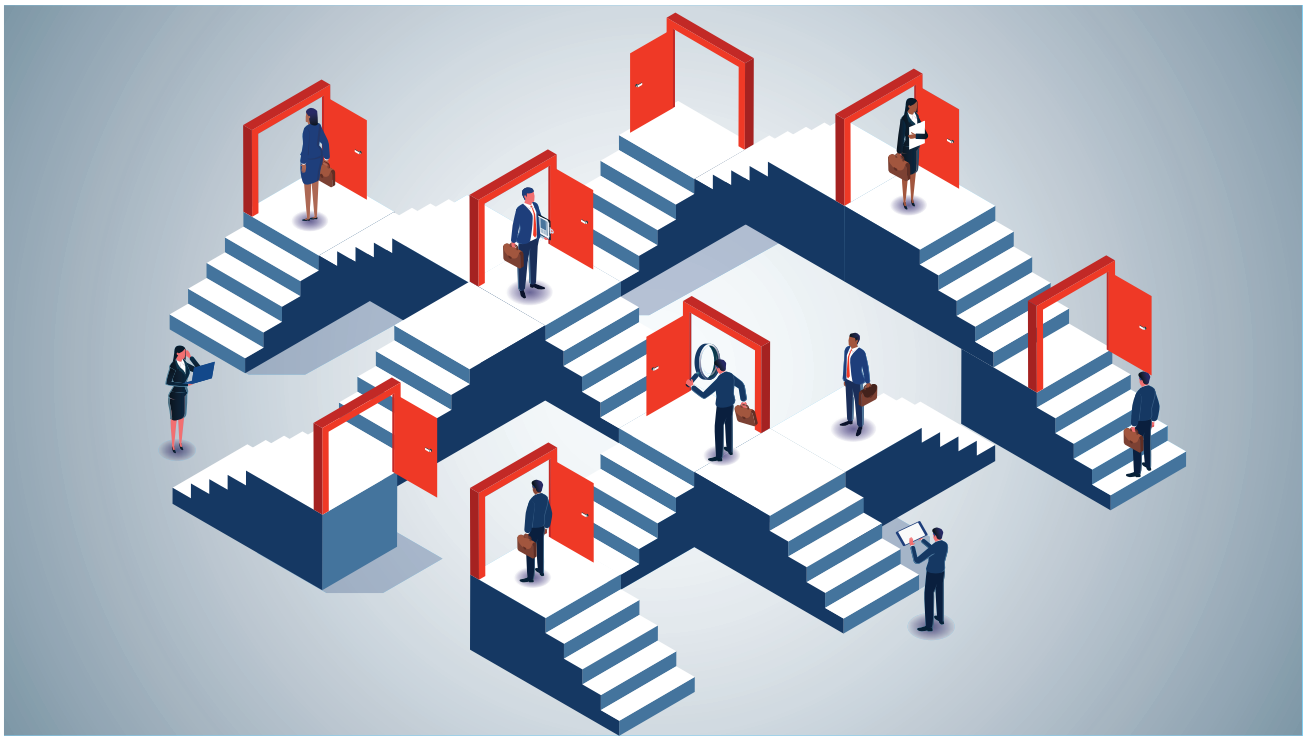

Time for a Trade Secret Audit as Non-Competes Under Attack?

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By Galit Kierkut

It is no secret that non-competes have been under attack in the last several years. There are numerous states that have recently passed or seem to be on the verge of passing much more stringent laws restricting the ability of companies to impose broad non-competes on their workforces. According to the U.S. Government Accountability Office (GAO), as of May 16, 2023, "two recent nationally representative studies GAO reviewed estimated that 18 percent of workers were subject to non-compete agreements (NCAs), and one of the studies estimated that 38 percent of workers had been subject to an NCA at some time in their careers. Over half of the 446 private sector employers responding to GAO's survey reported that at least some of their workers had NCAs."[1]

