I Wish They All Could Be California

Why Noncompete Critics Are Singing the Wrong Song

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Arguments criticizing noncompete agreements stem from flawed analyses and fail to take into account their full beneficial economic effect.

Noncompete agreements are facing a steady attack from various circles in the business, legal, political, and academic communities. Those attacks are often coupled with calls on state legislatures to ban or to limit the agreements drastically. Individuals argue that banning or limiting such agreements will help innovation and economic development to flourish. As facially appealing as those arguments might appear in a depressed economic environment, they ignore the positive effect noncompete agreements have on the economy. Reasonably tailored noncompete agreements do protect legitimate business interests and can exist without impeding innovation. In fact, noncompete agreements, as well as other types of restrictive covenants, promote and cultivate innovation and serve vital roles in a knowledge-based economy by protecting entrepreneurs' ideas, investments, goodwill, and other legitimate business interests.

The degree of criticism directed to noncompete agreements may be relatively new, but noncompete agreements themselves are not. In fact, they have been around and enforced for hundreds of years. *See* Harlan M. Blake, *Employee Agreements Not to Compete*, 73 Harv. L. Rev. 625, 625–46 (1960) (discussing the history of noncompete agreements and explaining that such issues have been before the courts for more than 500 years). Indeed, based on the recent intensity with which noncompete agreements have been attacked, someone might think that current employment practices resemble those used long ago to protect commercial interests in Venice, a significant center of economic development during the middle ages. *See*, *e.g.*, Leo Huberman, *Man's Worldly Goods: The Story of the Wealth of Nations* (Harper & Brothers Publishers 1936) (discussing a 1594 Venetian law: "'If a workman carry into another country any art or craft to the detriment of the Republic, he will be ordered to return it; if he disobeys, his nearest relatives will be imprisoned, in order that the solidarity of the family may persuade him to return;



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if he persists in his disobedience, secret measures will be taken to have him killed wherever he may be.'"). Although some employers in the current century might prefer the methods available in 15th century Venice to those currently available, the authors of this article certainly do not suggest that we return to those measures.

Nearly every state honors a restrictive covenant in some form as long as the restriction's duration, geography, and scope are reasonable. However, just as every rule has its exception, public policy on enforcing noncompete agreements does too. California and North Dakota generally prohibit noncompete agreements. *See* Cal. Bus. & Prof. Code §16600 (West 1941) and N.D. Cent. Code §9-08-06 (1943). Clearly, state laws treat noncompete agreements differently across the nation, and as illustrated by recent legislative developments in Georgia and Massachusetts, individual state policies about noncompete agreements change.

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Georgia has long had a history as an unfriendly territory for noncompete agreement enforcement. However, in 2010 voters overwhelmingly approved an amendment to the Georgia Constitution that permitted the state legislature to pass laws making it significantly easier to enforce noncompete agreements. *See* Randy Southerland, *New Non-Compete Laws Could Lead to Litigation*, Atlanta Business Chronicle, May 20, 2011. Conversely, other states have introduced legislation to make it more difficult to enforce noncompete agreements. *See* H.B. 0016, 97th Gen. Assem. (Ill. 2011); H.B. 2293, 187th Gen. Ct. (Mass. 2011); H.B. 2296, 187th Gen. Ct. (Mass. 2011); S.B. 932, 187th Gen. Ct. (Mass. 2011). The bills introduced in Massachusetts have drawn a significant amount of attention because two of the bills—House Bill 2296 and Senate Bill 932—would follow California's lead and effectively prohibit noncompete agreements if enacted. *See also* H.B. 1187, Va. Gen. Assem (Reg. Sess. 2012). The Virginia bill would make unlawful any contract that serves to restrict an employee or former employee from engaging in a lawful profession, trade, or business of any kind. It provides for exceptions for persons selling a business, former partners in a partnership, and former members in a limited liability company. Should other jurisdictions take California's lead and make noncompete agreements unenforceable? A careful review indicates that the answer is an emphatic "NO."

Flawed California Dreamin'

Critics of noncompete agreements often point to California, particularly Silicon Valley, as an example of the economic development that is possible when employees are free from the shackles of noncompete agreements. According to this argument, California companies and employees are "thriving" because of California's ban on noncompete agreements. *See* Scott Kirsner, *Some Common Sense on Noncompete Clauses*, Boston Globe, July 3, 2011 (stating that "California seems to do pretty well creating large and small companies without the protection of non-compete agreements."). The ban theoretically creates "high-velocity labor markets" with "greater employee mobility, ease of start-up, flow of lawful, nonproprietary information, across firm lines, patenting, and growth." Alan Hyde, *Should Noncompetes Be Enforced*, Regulation, Winter 2010–2011, at 6, 10–11. In other words, banning noncompete agreements promotes innovation.

