POTENTIAL FEDERAL REGULATION OF COVENANTS TO NOT COMPETE

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INTRODUCTION

The competition among companies for customers is obvious, but behind the scenes there is also fierce competition among these companies for the talent that develops and markets their products. One strategy companies employ to prevent a competitor from stealing top talent (and potentially also trade secrets or other confidential information) is to require employees to agree, in advance, that at the end of their employment they will not work for any competitor for a specified period of time, often a year or more. One of the most significant problems in employment law is the diversity of state law on enforcing these covenants not to compete (non-competes).[i] Some states freely enforce these agreements; some states enforce them in narrow circumstances; and a few states, including California, prohibit them altogether. Because employees are mobile, often moving to obtain new and better employment, this inconsistency creates uncertainty and in some cases a "race to the courthouse," with litigants trying to find the forum friendliest to their positions. Because the markets served by large companies and the talent pool they hire from are often nationwide, which implicates interstate commerce, the federal government could intervene and adopt a uniform, national rule. This paper will explore the pros and cons of adopting pro-noncompete federal regulation, anti-noncompete federal regulation, or leaving the issue for states to solve.

HISTORY

In the 15th, 16th, and 17th centuries, the courts of England invalidated noncompetes for two reasons: the value to society of keeping skilled labor in the public domain and maintaining the employee's right to seek a livelihood.[ii] In the 18th century, case law began to change. British

courts found that these partial restraints on trade could be enforceable if they were reasonable, that is, if they were specific to a time or place, not general in nature, and if employers could demonstrate an economic necessity for the restriction.[iii] These two conflicting concerns (the importance of free moving labor versus the importance of preventing unfair competition) are the foundation for the modern noncompete debate.

Current Use and Trends

According to a 2018 study, 18% of the labor force was bound by a noncompete in 2014, and 38% had been at some point in the past.[iv] This is a testament to the ubiquity of noncompetes in the modern labor market.[108] In addition, not all noncompetes are signed at the beginning of employment, when an employee has the option to sign or just look for other employment. One in three noncompetes is requested after the employee has already accepted the job and has made "employer specific investments" (i.e., moving or turning down other offers).[v] In that situation, the employee appears to have significantly lower bargaining power, and this is reflected in the data. Employees who sign noncompetes *before* accepting a job have better pay, training, access to relevant information, and job satisfaction than those who were required to sign after they had begun employment.[vi]

The Diversity of State Law

Most states, including Washington, Massachusetts, and Minnesota generally accept and enforce noncompetes. In these states, judges conduct balancing tests similar to those described above in English common law, enforcing the agreements if they are reasonable in scope and in what they protect the company from.[vii] In *Perry v. Moran* (1987) the court found that a

[108] Starr et al. found that 12% of employees without a bachelor's degree who earn less than $40,000 a year will sign a noncompete every year. This is a serious issue but will not be addressed due to space and because it is nearly universally frowned upon, inspiring the proposal of an act of congress to address it (the MOVE act), but not much debate.

noncompete "for a reasonable time and within a reasonable territory, as may be necessary for the protection of the interests of the employer without imposing undue hardship on the employee, is valid."[viii] The different states balance these factors slightly differently, but the parts of the equation are all the same, stemming from common law.[ix]

Other states impose statutory restrictions on the enforcement of noncompetes. Oregon takes a creative stance on noncompete enforcement.[x] In order for a noncompete to be enforceable, Oregon requires the employee to be notified of requirement at least two weeks before accepting the job, the employer to have legitimate interest in enforcement, the employee to be compensated for the agreement, and for it to last less than 2 years.[xi]

California, Colorado, North Dakota, and Oklahoma all categorically reject noncompetes as antithetical to public policy.[xii] Statute §16600 of the California State Code states "except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."[xiii] This makes California the ideal state for an employee who no longer wishes to be bound by her previous noncompete to sue a former employer to try to get out of such an agreement. The California courts are not shy about applying these laws, even in cases that seem to have little connection to the state. In *Application Group v. Hunter* (1998), the court found that it could apply the California law against noncompetes and refuse to enforce an agreement between a Maryland employee and her old Maryland employer, because the new company she wanted to join was based in California.[xiv] In this case, the employee in question would, if hired, continue to live in Maryland during her employment.[xv] The Maryland employment agreement even specified in a "choice of law" clause, that Maryland law would apply to any dispute about the agreement. California used the "red pencil doctrine"[xvi] to remove this provision from the contract. In this case, California assumed a

right to impose its law because the California court determined California had more interest in the dispute than the other state.[xvii] Despite the state's hostile view of noncompetes, 19% of workers in California are bound by a noncompete, suggesting that employers foresee an ability to enforce outside of California. [xviii]

