

EXPERT ANALYSIS

Moving Toward a Federal-State Approach To Noncompete Regulation?

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There has been a recent trend toward shedding light on and addressing anti-competitive business practices with respect to noncompete provisions — agreements between employers and employees preventing the employee from later joining a competitor¹ — which are currently exclusively regulated by state law.

Approximately 18 percent of American employees are subject to some form of noncompete agreement.² According to one study, published court decisions in noncompete cases have doubled since 2000.³ And no noncompete commentary this year would be complete without referencing the recent high-profile settlement between Jimmy John's and the New York attorney general over the sandwich chain's use of noncompete agreements for its low-wage sandwich makers.⁴

State attorneys general are not the only regulators who have set their sights on improper noncompete practices. Indeed, federal oversight seems imminent. Just last year, Democratic U.S. Sens. Al Franken of Minnesota and Chris Murphy of Connecticut proposed federal legislation limiting the use of noncompetes for employees who make less than \$15 an hour.⁵

In March, a U.S. Treasury report⁶ kicked off a series of executive branch recommendations relating to noncompete regulation, including a White House report⁷ and a White House call to action encouraging states to implement noncompete reforms.⁸ While this executive branch push for noncompete reform is likely to wane or perhaps even disappear with the upcoming change in administrations, various states have echoed or responded to this call to action.⁹

The term "noncompete" itself connotes that these provisions are uniformly anti-competitive, but the agreements are an important feature of the employer-employee relationship and can yield pro-competitive benefits to both parties and to the economy as a whole.

However, the recent increase in state and federal attention to noncompete use responds to new data suggesting that the current regulatory scheme, which is solely dependent on state law, is insufficient to curb noncompete use that is anti-competitive in nature.

NONCOMPETE THEORY

Agreements not to compete may seem antithetical to free market theory, but it is beyond dispute that they can secure legitimate employer interests, unlock employee value, and provide a suitable environment for fair competition and economic growth.

Employers are often characterized as the biggest beneficiaries of strong noncompete regimes. Indeed, one of the oft-heralded benefits of noncompetes for employers is that they can be used to prevent an employer's trade secrets from being revealed to competitors.



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However, significant benefits can also inure to employees in jurisdictions that enforce noncompetes. A noncompete provision is a bargaining chip that employees willing to commit to a single employer for a period of time may use to capture value in the form of higher compensation, additional benefits and/or increased training.

And noncompetes can strengthen the economy as a whole. They incentivize innovation through the protection of ideas, increase worker productivity by incentivizing employer investment in employees, and produce efficiency gains by facilitating the matching of employees unlikely to leave and employers willing to train.

NONCOMPETE PRACTICE

While noncompetes can substantially benefit employers, employees and the broader economy, the current state statutory schemes that exclusively regulate noncompetes appear insufficient to efficiently capture these benefits and deter practices that result in social loss.

Proponents of the current state-driven regime must deal with the following reality, as summarized in the executive branch reports referenced above.

Studies suggest that noncompete agreements are used — inadvertently or not — for reasons other than to protect trade secrets. Less than half of all employees with noncompetes possess trade secrets, and many employees without four-year college degrees and employees earning less than \$40,000 a year (i.e., employees unlikely to possess trade secrets) are subject to noncompete agreements.

Furthermore, it is unclear whether the current noncompete system is producing higher compensation or increased training for employees. The research on this topic is inconclusive.

On one hand, states that strictly enforce noncompete agreements have lower wage growth and lower employee mobility than states that do not enforce them. On the other hand, the rate at which wages increase over time (as a proxy for training) is higher in minimally enforcing states than in strictly enforcing states.

Finally — and also contrary to noncompete theory — employees more likely to stay with one employer are not more likely to work for employers who require noncompetes.¹⁰

MISUSE OF NONCOMPETES RESULTS IN INEFFICIENCY

The mismatch between theory and practice manifests itself in costs to employers, employees and the economy, with the latter two bearing the brunt of the burden. For employers, an ineffective noncompete regime results in diminished quality and quantity of available employees.

