STATES AND NON-COMPETES: WHERE ARE THINGS HEADED?

BY SCHONETTE J. WALKER & ARTHUR DURST[1]

1 Schonette Walker is Deputy Chief of the Antitrust Division, in the Maryland Attorney General's Office. Arthur Durst is an attorney with the Public Advocacy Division in the Office of the Attorney General for the District of Columbia. Neither writes on behalf of their employer; these are their personal views.

I. INTRODUCTION

Over at least the past ten years, a growing body of economic literature has been detailing the pernicious effects of non-compete agreements between employers and employees. Harm to low-wage workers from non-competes is particularly well established. Broadly, the provisions forbid employees from working for competitors of an employer, for a certain period of time and over a defined geographic area.[2] Non-competes also prevent the employee from anywise competing with the employer in the future, including starting a competing business. In this sense, non-competes can be especially problematic for one of the key drivers of the U.S. economy — new small businesses growth.

Ten years of mounting evidence may seem like a long time, but it is not in the context of affecting change in an area of law that goes back far longer. That is partly what is so surprising about the change going on with non-competes –these agreements have been around for so long and yet we don't have a full understanding of their impact. Non-competes have a very long history in common law and date all the way back to the 1400s.[3] A caveat to this condensed history is that non-compete *use* has not been constant; use has grown rapidly recently, thus non-compete circumstances haven't exactly stayed the same.[4] Now, the only constant we see in this longstanding area seems to be change.

II. NON-COMPETES IN BRIEF

Non-competes by definition have anticompetitive aspects.[5] A key issue however is their reasonableness. Reasonableness analyses are built into the common law and the antitrust evaluations of non-competes. Reasonableness under common law requires passing a three-part test to show that the non-compete (1) is no greater than required to protect a legitimate business interest of the employer; (2) is not unduly harmful to the employee; and (3) does not injure the public.[6] Of course, antitrust standards of analysis, whether *per se*, quick look or full rule of reason, all have reasonableness baked in. While not addressing how these agreements should be analyzed through an antirust lens, we acknowledge a growing chorus that, in the antitrust context, employment non-competes are almost always unreasonable and should be presumptively illegal.

2 Eric Posner, *The Antitrust Challenge to Covenants Not to Compete in Employment Contracts*, 83 Antitrust L. J. 165 (2020).

3 Norman D. Bishara & Evan Starr, *The Incomplete Noncompete Picture*, 20 Lewis & Clark L. Rev. 497, 504 (2016).

4 Around 20 percent of workers are currently under a non-compete agreement. See e.g., FTC Transcript from "Non-Competes in the Workplace" 118 (Jan. 9, 2020), https://www.ftc.gov/system/files/documents/public_events/1556256/non-compete-workshop-transcript-full.pdf; Conor Dougherty, *How Noncompete Clauses Keep Workers Locked In*, N.Y. Times, May 13, 2017, https://www.nytimes.com/2017/05/13/business/noncompete-clauses.html (quoting Russell Beck, '"Companies of all sorts use them for people at all levels,' he said. 'That's a change.'").

5 Bishara & Starr, *supra* note 3, at 506.

6 E.g. *Reliable Fire Equipment Co. v. Arrendondo*, 965 NE. 2d. 393, 396 (2011).

III. NON-COMPETES HARM WORKERS

The economic literature will continue to develop, but already there is a clear signal coming through: non-compete agreements are suppressing wages. Perhaps the best evidence of this comes from Oregon. It banned non-competes for hourly workers, which resulted in increased wages and job mobility.[7] Further evidence comes from Hawaii, which banned non-competes for technology workers, resulting in a 4 percent increase in new-hire wages in the technology sector.[8] This evidence supports the notion that non-competes may be harmful even for higher wage employees.

Aside from reduced wages for workers, there is a greater realization that non-competes have negative externalities (i.e. they are harmful to people not party to the contract). The harmed third-parties are proximately other workers in the same labor market that suffer depressed wages and the potential market entrants that have difficulty attracting necessary workers, as discussed more below.[9] Finally, consumers also suffer because innovation is reduced because there is less information flow and entry within an industry.

