Westlaw Today
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Protecting trade secrets in the face of FTC's ban of non-compete clauses

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MAY 28, 2024

Federal and state trade secret laws generally require that a trade secret owner take reasonable measures to preserve the secrecy of a trade secret. A non-compete agreement has frequently been used to preserve the secrecy of qualifying trade secret information.

Such agreements, however, have increasingly come under attack by regulators and legislative bodies as unfair methods of competition. Trade secret owners should prepare for shifting legal sands and re-assess the steps that they have traditionally deployed for protecting their trade secrets.

The U.S. Federal Trade Commission ("FTC") recently issued a final rule (effective September 4, 2024) banning companies from entering into new non-compete agreements with employees and barring the enforcement of most existing non-compete agreements.[1]

According to the FTC, non-compete clauses "tend to harm competitive conditions in labor, product, and service markets" and "suppress[ ] new business formation and innovation." Whether the FTC's Rule survives legal challenges and actually goes into effect later this year is unclear.

However, the FTC has not been alone in restricting the use of non-compete agreements. Non-compete agreements have long been unenforceable in California, Oklahoma, and North Dakota.

Other legislative or administrative bodies across the U.S., including New York, have either passed or at least considered passing laws to restrict the use of broad-based non-competition agreements. Thus, the long-term viability of across-the-board non- compete clauses aimed to protect trade secrets is at least uncertain.

The FTC's rule

The FTC's Rule addresses two employment categories — "workers other than senior executive" and "senior executives." "Senior executives" comprise those employees who are "in a policy-making position" and received or would have received an annual compensation of $151,164 or more in the preceding year.[2]

A "policy-making position means a business entity's president, chief executive officer or the equivalent, any other officer of a business entity who has policy-making authority, or any other natural person who has policymaking authority for the business entity similar to an officer with policy-making authority."[3]

The FTC stated two reasons for distinguishing "senior executives" from other workers. First, "senior executives are substantially less likely than other workers to be exploited or coerced in connection with non-competes."[4]

Second, "senior executives" were more likely to have negotiated the non-compete agreement and received substantial consideration for entering into the same.

The inevitable disclosure doctrine may help address concerns that were previously addressed by noncompetition agreements.

For either employment category, the FTC's Rule bans companies from prospectively "enter[ing] into or attempt[ing] to enter into a non-compete clause."[5] For non-senior executive workers, the Rule precludes companies from enforcing or attempting to enforce existing non-compete clauses, or representing that the worker is subject to a non-compete clause.

Companies, however, may enforce existing non-compete clauses with senior executives that had been entered into before the Rule's effective date and represent that the senior executive is subject to a non-compete clause that was entered into before the Rule's effective date.

The FTC Rule also creates three exceptions to this framework: (i) a bona fide sale of business; (ii) a cause of action that accrued prior to the effective date; and (iii) a good faith enforcement or attempted enforcement of a non-compete clause where a person has a good faith belief that the rule is inapplicable.[6]

Alternative measures for adequately safeguarding trade secret information?

The oft-cited business justifications for non-compete agreements concern protecting investments in research and development, capital expenditures, and human capital. While the subject of healthy debate, the logic is that a firm would be less inclined to

make an unprotected investment if an employee could depart to work for and disclose information to a competitor.

In promulgating its Rule, the FTC explained that employers' preference to "wield non-competes as a blunt instrument on top of or in lieu of the specific legal tools designed to protect legitimate investments in intellectual property and other investments cannot justify an unfair method of competition."[7]

It found that — pointing to the real-world experience in California, North Dakota, and Oklahoma — alternative measures could be used to protect such investments while imposing less competitive harm. The FTC highlighted existing trade secret laws, the availability of non-disclosure agreements, and other means for protecting intellectual property.

Federal and state trade secret laws protect against the misappropriation of protected information having independent economic value. While many of these laws adopt the general framework set forth in Uniform Trade Secrets Act, trade secret laws do still vary in scope and application.

The FTC's rule marks an opportunity for employers to review their trade secret management practices.

Companies should therefore understand the specific protections or limitations of trade secret laws in the jurisdictions they reside, maintain operations, or employ personnel.

