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Protecting Competition in the Marketplace

The Case for Reforming Non-Compete Agreements

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> *You must distinguish sharply between being pro-free enterprise, which I am, and being pro-business, which I am not. Those are two different things. The reason I am pro-free enterprise, the reason I am for a free market on a political level, is primarily because I believe the problem in this world is to avoid a concentration of power, to have a dispersal of power. Unless we have a dispersal of power we will not have a free society. —Milton Friedman, "Big Business, Big Government" (video, 1978)*

Defining the Problem

Noncompete agreements are "contracts that impose restrictions on an employee's ability to join or start a business in competition with his or her prior employer or solicit a prior employer's employees or customers during a prescribed time period following the employee's departure," according to an article in the *Buffalo Law Review*.[1] Noncompete agreements have a long history within English common law.[2] However, their prevalence has recently obtained renewed attention.[3] This spotlight has highlighted the urgency of reforming noncompete agreements to cultivate economic freedom in the twenty-first century.

Research suggests noncompete agreements bind at least 20 percent of the workforce.[4] It is true that professionals within specialized industries are more likely to sign noncompetes.[5] But there is also sufficient data[6] and anecdotal evidence[7] to show that noncompetes are being used for segments of the workforce where they were never intended to be used, such as hair stylists, fast food workers, and interns.[8] This pervasiveness has had widespread negative effects on economic mobility, which in turn has resulted in adverse effects for workers, entrepreneurs, and the American public.[9]

Workers have felt the effect of noncompete agreements through a reduction in wages.[10] Theoretically, the opposite should occur. Employees should be able to use the process of signing noncompete agreements to bargain for higher wages. However, this presumes the process of forming a noncompete agreement is transparent, which is a mistaken assumption. For instance, a survey of engineers found that of those who had signed noncompete agreements, only around 30 percent were provided with the noncompete agreement with their offer of employment, while the remaining roughly 70 percent received the noncompete sometime later.[11] Thus, instead of raising the bargaining power, and therefore wages,[12] of workers, noncompete agreements lower wages by limiting job-hopping, critical to wage growth in early careers.[13] They also reduce the incentive for employers to pay their employees' labor value on the open market.[14]

Entrepreneurship is another casualty of the excessive use of noncompetes. Noncompete agreements reduce the capacity for employees to create start-ups.[15] They also make it more difficult for start-ups to attract talented employees.[16] One interviewee of a study[17] surveying those bound by noncompetes said, "I consciously excluded small companies [from my job search] because I felt I couldn't burden them with the risk of being sued. [They] wouldn't necessarily be able to survive the lawsuit whereas a larger company would."[18] Research suggests this quote to be less an isolated occurrence and more a representation of how noncompete agreements scare talent away from start-ups.[19]

This is worrisome for several reasons. First, the US business start-up rate remains close to historically low levels,[20] an alarming fact when one realizes start-ups drive economic innovation to a significant degree as entrepreneurs serve as "carriers of knowledge spillovers," according to a paper from the Institute of Labor Economics.[21] Especially when one considers research suggesting 70 percent of the decline in economic dynamism is due to a slowdown in knowledge diffusion, contracts created with the express purpose of limiting knowledge diffusion should be treated with due caution.[22] Second, a reduction in start-ups (and small businesses more generally) means less competition in the marketplace and the expansion of market power for existing firms.[23] While market concentration driven by market forces is not inherently problematic, market concentration driven by government policy is. When businesses rely upon consumers for their market power, they invest in a better product; when they rely upon the government, they invest in more lobbyists.

Legitimate arguments can be made in favor of noncompetes. One common justification is that they reduce hiring costs by decreasing turnover.[24] But there is a serious issue with this justification—noncompetes by no means serve as the only way to reduce turnover. Rather than taking their employees hostage, businesses can alternatively keep their employees by raising wages or aligning company values with the workforce.[25] These alternative strategies increase employee retention without the injurious macro-level effects previously described.

Tied to this argument is research suggesting the enforceability of noncompetes is positively correlated with employer investment in the human capital of employees.[26] While this is a fair concern, it is important to recognize that little research suggests this translates into higher wages or outweighs the harm done by lower knowledge spillovers.[27] Furthermore, it is relevant to note that the causal relationship between noncompete agreements and personnel investment may be mistaken; employers may not be investing more in their employees because their investments are protected, but rather because noncompete agreements prevent them from hiring workers with the skill sets they are looking for, thus requiring investment in current employees.

