rule does not require that every contract contain an onerous clause explaining the DTSA's requirements in excruciating detail. Instead, the statute offers an elegant solution by permitting the use of cross-references to "a policy document provided to the employee that sets forth the employer's reporting policy for a suspected violation of law."[24]

Moreover, the consequences of failure to provide notice are limited: preclusion of the award of exemplary damages and attorney's fees under the federal statute.[25] While this limitation may seem to open the door for employers to make a calculated decision—weighing the risk of possibly encouraging employees to disclose proprietary information against the loss of certain legal remedies—in light of the SEC's actions, companies under its jurisdiction might want to think twice before deciding to omit a statutorily mandated notice.

OTHER LIMITATIONS ON CONFIDENTIALITY CLAUSES

The ultimate scope of the SEC's enforcement power is limited to those entities subject to its jurisdiction. The Defend Trade Secrets Act's whistleblower protections are also narrow in effect because they only limit some, but not all, remedies. Keep in mind, however, that these are not the sole sources of law protecting whistleblowers. As mentioned in our article last year, even the EEOC has stepped up its enforcement actions against companies for provisions it considers designed to stifle reporting of discrimination.[26] Both the National Labor Relations Board and the Department of Labor have also expressed similar leanings in the past.[27] In fact, the Occupational Health and Safety Division issued new guidance just last September declaring that it "will not approve a 'gag' provision" in a settlement agreement.[28] Furthermore, federal trends may prompt local governments to follow suit. Even non-governmental regulatory bodies, such as FINRA, have taken a stance on the issue.[29]

Doubtless, the recent sea change at the highest level of government has made it nearly impossible to predict how long this trend will go on;

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that seems to be true of almost everything in national politics at the moment. Nevertheless, at this point, the precedents are racking up. It is pretty clear that the SEC intends for businesses under its jurisdiction to make it explicit that "communicating directly with Commission staff about a possible securities law violation" is not affected in any way by contractual confidentiality clauses.[30]

In response, all businesses should consider taking stock of the numerous agencies under whose jurisdiction they may fall and ask one simple question: do the agencies regulating your activities have rules protecting whistleblowers? If so, it is plausible that these regulators may follow in the SEC's footsteps, and it may be prudent to review regulations applicable to your business to determine whether the confidentiality, non-disparagement or other provisions in employee agreements may be construed as improperly chilling whistleblowing.

While a clause specific to each relevant regulator should be effective, it is unclear whether or not a general clause will be either necessary or sufficient in all circumstances. The DTSA can be read to require specific notice of *its* immunity provisions, so a general carve-out may not be enough. What's more, the DTSA immunity provision expands beyond just whistleblowing activities to include court filings so long as they are under seal. A generalized whistleblowing carve-out may not need to be so liberal with respect to information that is confidential if trade secrets are not at stake. Consequently, there may be no one size-fits-all solution, and businesses should try to find a solution crafted to address their unique business needs.

CRAFTING CONSCIENTIOUS CONFIDENTIALITY POLICIES

Confidentiality provisions are routinely included in the many contracts that govern the employment relationship from beginning to end. They also often vary based on the nature and stage of the relationship between the parties, and their scope depends upon the parties' expectations about the kinds of information likely to be handled.

Two typical examples of employment contracts containing confidentiality provisions are initial employment contracts and separation agreements, but they are also found in applications, handbooks, noncompetition agreements, independent contractor agreements, settlement agreements, or stand-alone confidential and proprietary information agreements.

Because of the many forms in which confidentiality clauses may present themselves, there simply is no single set of magic words that can accommodate all situations. To ensure that information is properly protected while also avoiding crossing the line into obstruction, businesses should develop individualized information handling and whistleblower reporting policies. These policies should be adapted to account for two sets of factors: 1) the peculiarities of the business's trade and 2) the particular relationships a business has with employees, consumers, regulators, and other businesses. With central policies in place, businesses can rely on cross-references or regular reviews to ensure compliance.

In developing information handling policies, it is a good idea to try to be as specific as possible about the kinds of information employers need to protect and to be explicit about the fact that any confidentiality agreement is not intended to limit or discourage whistleblowing activities. Not only may it be wise for employers to include the notice called for by the DTSA, but they also should consider making it clear that nothing in the agreements is intended to limit or interfere with an employee's ability to make confidential disclosures of information to law enforcement agencies in accordance with whistleblower laws. It may also be helpful for employers to remind employees of procedures for internal reporting, though it is imperative not to give the impression that they are required to report by only those means or that they must do so before going to law enforcement. In fact, the day before the inauguration, a major oil and gas company announced it recently introduced express notices and carve-outs to its severance agreements in one of its SEC filings.

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Because of the wide variation among confidentiality agreements, each will need to be tailored to the needs of the business. Navigating the many legal requirements that limit the scope of confidentiality clauses can be a daunting task. Fortunately, help sorting through these issues is just a phone call or email away.