Notwithstanding the availability of trade secret laws, detecting and stating a claim for misappropriation imposes a higher hurdle than asserting a claim for breach of a non-compete agreement.

Even if a misappropriation might be detectable, stating a plausible claim typically requires a trade secret owner to adequately identify the trade secret, identify the reasonable measures used to protect the secret, and allege facts capable of establishing that a defendant acquired the trade secret using improper means. The absence of an express contractual duty offered by a non-compete agreement might further raise the bar.[8]

In contrast, pleading a breach of contract claim against, for example, a former senior executive who has departed to work for a direct competitor in the same or similar capacity is typically more straightforward, even if certain jurisdictions impose certain pleading requirements for non-compete agreements.

Claims of threatened trade secret misappropriation also face uncertainties. For example, the inevitable disclosure doctrine may help address concerns that were previously addressed by noncompetition agreements.[9] This doctrine seeks to prevent the highly probable use of trade secret information by a former employee at a competitor.

Only a minority of courts, however, have endorsed this doctrine. It has been at least disfavored or outright rejected in several courts. Even if the doctrine remains available in certain jurisdictions, trade secret owners will ordinarily face a heavy burden in attempting to bring this type of claim.[10]

In addition, it is unclear whether the policies underlying FTC's rule might call the application of this doctrine into further question. The FTC described the inevitable disclosure doctrine as "controversial" when issuing the Rule.[11] Yet, it neither endorsed nor criticized the doctrine, which arguably functions as "a *de facto* noncompetition agreement."[12]

Further, the inevitable disclosure doctrine may be the most applicable to "senior executives," whom the FTC identified as having the knowledge and expertise most critical to new business formation and innovation.

Trade secret owners should also anticipate and assume that former employees will cast their experiences as "general skills and knowledge acquired during [an employee's] tenure" that cannot be protected under the inevitable disclosure doctrine.[13]

The FTC's Rule is narrowly constrained and does not apply to the most commonly-used tool to protect trade secrets — non- disclosure agreements. FTC has expressly stated that "garden variety" non-disclosure clauses do not constitute an unfair method of competition provided that they do not apply to information that "(1) arises from the worker's general training, knowledge, skill or experience, gained on the job or otherwise; or (2) is readily ascertainable to other employers or the general public."[14]

FTC has also cautioned, however, that such agreements "may be non-competes under the 'functions to prevent' prong of the definition [of 'non-compete clause'] where they span such a large scope of information that they function to prevent workers from seeking or accepting other work or starting a business after they leave their job."[15]

While these distinctions might be seemingly straightforward, they are far less so in real-world settings depending on the information or technology. Therefore, employers should be purposeful and vigilant in the use of non-disclosure and may be wise to avoid a one-size-fits-all approach.

Other measures are not impacted by the FTC's Rule and continue to be useful to protect trade secrets. For example, the FTC endorsed the use of fixed-duration employment contracts and certain non-solicitation agreements.[16]

Moreover, long-term incentive programs intended to retain employees that do not restrain postemployment opportunities would not appear to run afoul of FTC's Rule. The FTC's underlying message should be heeded, however, and thought should be given to the impact of any of these measures on employee mobility and legitimate use of their training and experiences.

Trade secret owners should at least consider whether using such measures may further guard against the improper disclosure of trade secret information.

Practicing good trade secret hygiene

The FTC's rule — whether it goes into effect or succumbs to legal challenge — marks an opportunity for employers to review their

trade secret management practices. An over-reliance on "blunt" instruments or a one-size approach to protect trade secrets may neither be advisable nor foster a trade secret-friendly culture.

More specifically, and subject to the nature of any specific trade secret, it may be wise to implement practices that do not lean too heavily on any specific measure for maintaining the trade secret information, or that may be easily adapted for shifts in laws or policies.

Employers seeking to practice good trade secret hygiene should focus foremost on developing trade secret-friendly cultures. This may start with training or incentive programs directed to educating personnel about the subject matter, value, and importance of trade secrets to the company.

For example, a bonus program directed to rewarding good trade secret hygiene, or trade secret development, may provide a carrot versus a stick approach when developing buy-in from stakeholders. A trade secret-friendly culture may also include periodically auditing the types of information that companies consider their trade secrets.