A few defenders of noncompete agreements may also highlight research suggesting noncompete agreements have a positive effect on employee motivation.[28] While there is too little concurrence to come to this conclusion, comparing the explanations for whether they boost or depress motivation is telling.[29] Those who argue that noncompete agreements decrease employee motivation underscore how

noncompetes sever the link between hard work and more economic opportunities, as industrious employees are unable to take their experience elsewhere if not adequately compensated. On the other hand, those who see noncompetes as improving employee motivation highlight how employees no longer have to fear not only losing their jobs due to a mistake, but losing access to the industry in which they are most experienced and most likely feel the most fulfillment. This may not be an either/or situation, as both forces may exist. Nevertheless, normatively, these two forces are not the same; the former is based upon the hope for a better future and the latter is based upon a fear of career ruination.

Recommendations

Noncompete agreements serve as a chain on economic dynamism and require reform. But they do not require elimination. Noncompetes serve a purpose in protecting intellectual property, especially when that property is difficult to safeguard using a nondisclosure agreement. Activists wishing to ban noncompete agreements entirely are forgetting the historic basis of noncompetes within common law.[30] They also fail to recognize how outlawing noncompetes completely could have unintended consequences.[31] Instead, reforms should focus on shrinking the size of the workforce constrained by noncompete agreements and on curtailing their more abusive elements. There are several practical solutions which would accomplish this without excessively expanding the authority of government. Ideally, these reforms would happen at the state level, which would allow for a systematic evaluation of their effects.

First, employers should be required to provide prior notice to applicants that a position requires signing a noncompete agreement.[32] By reintroducing transparency to the partnership, job applicants would be able to leverage the potential loss of income in the future to obtain higher income in the present or to use that information to decide that a position would not be a proper fit for them. Employers could also shift away from the use of noncompete agreements as they discover their adoption scares talent toward rival companies which do not require them. In particular, laws should require businesses to clearly disclose that a position requires a noncompete agreement at the time of a job offer, or, preferably, in the job posting.

Second, in an effort to incentivize employers to shift away from noncompete agreements, employers should be required to offer continued payment for the duration of the contract, often referred to as "garden leave." By increasing the cost of noncompetes for employers, businesses are forced to reconsider which positions truly require noncompete agreements and whether it would be sensible to shorten the duration of the agreement.[33] By aligning the costs of noncompetes for the employer with the costs for the worker, garden leave laws can direct the behavior of firms toward the public interest. While the principle of requiring garden leave is more important at this juncture than the exact value of that garden leave, 50 percent of the employee's most recent salary is an increasingly common amount.[34]

On the judicial level, states should direct courts toward a red-pencil analysis of noncompete agreements which requires courts to declare an entire noncompete agreement null and void if there are elements found to be illegal under state law.[35] This is in contrast to blue-pencil analysis, used in most parts of the country, which allows judges to eliminate or rewrite elements of a noncompete agreement found to be in violation of state law while keeping the remaining elements in force. While blue-pencil analysis is noble in its quest to smooth over contracting disputes between employer and employee, it creates the wrong incentives for businesses that realize there is no systemic consequence for creating overly broad noncompete agreements. This incentive structure is intensified by the fact that few noncompete agreements go to court.[36] Thus an overly broad contract will likely be fully complied with, even if it is illegal.[37]

However, judges should maintain enough discretion to revise noncompete agreements to fit laws which were legislated after the noncompete agreement was formed. Putting the emphasis on red-pencil analysis is meant to reduce the employer's incentive to misuse them, not punish them for lacking omniscience.

Finally, state attorneys general should be empowered to go after illegal noncompete agreements on the explicit request of the individual bound by the agreement. While those bound by noncompetes currently have the legal right to challenge them, they often lack the financial resources to do so. Giving state attorneys general the right to challenge a specific noncompete at the request of a complainant would balance the scales and shift employers toward a more sparing use of noncompete agreements.

However, a word of caution is in order. Requiring the explicit request of a complainant is required for this policy change to operate properly. Giving state attorneys general the unilateral power to open an investigation shifts bargaining power not from the employer to the employee, but rather from private enterprise to public enterprise. An overactive state attorney general remains a concern even with this restraint, which is why it should be considered only if the other policy prescriptions have been exhausted without much effect.

Concluding Thoughts

None of these policy prescriptions should be perceived as driven by hostility toward business. Rather, they come from a view that innovation and economic prosperity are reliant upon institutions which incentivize ingenuity and hard work.[38] Cautiously revising these institutions to meet new circumstances is the proper responsibility of policymakers. The rampant use of noncompete agreements in the workplace suggests that the current institutional framework deserves revision guided by admiration for competition and respect for the enterprise of entrepreneurs and the industry of workers. The pervasiveness of noncompete agreements impedes competition, restrains enterprise, and discourages industriousness. Thus, policymakers must reform noncompetes to ensure the United States remains an innovative society which serves workers, entrepreneurs, and the public by enshrining competition in the marketplace.

Endnotes

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