Due to the diversity of state law, choosing a litigation venue is vital to a litigant's strategy. If the dispute over a noncompete agreement is fought in a California court, this may lead to invalidating a noncompete that another state's courts would have enforced. In contrast, in a dispute in a Washington court, an employer is more likely to have its agreement enforced.[xix] The judicial system generally prohibits trying the same case in multiple courts. So, the first state to hear the controversy is usually the one to see the issue through.[xx] This creates a situation where parties have incentives to sue fast and thereby pick the potentially favorable forum. Some state courts, notably California's, have been generous in allowing jurisdiction in a good faith attempt to protect their citizens' legitimate interests. This "race to the courthouse" disproportionately favors the departing employee, who usually knows all the facts (the fact that she has a job offer from a competitor) before her previous employer does. (This fact pattern is contrary to common perception that the employer has more power in noncompete litigation due to their superior resources.[xxi])

ANALYSIS

General Arguments for Federal Involvement

- Solves jurisdictional problems resulting in fairness and predictability
- Protects a person's ability to reasonably expect the fulfillment of a contract
- Preservation of constitutionally mandated judicial roles

Any federal law concerning noncompete enforcement would preempt conflicting state laws. This would adopt a uniform standard for enforcement nationwide and would reduce the forum shopping by parties to noncompete disputes. With only one law, the question of where to sue becomes less relevant. A nationwide standard and decreased incentive to look for a favorable court would create predictability for all involved.

The courts' ruling in *Home Insurance Co. v. Dick* (1930) implies that due process requires that a party to a contract be free of surprise in the process of adjudicating a claim.[xxii] Under the current system, two parties located in the same state can sign a contract in that state and choose that state in a choice of law provision. A reasonable person would be surprised to have to enforce that contract in another state under unforeseen, conflicting laws. The court said the U.S. Constitution's guarantee of due process means that people are entitled to know what law is governing their actions to be able to abide by it. In *Allstate co. v. Hauge* (1981), Justice Brennan asserted that "'change in residence to forum state' before filling suit is not, by itself, sufficient to justify application of forum law."[xxiii] This sets a precedent that implies noncompete cases decided on recent moves are not valid. Unfortunately, noncompete cases rarely receive appellate review. Most challenges stop because cases are rendered moot by the expiration of the terms of the contract before any higher appeals courts can rule on them.

<u>Arguments for the Federal Government to Invalidate all Noncompete Agreements</u>

- Employee Mobility and ownership of human Capital
- Promoting competition

The government has an interest in making sure that employee skills are a public good. As a part of working for a particular company a given employee gains human capital. Human capital is the combination of education, trade secrets, mundane knowledge about office management,

client relationships, and any training an employee has received on the job.[xxiv] This leads to the questions about who owns this capital. The company invested time and resources in bringing in this person and in training him or her. The employee, on the other hand, is the vessel for this knowledge and, beyond that, is an autonomous person with significant legal rights. Stone argues that this is part of an employee's compensation in a changing workplace because part of what people are compensated with is future marketability.[xxv]

If the federal government were to ban noncompetes, it would significantly increase employee mobility. The employee would be free to take his or her human capital to the public, to choose a job that realizes his or her full potential, or to open a new company. New companies increase competition which will benefit the public. Companies who want new talent are free to pursue it. When employees cannot work in their industry of expertise, their human capital is removed from the market and allowed to stagnate.[xxvi]

The burdens of a noncompete are especially heavy when employees get fired without cause. Getting fired in this manner has increased ramifications on the right of that person to work as they cannot apply their expertise to the relevant industry and employees fired in this manner have likely made no effort to account for a period of time when they cannot work at their highest earning potential. Even for those who are not fired, noncompetes can still cause problems: an employee with a noncompete is less likely to look for opportunities to get a better job or make more money because the noncompete creates a significant barrier to beginning that process. If the noncompetes are not enforced, then employees have more room to innovate and create competing products and services free from interference after their employment ends.