An understanding of the types of trade secrets a company possesses is critical to developing the measures for maintaining their secrecy. For example, knowledge of the classes of protected information will assist in-house counsel in structuring non- disclosure agreements and counseling employees during the on-boarding and off-boarding processes.

The ultimate goal is to foster stronger appreciation by employees of the subject matter that the company views as its trade secrets and the value to the company.

Re-assessing the physical or virtual security measures for protecting trade secrets may also lead to improvements in trade secret hygiene. What employees should have access to particular trade secrets? Do "senior executives" require access to specific technological or engineering information? Could the trade secret information be compartmentalized such that no single person has access to the entirety of the information?

Alternatively, could knowledge of the trade secret information be limited to a person who remains subject to an enforceable non-compete agreement? In addition, third party vendors offer software and applications capable of better tracking and securing trade secret information, which may help detect suspicious behaviors by departing employees.

Reviewing and updating contractual arrangements with employees and third parties is also advisable. Beyond the duty to notify non-"senior executives" regarding the non-enforceability of their non-compete agreements, these agreements may be refreshed to reflect the elevated station of an employee relative to the position in which that employee had started with a company, especially if that employee might now qualify as a "senior executive."

The company may also consider avoiding a one-size fits all approach for all employees that have differing degrees of access to or knowledge of trade secret information.

Furthermore, a proper review may uncover that contracts may have become lost or misplaced, individuals may have changed their names, the contracts may not reflect changes in a company's name or ownership over time, or may have other inaccuracies that are artifacts of the passage of time.

Further, agreements with third parties may have expired or otherwise become outdated in terms of parties, project, or scope of information.

Lastly, companies should consider a cross-functional approach to trade secret protection. In addition to the employee's business unit, stakeholders from human resources, legal, IT, and other respective business functions may have relevant knowledge and responsibilities. Moreover, a pre-identified team comprising these cross-functional areas may be beneficial when responding to a threat of misappropriation posed by a departing employee.

The FTC's Rule concerning non-compete agreements presents an opportunity for companies to re-evaluate their trade secret management practices to meet the demands of today and tomorrow. While there is not likely a set of pre-defined policies and procedures that will fit the needs of every company, ignoring the evolving legal environment will likely at least pose a risk to the company's trade secrets.

Notes:

[1] 89 Fed. Reg. 38,342 (May 7, 2024) ("Non-Compete Clause Rule" to be codified at 16 C.F.R. pts. 910 and 912).

[2] 89 Fed. Reg. 38,502.

[3] *Id.*

[4] 89 Fed. Reg. 38,411.

[5] 89 Fed. Reg. 38,503-504.

[6] *Id.* (to be codified at 16 C.F.R. pt. 910.3).

[7] 89 Fed. Reg. 38,427.

[8] *See Rencor Controls Inc. v. Stinson*, 230 F. Supp. 2d 99, 103 n.4 (D. Me. 2002) (refusing to apply doctrine in the absence of a non-compete agreement)

[9] *See PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995) (applying inevitable disclosure doctrine and enjoining defendant who left his job as General Manager of the California business unit of PepsiCo to work as Vice President of Field Operations for Quaker's Gatorade division.)

[10] *See, e.g., Int'l Bus. Machines Corp. v. Johnson*, 629 F. Supp. 2d 321 (S.D.N.Y. 2009) (refusing to enjoin employment of former employee who stole confidential business plans by competitor).

[11] 89 Fed. Reg. 38,427 n. 801.

[12] *See Kinship Partners, Inc. v. Embark Veterinary, Inc.*, C.A. No. 21-01631, 2022 WL 72123, at *7 (D. Or. Jan. 3, 2022) ("The doctrine requires a court to recognize and enforce a de facto noncompetition agreement to which the former employee is bound, even where no express agreement exists.").

[13] *PepsiCo*, 54 F.3d at 1269.

[14] 89 Fed. Reg. 38,365 and 38,426.

[15] *Id.*

[16] 89 Fed. Reg. 38,424, 38,426.

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This article was first published on Westlaw Today on May 28, 2024.