As the recent research suggests, noncompete use may not be resulting in the predicted increase in workforce training, and noncompetes undoubtedly decrease the number of employees legally available for hire.

Additionally, noncompetes create litigation risk for employers — regardless of whether the employer is hiring or parting ways with an employee subject to a noncompete.

For employees, the harms are obvious and significant. Mobility and choice are restricted. Employees subject to noncompetes often may have no choice but to leave industries in which their skill sets offer competitive advantages.

And it is now taken for granted that noncompetes improve employer leverage in negotiations with employees, and actually result in a lower cost of labor (i.e., wages) and lower costs associated with employee turnover.

The broader economy also suffers from an inefficient noncompete scheme. Reduced employee mobility makes it less likely that employers will find employees for whom they would be best suited, and therefore aggregate productivity decreases. Ineffective noncompete use can lead to reduced innovation if ideas and know-how are restricted in an anti-competitive manner.

THE INFORMATION GAP

In theory, noncompete use should not result in net benefits to employers, because employees who are willing to sign noncompetes should also be able to bargain for an appropriate increase in compensation, benefits or training.

So why the disconnect?

One of the chief culprits is the lack of informational parity between employers and employees. In many instances, employees do not know about noncompete provisions until they release their leverage by accepting an offer of employment or rejecting competing offers. Employees often do not understand the meaning of noncompete provisions. Nor do they negotiate noncompete provisions, such that they would be able to capture a better title, more responsibility, or increased compensation, benefits or training.

Even in jurisdictions such as California, which has effectively outlawed noncompetes with extremely limited exceptions,¹¹ employees are subject to noncompetes at a rate that is higher than the national average.¹²

FEDERAL REGULATION: CLOSING THE INFORMATION GAP

Anything resembling a federal uniform noncompete act is nowhere on the horizon. But given recent federal and state legislative trends, it is not too soon for employers to prepare for some level of federal oversight over the current state regulatory regime.

Indeed, the White House recently encouraged state implementation of three best practices:

- Banning noncompetes for certain categories of workers.
- Improving transparency and fairness of noncompete agreements.
- Incentivizing employers to write enforceable contracts.¹³

But these executive branch suggestions for state policy are not necessarily suitable for federal implementation. Overbroad federal legislation may be too heavy-handed for a number of reasons. For starters, it would drastically shift employer and employee expectations, run contrary to traditional notions of federalism, and fail to allow sufficient room for states to promote their legitimate local interests. And ambiguous and opaque laws at the federal level could do more harm than good.

Federal legislators, however, may find noncompetes to be uniquely suited for some level of federal regulation. States have already been acting in their traditional roles as laboratories of democracy — producing diverse and multifaceted noncompete laws that vary from state to state, at least in application — the effects of which are ripe for federal legislative consideration. Noncompetes also affect national labor and wage trends such that limited federal legislation may be appropriate.

If there is to be federal noncompete regulation, it should borrow from existing state law and focus on addressing the information gap between employers and employees, or otherwise facilitating the bargaining necessary to promote efficient matching between employee and employer. Such potential policies include:

- Requiring the presentation of noncompetes to employees prior to acceptance of a job offer, which would increase employee awareness and ability to bargain (as in New Hampshire and Oregon).

Noncompete agreements are an important feature of the employer-employee relationship and can yield pro-competitive benefits to both parties and to the economy as a whole.

A noncompete provision is a bargaining chip that employees willing to commit to a single employer for a period of time may use to capture value in the form of higher compensation and other benefits.

- Requiring separate consideration other than an indefinite term of continued employment for noncompete provisions (as in Wyoming and, to some degree, in the District of Columbia, Illinois and Mississippi).

This approach, targeted at the free flow of information and encouraging bargaining, allows the federal government to avoid a position that is overtly pro-employer or pro-employee while permitting states to retain their traditionally wide berth to continue to tailor their noncompete laws to their own economic realities and objectives — whether by choosing to shift the playing field to favor employer or employees (or certain groups of employers or employees) or choosing not to act at all.