IV. NON-COMPETES HARM INNOVATION

That non-competes can slow innovation takes on a different meaning in light of the fact that industries can cluster in specific areas. For example, the 65 miles around Dalton, Georgia is responsible for the lion's share of the country's carpet production.[10] And the San Francisco Bay Area needs no introduction as the center of the computer technology industry. Likewise, for New York City with finance.[11] The same goes for Detroit with cars. The way industries gather in a geographic area is known as agglomeration economies. One reason for this phenomenon is due to knowledge spillovers within an industry. In other words, employees gain knowledge at a company, and when they leave to go to a competitor or start their own company, their knowledge is shared with new people, yielding new ideas and innovation. If non-competes slow down labor movement, it makes sense that innovation might be stifled because access to a common labor pool has been a main reason firms have naturally tended to co-locate near each other. We are staying out of the debate of whether California's ban on non-competes has caused the phenomenon of Silicon Valley,[12] but point out that one of the reasons that industries cluster is to benefit from a pool of employees, and the benefits to the industry from that labor pool are lessened when non-competes become prevalent.

---

7 Michael Lipsitz & Evan Starr, *Banning Noncompete Agreements Benefits Low-Wage Workers*, Univ. Chicago, ProMarket (Oct. 18, 2019), https://promarket.org/2019/10/18/banning-noncompete-agreements-benefits-low-wage-workers/ ("[T]he noncompete ban increased average hourly workers' wages by 2-3 percent, rising to 6 percent five years after the ban was implemented. Moreover, because only 14 percent of the hourly-paid population signs noncompetes—and we cannot distinguish which ones in our data—our estimates of the earnings effect is an average across those who did and did not sign noncompetes. If we scale our estimates by the proportion of workers who actually signed noncompetes, the effect on noncompete signers may be as large as 14-21 percent, though spillover effects in the labor market likely mean that the true effect was somewhat lower.").

8 Natarajan Balasubramanian et al., *Locked In? The Enforceability of Covenants Not to Compete and the Careers of High-Tech Works*, (U.S. Census Bureau Center for Econ. Studies Paper No. CES-WP-17-09) (2017).

9 *Id.* at 132 ("What we're learning is that in occupations in labor markets where you have more non-competes and more stringent enforcement, you seem to have less entrepreneurship, less innovation . . . ").

10 Charles Davidson, *Carpeting on a Roll in Georgia*, Fed. Reserve Bank of Atlanta, Econ South (2006), https://www.frbatlanta.org/regional-economy/econsouth/econsouth-vol_8_no_4-carpeting_on_a_roll_in_georgia.

11 See Paul Krugman, *Increasing Returns and Economic Geography*, 99 J. Pol. Econ. 483, 485 (1991) ("[T]he concentration of several firms in single locations offers a pooled market for workers with industry specific skills, ensuring both a lower probability of unemployment and a lower probability of labor shortage. Second, localized industries, can support the production of non-tradable specialized inputs. Third, information spillovers can give clustered firms a better production function than isolated producers."); Ellison, et al. *What Causes Industry Agglomeration? Evidence from Coagglomeration Patterns*, 100 Am. Econ. Rev. 1195 (2010) (confirming Alfred Marshall's proposed reasons why industry concentrate in geographic areas, including knowledge transfer).

12 See Russell Beck, *Misconceptions In the Debate About Noncompetes*, Law360 (July 8, 2019), https://www.law360.com/articles/1174776/misconceptions-in-the-debate-about-noncompetes.

V. NON-COMPETES HARM ENTREPRENEURSHIP & COMPETITION

Employment non-competes can stymie the creation of smaller "disrupter" entrepreneurs in an industry. This stymieing happens because of (1) the mere existence of non-competes, (2) enforcement of non-competes, (3) difficulty hiring qualified personnel because of non-competes, and (4) higher non-compete enforceability levels in certain jurisdictions which tend to inhibit "spin outs" or startups within an industry.[13] Even without a non-compete ever being enforced or litigated, it can result in harm to entrepreneurship. They may, in themselves, deter individuals from leaving their jobs to start a competing enterprise.[14] This *in terrorem* or chilling effect may be related to just the fact that the former employee is subject to a non-compete; it may also be related to threats or reminders by an employer that a non-compete exists. Likewise, when a former employer actually sues to enforce a non-compete, this can prevent a start-up from entering a market if the lawsuit is successful and may delay entry even if the lawsuit is unsuccessful.[15]

Non-competes also can have an impact on the availability of key labor inputs for start-ups because they may prevent the hiring of prospective employees. Anecdotal complaints from start-ups unable to hire qualified employees because of non-competes are common.[16] And although some larger firms may be willing to take on the risk of hiring an employee subject to a non-compete, even to the point of litigation, many smaller and growing firms are unable to take on that risk and are therefore blocked from hiring needed talent and entering certain markets.