Arguments for the Federal Government to Protect Noncompete Agreements

- Protects employers and any investments in training employees
- Protects Trade Secrets
- Help to keep labor cost reasonable and therefore lower consumer cost for goods

One of main reasons employers use noncompetes is to help protect their trade secrets; the agreements can prevent or at least delay the loss of confidential information (known by a departing employee) to a competitor. Some argue that enforcing existing trade secret rules would adequately protect the employer's interests without damaging employee mobility.[xxvii] This is a good idea in theory but the law has to take in to account practice. In practice, trade secret violations are very hard to prove. It is difficult to establish who had an idea first, if the competitor had thought of the idea before the new employee was hired, if the employee even knew that particular trade secret in the course of their duties, and many other questions of the kind. All of these disputes will be costly to fight out in court. Noncompetes simplify the protection of confidential information.

Noncompetes also facilitate employer investment in training and employee access to job-related trade secrets.[xxviii] Employers argue that they need noncompetes to protect the investments that they make in employee training, which can be costly and time consuming for a company. Noncompetes are a profit-maximizing tool for companies by "depressing wage growth, enhancing productivity through training, information sharing, lowering turnover costs, lowering product-market competition by preventing valuable info and skills from reaching competitors."[xxix] Companies argue that they need these benefits in order to remain competitive and produce goods at a cost that consumers can afford. The employer has a legitimate interest in keeping other companies from "free riding" by hiring an employee who has specialized

knowledge and training provided by and specific to that employer's company.[xxx] The law is unfriendly to "free riding," and intellectual property rights “promote innovation by allowing owners to prevent others from appropriating much of the value derived from their inventions or original expressions."[xxxi] In noncompetes, the proprietary information is contained in a free person. However, the court has consistently found that the innovations of a company belong to that company.[xxxii] Even the individual who invents the innovation does not have a right to it if they were hired to come up with it.[xxxiii] This establishes a legal precedent to support using noncompetes to protect employers by showing that having knowledge does not translate to a right to use that knowledge however one pleases.

The country and the market would both benefit from the enforcement of noncompetes. As established above, noncompetes are instrumental in protecting secrets, which increases innovation, and in facilitating investment and training. Establishing a uniform national rule would result in less forum shopping and more predictability, so that no single state, e.g., CA, would benefit from having laws that let its companies raid employees from other states with noncompetes, and would keep costly trade secret litigation to a minimum by replacing it with simpler noncompete cases.

Arguments for the Status Quo

- Federalism and innovation
- Lack of national consensus among states or companies

Some, if very few, noncompetes and employment arrangements involve no interstate commerce at all. In these cases, federal oversight would be unconstitutional and violate the principles of federalism. This may not be a significant barrier since the market is interstate. Despite changes in the economy in the past few decades, it is reasonable to assume states still

have unique interests that are harmed by federal preemption. Additionally, the public may benefit by allowing states to continue to be, as Justice Brandeis described, "laboratories of democracy".[xxxiv] If a standard federal system is imposed, states may stop coming up with innovative laws. There will be no way to try new ideas on a small scale to test their viability. States who want to innovate will have their hands tied. The current system certainly comes with extra costs as it also allows companies to choose locations/headquarters. Some companies go to California (Google, Apple) where there are no noncompetes, but others go to Washington (Microsoft, Amazon) where the agreements are enforced. The fact that large tech companies with many high skilled workers have chosen different states with very different noncompete policies suggests that companies do not all agree on what the best policy is. Similarly, the diversity of state law suggests that the United States lacks a national consensus on noncompetes. Therefore, federal intervention would be contrary to what the legislators of some states have found to best protect their interests.

CONCLUSION AND PERSONAL STATEMENT

Given current trends in practice, the most practical way to impose constitutionally-valid practices in noncompete enforcement is federal regulation that enforces reasonable noncompetes. The difficulty of proving trade secret cases makes a solution based on intellectual property law too burdensome on courts and parties. A broad federal law could contain limits on noncompete practice. It could protect employees with regulations on duration, income, and other factors.