The list of actual and potential state noncompete regulations is practically endless.

For instance, some states may exempt certain categories of employees, such as low-wage or junior employees, from noncompetes. Other states may promote the growth of industries of local priority by exempting those sectors from noncompetes and encouraging talent to migrate to the state.

Some states may discourage truly anti-competitive noncompete use by completely voiding noncompetes that are overbroad in any respect, applying unfair competition laws to noncompete abuse and implementing fee-shifting provisions into noncompete statutes.

These laws have obvious effects on employers and employees. But determining whether and which of them are appropriate is a decision best left to state policymakers, to conform to each state's unique economic landscape as well as employer and employee demographics.

Pro-competitive noncompete use undoubtedly benefits all parties involved, and anti-competitive noncompete use results in social loss. Limited federal legislation to address the information gap between employers and employees may be appropriate, whereas a comprehensive federal noncompete scheme — apart from the issue of whether such legislation could actually pass — would improperly tilt the playing field in favor of the employer or the employee and impinge on an area best left to state regulation.

NOTES

¹ As used herein, “noncompete” primarily refers to these provisions. Elsewhere, the term has been understood to include provisions preventing employees from soliciting a former employer's clients or employees.

² Olav Sorenson & Matthew Marx, *Restricting Employment Restrictions*, YALE INSIGHTS (Nov. 21, 2016), <http://insights.yale.edu/insights/restricting-employment-restrictions>.

³ Ruth Simon & Angus Loten, *Litigation Over Noncompete Clauses Is Rising*, WALL ST. J., Aug. 14, 2013, <http://www.wsj.com/articles/SB10001424127887323446404579011501388418552>.

⁴ *Jimmy John's agrees not to enforce noncompete agreement*, CHICAGO SUN-TIMES, June 22, 2016, <http://chicago.suntimes.com/news/jimmy-johns-noncompete-agreements/>.

⁵ S. 1504, 114th Cong. (2015-2016), <https://www.congress.gov/bill/114th-congress/senate-bill/1504>.

⁶ U.S. Dep't of the Treasury, Office of Economic Policy, *Noncompete Contracts: Economic Effects and Policy Implications* (March 2016), <https://www.treasury.gov/resource-center/economic-policy/Documents/UST%20Noncompetes%20Report.pdf>.

⁷ The White House, *Noncompete Agreements: Analysis of the Usage, Potential Issues, and State Responses* (May 2016), https://www.whitehouse.gov/sites/default/files/noncompetes_report_final2.pdf.

⁸ THE WHITE HOUSE, *STATE CALL TO ACTION ON NONCOMPETE AGREEMENTS*, <https://www.whitehouse.gov/sites/default/files/competition/noncompetes-calltoaction-final.pdf>.

⁹ National Law Review, *Federal Attack on Noncompetes Likely Another Casualty of Election*, Nov. 21, 2016; see, e.g., Shira Schoenberg, *Lawmakers try to reach end-of-year agreement on noncompete bill*, MASS LIVE (Nov. 22, 2016, 5:10 PM), http://www.masslive.com/politics/index.ssf/2016/11/lawmakers_try_to_reach_end-of-.html; Mark Iandolo, *New York attorney general to introduce legislation aimed at curbing*

misuse of noncompete agreements, LEGAL NEWSLINE (Nov. 1, 2016, 9:24 AM), <http://legalnewsline.com/stories/511036426-new-york-attorney-general-to-introduce-legislation-aimed-at-curbing-misuse-of-noncompete-agreements>.

¹⁰ These findings are explored in detail in the reports cited in footnotes 6 through 8.

¹¹ See CAL. BUS. & PROF. CODE § 16600 (Deering 2016)..

¹² See NONCOMPETE CONTRACTS, *supra* note 6, at 12.

¹³ Thomas E. Wallerstein, *White House Call to Action to Limit Noncompetes*, VENABLE LLP: TRADE SECRETS & TRANSITIONS (Nov. 1, 2016), <http://www.tradesecretsandtransitions.com/2016/11/white-house-call-to-action-to-limit-noncompetes/>.



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