Niles Pierson is an associate in our Los Angeles office and can be reached (213) 892-5278 or npierson@mofo.com.

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1 Benjamin D. Williams, *Separation Anxiety: Best Practices for Employee Severance Agreements*, Morrison & Foerster Employment Law Commentary, Vol. 28, Issue 2 (Feb. 2016) *available at* https://media2.mofo.com/documents/160301ELC.pdf.

2 We initially called attention to this issue nearly a year prior. *See* Janie F. Schulman, *Does the Government Think Your Confidentiality Agreements Chill Whistleblower?* Morrison & Foerster Employment Law Commentary, Vol. 27, Issue 3 (Mar. 2015) *available at* https://media2.mofo.com/documents/150402EmploymentLawCommentary.pdf.

3 Pub. L. No. 114-153 (May 11, 2016).

4 18 U.S.C. § 1833(b)(1).

5 18 U.S.C. § 1833(b)(3).

6 *See* Kathryn Hastings, Keeping Whistleblowers Quiet: Addressing Employer Agreements to Discourage Whistleblowing, 90 Tul. L. Rev. 495 (2015).

7 S.E.C. Release No. 79804 (Jan. 17, 2017) *available at* https://www.sec.gov/litigation/admin/2017/34-79804.pdf.

8 S.E.C. Release No. 3852 (Jan. 19, 2017) *available at* https://www.sec.gov/litigation/admin/2017/34-79844.pdf.

9 S.E.C. Release No. 79804.

10 S.E.C. Release No. 79607 (Dec. 20, 2016) *available at* https://www.sec.gov/litigation/admin/2016/34-79607.pdf.

11 S.E.C. Release No. 78528 (Aug. 10, 2016) *available at* https://www.sec.gov/litigation/admin/2016/34-78528.pdf.

12 S.E.C. Release No. 78590 (Aug. 16, 2016) *available at* https://www.sec.gov/litigation/admin/2016/34-78590.pdf.

13 S.E.C. Release No. 78141 (June 23, 2016) *available at* https://www.sec.gov/litigation/admin/2016/34-78141.pdf.

14 S.E.C. Release No. 3808 (Sept. 28, 2016) *available at* https://www.sec.gov/litigation/admin/2016/34-78957.pdf.

15 S.E.C. Litigation Release No. 23453 (Jan. 27, 2016) *available at* https://www.sec.gov/litigation/litreleases/2016/lr23453.htm.

16 *SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements* (Apr. 1, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-54.html.

17 S.E.C. Release No. 74619 (Apr. 1, 2015) *available at* https://www.sec.gov/litigation/admin/2015/34-74619.pdf.

18 National Exam Program Risk Alert, Vol. VI, Issue 1 (Oct. 24, 2016) *available at* https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf.

19 S.E.C. Release No. 79804.

20 *See also* John A. Trocki III, *The Defend Trade Secrets Act – What Employers Need to Know Right Now*, Morrison & Foerster Employment Law Commentary, Vol. 28, Issue 6 (June 2016) *available at* https://media2.mofo.com/documents/160629employmentlawcommentary.pdf.

21 18 U.S.C. 1836(b)(3).

22 18 U.S.C. 1833(b)(1)(A).

23 18 U.S.C. 1833(b)(1)(B).

24 18 U.S.C. 1833(b)(3)(B).

25 18 U.S.C. 1833(b)(3)(C).

26 *See, e.g.*, Abigail Rubenstien, *Book Distributor Settles EEOC Suit Over Severance Deals*, Law360.com (Jul. 15, 2013) *available at* https://www.law360.com/articles/457243/book-distributor-settles-eeoc-suit-over-severance-deals; *EEOC v. Baker & Taylor, Inc.*, No. 1:13-cv-03729 (N.D. Ill., filed May 20, 2013); *but see* EEOC v. CVS Pharm., Inc., 809 F.3d 335, 336 (7th Cir. 2015) (noting that contracts that include explicit exceptions for reports to government agencies do not reflect a pattern or practice of resistance to the full enjoyment of rights guaranteed under Title VII).

27 *See Banner Health System*, 358 N.L.R.B. No. 93 (July 30, 2012); *Vannoy v. Celanese Corp.*, ALJ Case No. 2008-SOX-00064, ARB Case No. 09-118 (ALJ July 24, 2013).

28 Memorandum from Maryann Garrahan to Regional Administrators; Whistleblower Program Managers (Aug. 23, 2016) *available at* https://www.whistleblowers.gov/memo/InterimGuidance-DeFactoGagOrderProvisions.html.

29 FINRA Regulatory Notice 14-40 (Oct. 2014), *available at* http://www.financialservicesemploymentlaw.com/files/2014/10/FINRA-Regulatory-Notice-14-40.pdf.

30 17 C.F.R. § 240.21F-17(a).