The degree to which a state is welcoming (or not) to non-competes, including how easy (or not) a non-compete is to enforce, likely also affects some entrepreneurship. Studies have shown that start-ups launch at lower rates and have a harder time attracting talent where employment non-competes are strictly enforced.[17] One study found that enforcement of employment non-competes decreases the creation of spinout firms within an industry.[18] And, for those spinouts that are created in the same industry, they start larger, stay larger, and survive longer than other new ventures.[19] Because some of this reduced entrepreneurship is the result of a sort of Darwinian weeding out of weaker start-ups, some consider this a social good. This however is a shortsighted since the proliferation of fewer, larger competitors leads to market concentration, for products and for labor, which is currently of great concern. To give an example, when Florida increased enforceability of employment non-competes in 1996, large firms moved to or were established in the state faster than small firms, resulting in more large-firm employment and higher labor market concentration.[20]

Similar impediments to entrepreneurship related to non-compete enforceability is seen following IPOs or acquisitions. Typically, following events like IPOs or acquisitions in biotech industries, there are spikes in entrepreneurship. This response, however, is muted in states with stronger enforcement of employment non-competes.[21]

As the debate on non-competes continues and new evidence sharpens the picture, governments and employees might not be the only ones seeking a future with fewer non-competes, but employers may as well. After all, non-competes make it harder for firms to hire employees. Also, aside from self-interested motives, it may become apparent at least to the leaders of the largest companies that non-compete agreements may be at odds with their public statements through the Business Roundtable and similar organizations that say they will serve all their "stakeholders," including employees.[22]

---

13 For the purposes of this article "spinout" means firms founded by employees who leave their previous employer to start a new firm. Posner, *supra* note 2, at 188; Evan Star, Natarajan Balasubramanian & Mariko Sakakibara, *Screening Spinouts? How Noncompete Enforceability Affects the Creation, Growth, and Survival of New Firms*, 64 Mgmt. Sci. 552, 552-53 (2018).

14 Bishara & Starr, *supra* note 3, at 539.

15 Florence Shy-Acquaye, *The Effect of Non-Compete Agreements on Entrepreneurship: Time to Reconsider?*, 10 U. Puerto Bus. L. J. 92, 100 (2019) (describing a former employee sued by former employer soon after starting business who spent six months litigating a settlement).

16 *Id.* (business owner unable to hire qualified employees because non-competes prevented work for competitors).

17 Karla Walter, Center for American Progress, *The Freedom to Leave, Curbing Noncompete Agreements to Protect Workers and Support Entrepreneurship*, 3. (2019).

18 Posner, *supra* note 2, at 188.

19 Bishara & Starr, *supra* note 3, at 526.

20 Posner, *supra* note 2, at 188.

21 Bishara & Starr, *supra* note 3, at 523.

22 *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans*,' Bus. Roundtable, (Aug. 19, 2019), https://www.business-

Currently, in the Eighth Circuit, two trucking companies' hiring practices have led to litigation. The defendant trucking company hired the drivers of a competitor that bound its drivers with employment agreements tied to training in exchange for reduced pay and a ten-month non-compete. This case provides an example of an employer (Transam Trucking) who likely would prefer a world with fewer non-competes. Judge Stras dissented from the panel decision that reversed the dismissal of the plaintiff's claims by noting that the dispute was "about competition for long-haul truck drivers . . . [and that] [t]ortious interference with contract is not about favoring some business models over others."[23] With cases like this and non-competes becoming more prevalent, companies who do not use non-competes may become more public about the use and impediments of non-competes in their industry.