The government has a legitimate interest in enforcing fair noncompetes signed by autonomous adults. The law is only legitimate if its effects can be reasonably predicted and uniformly applied. The system needs to reward good faith efforts to follow the law and enforce legitimately constructed contracts. Noncompetes have the potential to optimally balance the

importance of employee mobility (to employees and the economy) with the need to protect company investments in people and technology, as well as to prevent unfair competition.

As a person who tends to side with legal formalists, I am wary of increasing federal oversight of something as fundamental as the right to work. However, I think that the current interstate discrepancy raises a serious constitutional question when states claim jurisdiction over cases that are at best tangentially related; it also poses practical problems. I would rather have a single, if imperfect, law, than 50 different laws, which creates inconsistency and unpredictability. In the first scenario, every person who signs a contract can reasonably predict the consequences of their actions and rely on the legal protection of it. Our economy relies on a trust that contracts will be fulfilled. Enforcing noncompetes creates stability and rewards innovation in the market.

Footnotes

[i] Viva R. Moffat* (2012). ARTICLE: Making Non-Competes Unenforceable. *Arizona Law Review, 54,* 939.
[ii] U.S. Department of the Treasury Office of Economic Policy (March 2016). Non-compete contracts: economic effects and policy implications
[iii] *Ibid*
[iv] Starr, Evan and Prescott, J.J. and Bishara, Norman D, Noncompetes in the U.S. Labor Force (September 12, 2018). U of Michigan Law & Econ Research Paper No. 18-013. Available at SSRN: https://ssrn.com/abstract=2625714 or http://dx.doi.org/10.2139/ssrn.2625714 p.2).
[v] Starr, Evan and Prescott, J.J. and Bishara, Norman D, Noncompetes in the U.S. Labor Force (September 12, 2018). U of Michigan Law & Econ Research Paper No. 18-013. (p.3)
[vi] *Ibid*
[vii] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[viii] *Perry v. Moran*
[ix] Phillip D. Thomas + (2018). ARTICLE: Would California Survive the MOVE Act?: A Preemption Analysis of Employee Noncompetition Law. *University of Chicago Legal Forum, 2017,* 823
[x] Melissa Ilyse Rassas* (Winter, 2009). Comment: Explaining the Outlier: Oregon's New Non-Compete Agreement Law & the Broadcasting Industry. *University Of Pennsylvania Journal Of Business Law, 11,* 447.
[xi] ORS §653.295
[xii] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xiii] California Code §1600. Note: This statute's exceptions are incredibly narrow.
[xiv] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xv] Phillip D. Thomas + (2018). ARTICLE: Would California Survive the MOVE Act?: A Preemption Analysis of Employee Noncompetition Law. *University of Chicago Legal Forum, 2017,* 823
[xvi] Lara Grow* & Nathaniel Grow** (Summer, 2017). ARTICLE: Protecting Big Data in the Big Leagues: Trade Secrets in Professional Sports. *Washington and Lee Law Review, 74,* 1567.
[xvii] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xviii] U.S. Department of the Treasury Office of Economic Policy (March 2016). Non-compete contracts: economic effects and policy implications p.3
[xix] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xx] Home Insurance Co. v. Dick, 281 U.S. 397
[xxi] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xxii] *ibid*
[xxiii] *ibid*
[xxiv] Katherine V.W. Stone* (February, 2001). ARTICLE:The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law. *UCLA Law Review, 48,* 519.
[xxv] *ibid*
[xxvi] *Ibid*
[xxvii] CHARLES TAIT GRAVES * (Winter, 2010). ARTICLE: Analyzing the Non-Competition Covenant as a Category of Intellectual Property Regulation. *Hastings Science & Technology Law Journal, 3,* 69.
[xxviii] *ibid*
[xxix] Starr et al.
[xxx] David A. Linehan* (2012). ARTICLE: Due Process Denied: The Forgotten Constitutional Limits on Choice of Law in the Enforcement of Employee Covenants Not to Compete. *Utah Law Review, 2012,* 209.
[xxxi]The U.S. Treasury Department (2007) Antitrust Guidelines and Policy Statements § 114.

[xxxii] Catherine L. Fisk + (Fall, 1998). ARTICLE: Removing the 'Fuel of Interest' from the 'Fire of Genius': Law and the Employee-Inventor, 1830-1930. *65,* 1127.
[xxxiii] *Ibid*
[xxxiv] Justice Louis Brandeis in *New State Ice co. v. Liebmann* (1932).

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