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De Facto Noncompetes Could Vastly Widen FTC Rule's Reach

By **Bryan Koenig**

Law360 (March 14, 2023, 3:04 PM EDT) -- To combat employment restrictions that hamper employee mobility and dampen wages, the Federal Trade Commission in early January proposed a nearly complete ban on noncompete agreements, which the agency says affect 1 in 5 U.S. workers.

In trying to prevent employers from skirting the new rule, the commission also plans to forbid "de facto" noncompetes, a move that could also rein in many nondisclosure and other agreements common to worker contracts.

When it unveiled planned restrictions on noncompetes, the FTC knew it wouldn't be enough just to ban blatant noncompete provisions in employment contracts.

Instead, according to an FTC official, the agency also would have to prevent employers from making their own loopholes through nondisclosure agreements, training reimbursement obligations and other language so restrictive that it would amount to de facto noncompetes.

To justify banning noncompetes, which many employer-side attorneys contend are needed to protect sensitive information that workers carry in their heads when they leave an employer, the agency is counting on "appropriately tailored" nondisclosure agreements as an adequate safeguard.

But some trade secrets and employment attorneys say the language that may be affected by the FTC's proposed ban on "NDAs that are unusually broad in scope [that] may function as de facto non-compete clauses" is widely used in contracts.

"You typically don't want to run the risk of drafting something too narrow," said Eric Akira Tate, co-chair of the global employment and labor group at Morrison Foerster LLP. "A lot of them, they're drafted broadly. Intentionally and necessarily just to get the proper protection."

Jeffrey M. Glass, an Amundsen Davis LLC partner who works on restrictive covenant, unfair competition and trade secret cases, says that "the vast majority" of employee NDAs are drafted very broadly in an effort to "protect everything under the sun."

Companies "draft them as broad as they can. And they think they're doing a good job," he said.

Kohn Kohn & Colapinto LLP founding partner Stephen M. Kohn, a specialist in representing would-be whistleblowers disclosing illegal corporate conduct, similarly said that most large corporations use

extremely broad NDAs.

"I don't know of any major company that I've dealt with that doesn't," he said.

As written, the FTC's proposed rulemaking offers an open-ended definition of what could count as a de facto noncompete, deemed as such "because it 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."

The FTC official, speaking on the condition of anonymity, pushed back on the characterization of the de facto language as open-ended. Instead, the official argued the demarcation is clear: Language preventing workers from seeking employment elsewhere amounts to de facto noncompetes.

Others argue, however, that the current rulemaking, which could be revised as the FTC moves forward and reviews the thousands of public comments already received and more still to come by the April 19 deadline, does not adequately define de facto noncompetes.

"Not only is the standard vague," Tate said, applying it "could impact exponentially more agreements and employees" than the number of employees bound by express noncompetes now.

While Tate said he believes he could craft an NDA that addresses reasonable concerns about overbroad language, "it takes two to tango" and it's the job of plaintiffs' attorneys to push the envelope and argue for an expansive reading of the kind of confidentiality provisions that amount to de facto noncompetes.

"What does the FTC mean when it says 'unusually broad,'" said Kevin M. Passerini, a Blank Rome LLP labor and employment attorney critical of the FTC's examples of potential de facto noncompetes, examples he said indicate an overly broad reach.

According to Passerini, the "very vague standard" for de facto noncompetes could let the FTC go after a host of legitimate agreements, such as commitments to pay back or give up equity in an employer.

"They all create a disincentive to somebody leaving," and that hook might be enough for the FTC to ban otherwise reasonable employment provisions, Passerini said.

Trends in state courts, which for years have been ruling on what kinds of employment agreements are reasonable and which are not, could serve as a guide for what the FTC might count as a de facto noncompete, according to Herrick Feinstein LLP restructuring and finance litigation partner John H. Chun.

"Those give us a pretty good idea of ... what the FTC may ultimately deem an overbroad [agreement]," Chun said.

While around 10 states have already imposed wage-based limits on noncompetes, only a handful of such agreements have been rendered unenforceable.

The breadth of the rulemaking's working language feeds into wider criticisms saying the proposed ban is a hammer being used on an issue in need of a scalpel to protect sensitive business information that employers contend cannot be adequately guarded through NDAs.

"The FTC's rule is not only sweeping but also vague as to when any restrictive covenant becomes a 'defacto' noncompete agreement. Under this poorly drafted rule, nonsolicitation, nondisclosures, and forfeiture agreements could all run afoul of the FTC's interpretation," Sean Heather, senior vice president for international regulatory affairs and antitrust at the U.S. Chamber of Commerce, said in a statement. The Chamber has been leading pushback against the proposed ban.

Neither the FTC nor the Chamber said they have data indicating just how many NDAs could be considered de facto noncompetes.

The proposal lists only two possible examples: an employee NDA "written so broadly that it effectively precludes the worker from working in the same field" after moving on, and obligations for the individual to pay for training costs if their employment ends within a defined period and the amount they're on the hook for "is not reasonably related to the costs the employer incurred for training the worker."

The proposed rulemaking makes clear that those two examples are not the only possible kinds of de facto noncompetes. The rulemaking also expresses concern that similar workplace policies could have the same effect as a noncompete if employees think those policies "are binding, even if they do not impose a contractual obligation." Specifically, the NPRM points to employee handbook language that may state that workers are barred from going to competitors.

"Therefore, the commission also seeks comment on whether non-compete clause should be defined not only as a 'contractual term' between an employer and a worker, but also as a provision in a workplace policy," the proposal states.

Kohn agreed that NDAs can have a powerful chilling effect. Even if certain kinds of disclosures are allowed under such agreements, "these types of restrictions will shut them up," he said. "They're very intimidating. So most employees do the easy thing and just will not violate these things."

And the NDAs themselves are just the beginning of the chilling effect, as employees are often threatened with stiff sanctions for violating their agreements, which could include paying for their employer's legal costs, Kohn said.

The legal costs of fighting an NDA, even successfully, was an important theme of a public comment session the FTC held Feb. 16, where the agency was told that fighting even those noncompetes that a court deems too broad to justify safeguarding corporate secrets is prohibitively expensive.

"We end up telling the employees that if they get sued, they will likely, even if they win, have to pay roughly $100,000 to $150,000 in attorney fees," HKM Employment Attorneys founder Daniel Kalish told the FTC, according to an agency transcript. Thus even employees who prevail in court face potential bankruptcy, he said.

"As a result, most of our employees that we advise make the correct decision in this case, which is not to go to the new company," Kalish continued. "They either decide to stay at the company even though they don't want to or they decide to leave the field altogether."

In an interview, Kalish told Law360 that if the rulemaking goes into effect, employers are bound to turn to their NDAs and other confidentiality provisions.

"You can bet your bottom dollar, companies will come up with alternate ways to keep their employees

from leaving," he said.

Chun similarly said companies will turn to NDAs. He said they'll do it to defend corporate secrets rather than restricting employee mobility.

"Employers have a legitimate interest in protecting their confidential information and protecting their goodwill," he said. If the FTC bans noncompetes, "I would expect that employers would turn to alternative sources to protect those interests."

Glass said firms will need detailed introspection if the FTC ultimately does prohibit noncompetes and the restriction survives inevitable court challenges. Instead of broad nondisclosure language, Glass said companies must identify the information that rivals could use against them and narrow their NDA terms accordingly. "That way it'll stick," he said.

--Editing by Brian Baresch.