Federal Attempts at Non-Compete Regulation

In 2021, in an attempt to curtail the use of non-competes nationwide, President Biden signed an executive order (Biden Executive Order) stating an intent to prohibit all non-compete agreements, except those essential to protecting a narrowly defined category of trade secrets. The order issued a directive to the Federal Trade Commission

(FTC), which encourages the FTC to use its rulemaking authority to restrict and reduce—and even ban—certain types of non-compete agreements. Specifically, it provides that "the Chair of the FTC is encouraged to consider working with the rest of the Commission to exercise the FTC's statutory rulemaking authority under the FTC Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."[2]

Responding to the Biden Executive Order, on Jan. 5, 2023, the FTC took a significant step towards banning non-compete agreements between companies and workers. The FTC proposed a broad rule that would effectively ban all non-compete clauses entered into in the employment context. It would also require companies to rescind existing non-compete agreements. The scope of the rule could also implicate other restrictive covenants, like nondisclosure and non-solicitation agreements.[3]

The proposed rule defines a "non-compete clause" as "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."[4] The definition expressly includes a broad clause that "*has the effect* of prohibiting 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" under a so-called "functional test." "Worker" is broadly defined. It includes paid and unpaid individuals who work for an employer, including individuals "classified as an independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a client or customer."[5]

The proposed rule also provides two examples of "de facto" non-competes under the "functional test": (1) a non-disclosure agreement "written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer" and (2) a contractual term requiring the worker to repay training costs where such payment "is not reasonably related to the costs the employer incurred for training the worker." The proposed rule includes only a single exception, for a non-compete clause entered into in the context of a sale of a business provided the clause applies to an individual who owned more than 25% of the business being sold.[6]

The proposed rule would apply retroactively and provides that it is an unfair method of competition for an employer to "maintain" an existing non-compete agreement or represent to a worker that the worker is subject to a non-compete clause. To comply with that restriction, the proposed rule would require employers to "rescind the non-compete clause no later than the compliance date" and provide "individualized communication" to the affected worker regarding the rescission.[7] The proposed rule also provides that it "shall supersede any State statute, regulation, order, or interpretation to the extent that such statute, regulation, order, or interpretation is inconsistent" with the proposed rule. Any State statute, regulation, order, or interpretation offering greater protection to the worker would not, however, be superseded.[8]

The Notice of Proposed Rulemaking (NPRM) provides a great deal of background information regarding the proposed rule, and, in Section VI, it also highlights two potential alternatives to the FTC's proposed rule.[9] First, the NPRM suggests the FTC could impose a "rebuttable presumption of unlawfulness instead of a categorical ban." If the FTC were to take this approach, non-compete agreements would be presumptively unlawful, but an employer would be permitted to show that the clause should be enforceable under particular circumstances. The NPRM notes that such an approach would be similar to most existing state law where non-compete agreements are "disfavored" but permissible when used to protect "legitimate business interests" like confidential information or goodwill. However, the NPRM says that if the FTC were to ultimately adopt the rebuttable presumption approach, its rule would be more restrictive than current law.[10]

Second, the NPRM suggests that rather than a categorical ban, the FTC "could apply different rules to different categories of workers." Under that approach, the FTC could promulgate a rule with a categorical ban for some workers (e.g., low-paid workers) but impose a rebuttable presumption of unlawfulness for others (e.g., "highly paid, highly skilled workers such as executives"). The NPRM notes that there is no accepted definition for "executives" under federal law, but points to U.S. Securities and Exchange Commission reporting requirements as a potential source for such a definition.[11]

The FTC held a public forum and extended the public comment period, and it has received extensive public comments—in support of and in opposition to—in response to its proposed rule. Given the number of comments, the FTC is not expected to vote on its proposed ban, or some version of it, until April 2024. Any final rule will take effect 180 days after its publication and then will be subject to legal challenge, so the reality for employers is that the version of the law that is passed will likely not take effect until the challenges are resolved (assuming a nationwide stay is put in place). So, the federal law prohibition on non-competes will begin to take shape this spring but will likely not be fully resolved until at least 2025.