Critics in Massachusetts have been particularly interested in this argument due to recent suggestions that "the main reason for the success of the high technology industrial district in Silicon Valley and the failure of the one in Massachusetts' Route 128 was the differential enforcement of [covenants not to compete]." Franco and Mitchell, *Covenants Not to Compete, Labor Mobility, and Industry Dynamics*, 17 J. Econ. & Mgmt. Strategy 581 (2008). However, notably and consistently absent from this argument are the following facts and statistics about California. First, as of October 2011, unemployment in California was approximately 40 percent higher than Massachusetts. California's unemployment rate was 11.4 percent while Massachusetts's was 7.2 percent, and California had the second highest unemployment rate in the country. Regional and State Employment and Unemployment—October 2011, News Release, Bureau of Labor Statistics. Second, California had more venture-capital flameouts, outdueling Massachusetts. *See* Robert Buderi, Silicon Valley Beats Boston in VC-Backed Flame-Outs, Too, xconomy, Oct. 2, 2009, http://www.xconomy.com/boston/2009/10/02/silicon-valley-beats-boston-in-vc-backed-flameouts-too/.

Overlooking the facts that California has the nation's second highest unemployment rate, a significant level of venture-capital flameouts, and a well-publicized budget deficit, what would lead anyone to believe that California has done it right? Nothing, as it turns out. Companies increasingly have decided not to commit resources to business operations in California due to its unfriendly business climate. Tami Luhby, *California Companies Fleeing the Golden State*, CNNMoney.com, July 12, 2011. In addition, some legal scholars suggest that Silicon Valley is not easily replicated and that its success is attributable "to factors beyond the legal framework of covenants not to compete." Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment*, 27 Berkeley J. Empl. & Lab. L. 287, 309, 318 (2006). Even Californians have questioned the wisdom of the state's laid-back approach toward noncompete agreements. Brandon R. Blevans, *Thou Shalt Not Compete!* (*Unless You Want To*), North Bay Biz.com, March 2010 (describing California's business climate as "almost comical when you realize that one set of our laws so promotes competition that it allows your employees to engage in almost unfettered competition with you—even to go so far as to set up a competing business right next door, using the know-how, contacts and information they gained from working with you").

The Common Misconception About Noncompete Agreements

Noncompete agreements are commonly perceived as completely barring individ-

uals from earning livelihoods. That simply is not true. An enforceable noncompete agreement in most states can only reasonably limit competition by narrowly tailoring duration, geography, and scope restrictions, and it also must protect the legitimate business interests of the party seeking its enforcement. *See*, *e.g.*, *Rehmann, Robson & Co v. McMahan*, 187 Mich. App. 36, 46; 466 N.W.2d 325 (Mich. Ct. App. 1991); *Lowry Computer Products, Inc. v. Head*, 984 F. Supp. 1111, 1113 (E.D. Mich. 1997). To the extent that a court deems a noncompete agreement unreasonable, it will not enforce the restrictions.

A real-world example will illustrate these points. A male employee works for a staffing company as a sales manager. He has a noncompete agreement that prohibits him from competing against that staffing company for a period of one year after he no longer works for the company within the market area for which he offered service—the state of Texas. This prohibition is restricted to a narrow and focused industry—the staffing industry. The prohibition is further limited to the market area in which the employee worked and for which he or she had responsibility—Texas. The employee, therefore, has many opportunities to work for other companies in a plethora of other industries inside of the restricted market area and even for competitors in areas outside of the restricted market area. He could even work in a truly noncompetitive position for a competitor in the restricted market area. The employee is not unduly restricted from earning a livelihood by the noncompete agreement. The employee just has to move or ply his or her trade in a territory outside of a limited territory that his former employer seeks to protect. *See*, *e.g.*, *Kelly Services v. Marzullo*, 591 F. Supp. 2d 924 (E.D. Mich. 2008) ("[former employee]" will only be precluded for working for [competitor] in the Texas market for one year. He can still work in the Colorado market and any other area where he did not work for [the former employer]").

In the Massachusetts debate, critics have drawn attention to *Zona Corp. v. McKinnon*, 28 Mass. L. Rptr. 233 (Mass. Super. Ct. Mar. 14, 2011) as a "prime example" of why the state should ban noncompete agreements. However, this case actually shows how a *reasonably* tailored and effective noncompete agreement can permissibly protect a legitimate business interest.