VI. BROAD JUSTIFICATIONS FOR NON-COMPETES ARE NOT SUPPORTABLE

It's worth recalling justifications that have supported non-competes. There are principally two: 1) to protect and encourage the sharing of trade secrets within the company and 2) to encourage and protect an investment in training employees. However, the general difficulty for an employee to change jobs renders these justifications less relevant.[24]

Moreover, to the extent a goal of a non-compete is to protect certain business assets, the use of the non-compete is a remarkably inefficient tool. If we examine just a limited number of examples, we see that there are other more specific areas of law to address the protection of assets the former employer desires. A major argument for the use of non-competes is that the former employee may have access to trade secrets of the former employer and may use those trade secrets in her employment with a new employer or use them in her own new start-up business. The non-compete however is not the best tool to fight that misappropriation of a business asset. A leading scholar in this field "[r]eview[ed] the variety of mechanisms that may be used to protect intangible assets" and came to the conclusion "that using noncompetes is a part of a 'belt-and-suspenders' approach to IP protection...[and][t]his approach relies on the assumption that more protection is always better, but this assumption is faulty."[25]

Indeed, other instruments like non-disclosure agreements, confidentiality agreements and/or intellectual property laws are arguably more appropriate. NDAs and CAs are contracts that can have clearly spelled out penalties for breach, including liquidated damages. Some argue that resorting to these contract terms amount to seeking redress after the fact and that is inadequate because the trade secrets may have been disclosed already. But a trade secret could be divulged or stolen by a current employee just as easily, and the remedies would be similar if not the same: an action for theft of intellectual property. Indeed, many employers may have found that resort trade secret litigation is the right tool to protect corporate secrets. A 2018 report showed that the Central District of California had more trade secret lawsuits in the last decade than any other district in the country.[26] There could be a number of reasons for this and the fact that California courts do not enforce employment non-competes may very well be a contributing factor.

Proponents of non-competes will also point to the protection of customer lists and goodwill as additional justification for post-employment restrictive covenants. Again, there are less restrictive alternatives to using non-competes that potentially thwart or destroy competition — the non-solicitation agreement. With this provision, the former employee may not solicit customers of her former employer. Breach of this provision will likely involve the payment of damages from the breaching former employee to the former employer. This approach addresses a specific potential problem with a specific tool — not an overbroad restriction with a propensity to harm workers and lessen competition.

---

roundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

23 *CRST Expedited, Inc. v. Transam Trucking, Inc.*, No. 18-2633 at 16 (8th Cir. 2020) (J. Stras, dissenting).

24 See Posner, *supra* note 2, at 181-182 ("If real-world labor market frictions often prevent employers from switching jobs, then these frictions should also enable employers to invest in general human capital and intangible assets like good will and trade secrets. A noncompete is necessary only to the extent that those frictions fall short. The benefit of a noncompete should thus be understood in marginal terms.").

25 Viva R. Moffat, *The Wrong Tool for the Job: The IP Problem with Noncompetition Agreements*, 52 Wm. & Mary L. Rev. 873, 911 (2010).

26 https://www.hklaw.com/en/insights/publications/2018/08/california-district-leads-nation-in-trade-secret-l (last visited July 13, 2020).

VII. STATES ARE TAKING ACTION

With no federal rule or law controlling non-compete agreements, several states, whether through their Attorneys General or their Legislatures, have been acting against non-competes. At the end of last year, the Washington State Attorney General's Office settled a case against a coffee chain that included a non-compete provision in employment agreements with all of its retail employees.[27] On the legislative front, in June, Virginia joined a trend of states that bar enforcement of non-competes against low-wages workers (defined as earning less than the weekly average of a Virginia worker).[28] Indiana also recently created new requirements for non-competes with doctors, including that the doctor have the option to buy out the provision for a "reasonable price."[29] Maryland's legislature also passed a low-wage worker non-compete prohibition in 2019.[30]

VIII. POTENTIAL NON-COMPETE PROBLEMS IN THE FUTURE — NEXT CONSIDERATIONS

As with many things, the COVID-19 pandemic may change how non-competes are viewed. Mass layoffs and furloughs are impacting dozens of industries and millions of workers. A company that furloughs or lays off a worker and then attempts to enforce a non-compete may face a different environment in a courtroom that looks to whether a non-compete provision violates public policy. A few states already prohibit the enforcement of a non-compete if the employee was terminated without cause, but many are undecided.[31] If companies try to enforce non-competes, some courts may have the opportunity to answer the question of whether an employee terminated without cause is still subject to the provision.