Recent State Attempts at Non-Compete Restrictions

Several states have also recently enacted or strengthened laws (e.g., Massachusetts, Colorado, Illinois and California)

or are considering new laws (e.g., New York, New Jersey) significantly restricting the use of non-compete agreements. In New York, Governor Hochul has recently vetoed a very broad New York Senate bill that would have effectively banned most non-competes in the state. A form of the legislation is likely to be reintroduced in 2024. In New Jersey, the Assembly's Labor Committee passed bill A3715A in 2022, however the bill has not yet been acted upon. The most recent Appellate Division case regarding non-competes, *ADP v. Kusins*, validated the use of both non-competes and non-solicit agreements in New Jersey[12], and at the moment, employers can certainly continue complying with the construct that has been approved by the courts, a narrowly drawn agreement tailored to protect relationships and confidential information that is not unduly restrictive on employees. However, employers do need to be prepared to address potential changes in the law in New Jersey, in the states where they have employees (whether in offices or remote) and potentially soon nationwide. A company's restrictive covenants may be deemed unenforceable overnight leaving employers with little protection of their most important assets—their customer relationships and their confidential information.

Strengthening Confidentiality Protections and Non-Solicits as Best Practices for Employers

Due to the proposed federal rule, and to the growing trend of states to limit non-competes, now is a good time to take a fresh look at agreements, particularly for new employees, and ask the following questions: Is this restriction necessary for this particular type of employee? Can it be narrowed in scope or time? Does a non-solicit really suffice to protect our interests? With respect to salespeople, often a narrow and specific non-solicit can accomplish the employer's goal of protecting actual customer relationships that the company provided to or helped develop for the salesperson. Under current law in most states, those clauses tend to be far more enforceable than broad non-competes.

Often non-competes are used to protect confidential information from getting into the hands of a competitor. If non-competes become unenforceable, employers must still ensure that they are safeguarding their interests with respect to their confidential information. Trade secret statutes, both federally and in most states, will not be impacted by this trend in non-compete restrictions. Those protections are therefore the employer's best tool to protect confidential information if a key employee departs to a competitor and the non-compete becomes unenforceable under federal or state law. Even for employers located in states without non-compete restrictions who determine that they are not worried about the federal rules until they actually go into effect, their workforces likely have many remote only employees who live in states with greater protections than the employer's home state. The protection of trade secrets will be more important than ever in order to ensure a legal right to take action against an employee who takes those secrets to a competitor. In order for trade secrets to be protected under most statutes, including the under the Defend Trade Secrets Act of 2016 (DTSA)[13] the following test must be met:

1. The information must have economic value by being secret;
2. The information must not be readily discoverable by others who also can profit from it; and
3. The company must take reasonable steps to protect its secrecy.

The best way to ensure that this test is met for companies with significant confidential information is to put into place a trade secret protection plan. That plan must at a minimum ensure that the company has agreements with all employees regarding confidential information and has agreements with third parties to whom confidential information is disclosed. The plan should also implement written policies regarding how that information is protected, limit access to confidential information, train employees on those policies, and enforce the policies. When an employee who has been exposed to significant confidential information joins a competitor, the company should also have specific plans in place as to how to address that departure, including preservation of equipment, assessing whether employees actually took information with them and potentially the conducting of forensic examinations by qualified third party examiners who can ultimately testify if a matter goes to litigation. A narrowly drawn non-solicit agreement for salespeople and a robust trade secret plan that is consistently applied and enforced can be the answer to the changing landscape of non-competes. ■

Endnotes

1. GAO-23-103785
2. Executive Order on Promoting Competition in the American Economy *available at* whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.
3. 88 FR 3482, 16 CFR 910, 2023-00414
4. *Id*. § 910.1(b)(1).
5. *Id*. § 910.2
6. *Id*. § 910.3.
7. *Id*. § 901.2.
8. *Id*. § 910.4.
9. *Id*. at pp. 136 -156.
10. *Id*.
11. *Id*.
12. 215 A.3d 924 (2019)
13. 18 U.S.C. §§ 1831-1836