In *Zona Corp.*, a company operating two hair salons hired a recent graduate of a cosmetology school as a licensed hair stylist. The company required the hair stylist to sign a noncompete agreement that prohibited him from competing against the salon within the salon's market area, a seven-town area, for a period of one year after he stopped working for the salon. The noncompete agreement did not completely prevent the employee from earning a livelihood. The employee only would need to move his services to an area outside of the seven-town restricted area. *Id.* ("[former employee] is free to work anywhere in Massachusetts so long as it is not in the seven specified towns that [his former employer] serves…. [and such] restrictions are consistent with protecting the [former employer's] good will.").

The above examples show that reasonably tailored and effective noncompete agreements do not completely restrain an employee's ability to earn a livelihood; rather, they reasonably restrict work options.

Noncompete Agreements Are Voluntary

States vary widely in their enforcement of noncompete agreements. In some states an employer may require that certain employees sign noncompete agreements as a condition of employment, but an employee can certainly refuse to sign the agreement and seek employment elsewhere. *See*, *e.g.*, *Kelly Services v. Marzullo*, 591 F. Supp. 2d 924 (E.D. Mich. 2008) (discussing the potential harm suffered by the employee by not being able to compete in Texas the judge noted "this is certainly a risk he calculated and undertook both when he first signed the Agreement and when he decided to leave [the former employer] and go work for a competitor."). If you don't like it, as the saying goes, you can certainly leave it.

How Does Banning Noncompete Agreements Affect Innovation and Investment?

The primary argument advanced by critics of noncompete agreements is that by restricting employee mobility, noncompete agreements inhibit innovation. In other words, "How many start-ups were never created… because the would-be founders were tied to existing companies by non-competes?" Alison Loborn, *Free Labor Market*, Commonwealth, Summer 2009, 33. However, that argument focuses only on the would-be innovator, and completely overlooks the established entrepreneur. Any valid discussion of noncompete agreements requires the consideration of each perspective.

Nearly every state honors a restrictive covenant in some form as long as the restriction's duration, geography, and scope are reasonable.

Many areas of innovation and business development take considerable amounts of time, trial and error, and cost. Entrepreneurs and their investors invest and risk time, blood, sweat, tears, and a significant amount of money taking ideas from conception to reality. An entrepreneur wouldn't have incentive to invest in an idea and train and develop employees if one of those employees could take the idea, the customer base, or both, move across the street, and unfairly compete against the entrepreneur. Without adequate protection from such blatant theft of an entrepreneur's business, a former employee could unfairly step into the entrepreneur's shoes and reap the benefits without having to put in the time, money, and effort to develop an idea or business, as well as without any of the associated risks.

An entrepreneur and his or her investors would undoubtedly be reluctant to invest in a project or an idea that someone else could copy or otherwise undermine with abandon. Although investors complain about the lost opportunities that can result when innovators sign noncompete agreements, those same investors frequently and

hypocritically require noncompete agreements from employees of all of the projects that they fund. *See* Alison Loborn, *Free Labor Market*, Commonwealth, Summer 2009, 35–36. Noncompete agreements create an important incentive to innovate and protect an entrepreneur's and his or her investors' innovation. Banning noncompete agreements would remove that incentive and protection and stifle innovation by abandoning protections for innovation.

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Banning Noncompete Agreements Would Negatively Impact "Other" Employees

Critics of noncompete agreements often fail to look at how banning noncompete agreements might potentially affect a large number of workers. If a former employee can immediately go to a direct competitor, take the former employer's information or customer contacts or base, and directly compete with the former employer because the employer didn't have a noncompete agreement in place or only had a nonsolicitation or nondisclosure agreement in place, what protects a business and its other employees from the associated business losses? *See*, *e.g.*, *Lowry Computer Products, Inc. v. Head*, 984 F. Supp. 1111, 1116 (E.D. Mich. 1997) (noting that if a former employee "is working for a direct competitor in a similar area, their knowledge *is bound* to have a significant impact on [the former employer's] business."); *Kelly Services, Inc v. Noretto*, 495 F. Supp. 2d 645, 659 (E.D Mich. 2007) ("[I]t is entirely unreasonable to expect [a former employee] to work for a direct competitor in a position similar to that which he held with [the former employer], and forego the use of the intimate knowledge of [the former employer's] business operations…. Absent an order for preliminary injunction, it appears that [a former employee's] expansive knowledge of [the former employer's] business systems and operations will result in a loss of the customer goodwill developed by [the former employer]. Furthermore, [the former employer] will be forced to labor under the burden of unfair competition resulting from the informational asymmetry presented by its direct competitor having an employee with intimate knowledge of its operations").