As companies eventually hire workers back to replace their ranks, a good indication that a company is not being thoughtful about its non-compete policies is when non-competes are wholesale required for *all* employees. Although many of those companies may never expect to enforce a non-compete even if they have the opportunity, the existence of the non-compete does damage outside of the courtroom, too. They can "gum up" the hiring process by increasing uncertainty for current and former employees and prospective employers. Hopefully such companies will reconsider blanket non-compete policies as they hire employees back. Still, the likely relative scarcity of jobs will give employers more of an ability to have an employment contract that includes an abusive non-compete.[32]

A possible next area of consideration, study and state activity may be the other contract provisions that usually accompany non-competes: confidentiality, non-solicitation provisions, etc. The most likely candidate of these other provisions is the non-solicitation agreement prohibiting recruiting former fellow employees. This type of provision seems less harmful than non-competes, but at the same time also offers much less justification. We struggle to see the procompetitive benefits of employees silenced from sharing job opportunities or extolling the benefits of a new employer; this is in contrast to the former employee actively soliciting customers of her former employer.

Finally, states seem likely to continue defining different regulatory regimes for different types of workers and for different income levels. There may be significant pushes across the country to get more legislation passed to ban abusive non-competes. These legislative changes will provide further evidence and natural experiments for economists and researchers to determine the full effects of non-competes.

---

27 Press Release, Attorney General Bob Ferguson Stops King County Coffee Shop's Practice Requiring Baristas to Sign Unfair Non-Compete Agreements (Oct. 29, 2019) https://www.atg.wa.gov/news/news-releases/attorney-general-bob-ferguson-stops-king-county-coffee-shop-s-practice-requiring.

28 Garen E. Dodge & Nathaniel M. Glasser, Virginia Prohibits Non-Compete Agreements with *"Low-Wage" Workers*, Nat'l L. Rev. (June 23, 2020), https://www.natlawreview.com/article/virginia-prohibits-non-compete-agreements-low-wage-workers.

29 Michael W. Padgett & Robert Frederick Seidler, Indiana's New Restrictions on Physician Non-Compete Agreements, Nat'l L. Rev. (May 6, 2020), https://www.natlawreview.com/article/indiana-s-new-restrictions-physician-non-compete-agreements.

30 https://www.forbes.com/sites/tomspiggle/2019/08/13/how-maryland-is-continuing-the-trend-of-restricting-non-compete-agreements/#1c91d97e7463 (last visited 7-14-2020).

31 See Russell Beck, *Employee Noncompetes: A State by State Survey*, Beck Reed Riden, (April 27, 2019) https://www.beckreedriden.com/wp-content/uploads/2019/04/Non-competes-50-State-Survey-Chart-20190427.pdf. A helpful chart to see both whether a state considers public policy in enforcing a non-compete and whether a non-compete is enforceable against an employee terminated without cause.

32 Josh Eidelson, *How the American Worker Got Fleeced*, Bloomberg, July 2, 2020, https://www.bloomberg.com/graphics/2020-the-fleecing-of-the-american-worker/ ("The pandemic certainly could give employers even more power to set the rules.").

IX. CONCLUSION

A lot has changed with non-competes in the last ten years. Our understanding of the impact of non-competes and their prevalence is much improved. So far, it's clear that the prevalence and harms from non-competes have been under-appreciated. Further study and understanding seems likely at least in part because the states, at various levels, are reacting to this new information. Indeed, many states are enacting new and stricter legislation to regulate non-competes, especially as they impact low wage workers. This will create more opportunities for natural experiments related to these employment provisions. Additionally, we expect there will be further scrutiny of the additional contract provisions that usually accompany non-competes.

CPI COMPETITION POLICY INTERNATIONAL

CPI Subscriptions

CPI reaches more than 35,000 readers in over 150 countries every day. Our online library houses over 23,000 papers, articles and interviews.

Visit competitionpolicyinternational.com today to see our available plans and join CPI's global community of antitrust experts.