Simply put, without adequate noncompete protection a company could lose business or go out of business and numerous other employees could potentially lose their jobs, which would obviously have a negative economic impact. Indeed, the founder of one Massachusetts electronics company has stated that the effect on his company of losing his employees to a rival or having his employees start their own competing companies "could be devastating. It could put [my entire company] out of business." Scott Kirsner, *Some Common Sense on Non-Compete Clauses*, Boston Globe, July 3, 2011.

Studies Suggesting a "Brain Drain" Are Inconclusive

Noncompete agreement critics have cited some recent economic studies to support their challenges to restrictive agreements. One such study "examined" the effect of noncompete agreements on employee mobility. *See* Marx, Strumsky, and Fleming, *Mobility, Skills, and the Michigan Noncompete Experiment*, 55 Mgmt. Sci. 875 (2009). The study focused on employee mobility after the Michigan legislature enacted the Michigan Antitrust Reform Act (1985), which seemingly inadvertently repealed a long-standing statute that had made noncompete agreements illegal; shortly after passing the bill the legislature amended it, establishing a reasonableness standard for noncompete agreements in the state. Problematically, much of the study centered on patent filings in Michigan since 1985, which the authors acknowledged had drawbacks. The authors did, for instance, note that their statistical analysis was based on imperfect matching of inventors across patents and imperfect observations of job changes.

Based on that imperfect analysis, the Marx study "cautiously" suggested that noncompete agreements discouraged employee mobility and that such agreements inadvertently created a "brain drain" of the workers needed to create and build successful new firms. Importantly, though, the Marx study did not directly conclude that noncompete agreements thwarted innovation and economic growth; it concluded that they only impeded worker mobility. However, it appears to suggest indirectly more to the casual reader. *See*, *e.g.*, Bluestein and Barrett, *Stop Enforcing Noncompetes*, Inc.com, http://www.inc.com/magazine/20100701/stop-enforcing-noncompetes.html, July 1, 2010 (citing the study by Marx, Strumsky, and Fleming and suggesting that non-compete agreements should not be enforced "[b]ecause we need to promote competition for labor and talent among start-up companies in fast-growing industries").

While the Marx study is interesting and an admirable undertaking given the inherent difficulty of analyzing noncompete agreements and their effects on innovation and economic growth, the study has too many flaws to be instructive, much less convincing. First, using patent filings as a basis to measure the MARA's effect on employee mobility fails to account for various other factors that could affect patent filings, such as the automobile industry's continuous outsourcing during the study period, for example.

Second, while noncompete agreements and patents are sometimes gathered under the same general "protection of intellectual property" umbrella, they simply do not go hand-in-hand in practice as the study suggests. Indeed, the authors of this article have handled hundreds of noncompete and trade secret cases and only a handful of them have directly involved patent claims or issues.

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Third, as the Marx study recognizes, we must consider the economic effect of noncompete agreements on employers alongside the economic effect on individuals. This point seems lost on those that would use the study in efforts to bar noncompete agreements.

Noncompete agreements can protect confidential and proprietary business information, trade secrets, and customer relationships in a variety of industries, many of which do not file patents. Patents do offer protection to inventors and entrepreneurs, but disputes over noncompete agreements do not typically also involve patent disputes. Accordingly, suggesting that patent filings, noncompete agreements, and employee mobility significantly correlate misunderstands what noncompete agreements do, as does indirectly suggesting that they correlate with innovation and economic growth.

Conclusion

Reasonably tailored noncompete agreements, along with other types of restrictive covenants, promote and nurture innovation and serve to protect entrepreneurs' ideas, investments, goodwill, and other legitimate business concerns. The arguments presented by critics of noncompete agreements fail to take into account the full beneficial economic effect of such agreements. These arguments stem from flawed analyses, and the empirical evidence used to support the arguments is unconvincing. Reasonably tailored noncompete agreements do not prevent individuals from earning livelihoods. Proposing that states outlaw or limit such agreements fails to account for their potential benefits to businesses and employees generally. Further, arguing that California companies and employees are thriving due to a business climate free of noncompete agreements lacks merit as evident from California's chronically woeful economic condition. Noncompete agreements have played important roles in market economies for centuries, and there is no legitimate basis to change the legal landscape today. FD