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From Michigan To Washington:

Proposed Legislation To Ban Non-Competes Could Have A Chilling Effect On Innovation And Economic Growth[1]

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INTRODUCTION

Non-compete agreements continue to face a steady attack from a variety of circles in the business, legal, political and academic communities. Those attacks are often coupled with calls on state legislatures to ban or drastically limit enforcement of restrictive covenant agreements. Indeed, recently proposed legislation in both Michigan (House Bill 4198) and Washington (House Bill 1926) seeks to ban outright non-compete clauses in employment agreements. In 2014, Massachusetts state legislators also considered a bill to severely limit non-compete agreements as part of Governor Patrick's proposed economic recovery legislation; however, the economic bill ultimately passed did not include any change to non-compete laws in Massachusetts. Yet, the effort to ban or severely limit non-compete agreement enforcement has been renewed by the 2015 Massachusetts legislature with at least two new proposed bills being offered to ban most employee non-competes (House Bills 730 and 2157) as well as four other bills that take a more limited approach to restricting non-compete agreements (House Bill 2332, Senate Bill 809, Senate Bill 334 and House Bill 709). On the flip side, Wisconsin's legislature has before it a bill (Senate Bill 69) that would make it easier to enforce non-compete agreements. If enacted, that would be a dramatic change to the landscape of non-compete enforcement in Wisconsin, which has historically been one of the most reluctant of states for non-compete enforcement.

As to the recent and consistent effort to ban or limit non-compete agreements, many arguments against restrictive covenant agreements rely on the premise that in the absence of such agreements, innovation and economic development flourish. As facially appealing as that argument might appear in a depressed economic environment, it ignores the positive effect non-compete agreements have in our economy. Reasonably tailored non-compete agreements do protect legitimate business interests and can exist without impeding innovation. In fact, non-compete agreements, along with other types of restrictive covenants, promote and cultivate innovation and serve a vital role in a knowledge-based economy by protecting entrepreneurs' ideas, investments, goodwill and other legitimate business interests.

The degree of criticism directed at non-compete agreements may be relatively new, but non-compete 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 non-compete agreements and explaining that these issues have been before the courts for more than 500 years). Indeed, based on the recent intensity with which non-compete agreements have been attacked, one might think that the current practices of employers

1 This article is an update of a previous publication by the authors. In light of the uptick in efforts to ban or limit restrictive agreements in other states, the authors believe an update is warranted.

resemble those used long ago to protect commercial interests. *See e.g.*, Leo Huberman, *Man's Worldly Goods: The Story of the Wealth of Nations* (Harper & Brothers Publishers 1936) ("A Venetian law [Venice was one of the centers of significant economic development in the Middle Ages] of 1454 gives us a clue to at least one method: '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; 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 under 15th century Venetian law to those currently available, the authors of this article certainly do not suggest the return of such measures.

Nearly every state honors some form of restrictive covenant (e.g., non-compete, non-solicit, anti-piracy, etc.) so long as the restriction is reasonable as to its duration, geography, and scope of activity. However, just as every rule has its exceptions, so too does state enforcement of non-compete agreements - California and North Dakota generally prohibit non-compete agreements. *See* Cal. Bus. & Prof. Code § 16600 (West 1941) and N.D. Cent. Code § 9-08-06 (1943). Clearly, non-compete agreements are treated differently across the nation and, as illustrated by recent legislative developments in Michigan, Washington, Georgia, and Massachusetts, individual state policies regarding non-compete agreements are subject to variation.

Georgia, a state with a history of being unfriendly territory for non-compete enforcement, recently made it easier to enforce non-compete agreements. 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 non-compete agreements. *See*, Randy Southerland, *New non-compete laws could lead to litigation*, Atlanta Business Chronicle, May 20, 2011. Interestingly, a recent report published by CNBC concludes that Georgia is ranked as the number one state in which to do business. http://www.cnbc.com/id/101767549 . That is interesting to say the least. By the way, California ranked 32nd, Massachusetts and Michigan 25th and 26th, respectively and Washington 7th. One has to wonder even more why states that rank above California on a variety of business metrics would seek to be more like California.

That is what makes it puzzling that states like Michigan, Washington and Massachusetts have introduced legislation to make it more difficult to enforce non-compete agreements. The bills in Michigan and Washington (as well as the bill that ultimately died in Massachusetts) follow California's lead and effectively prohibit non-compete agreements if enacted. Indeed, the bill introduced in Washington is nearly identical to Section 16600 of the California Business and Professions Code, which bars employee non-compete and non-solicitation agreements in California. The efforts to ban non-compete agreements in these states begs the rhetorical question: Should other jurisdictions take California's lead and make non-compete agreements unenforceable? A careful review indicates that the answer is an emphatic "NO."

1. Flawed California Dreamin'

Critics of non-compete agreements often point to California, particularly Silicon Valley, as an example of the economic development that is not only possible, but that which flourishes when employees are free from the shackles of non-compete agreements. Indeed, the author of the bill in Washington, Rep. Derek Stanford (D-Bothell), stated that "California beat us to banning non-compete agreements – back in 1872. We've all heard of the Silicon Valley and companies like Apple, Google, Intel, Adobe and Facebook. These are all companies that thrive in a state where non-compete agreements have been banned for more than 100 years." http://housedemocrats.wa.gov/news/rep-derek-stanford-introduces-bill-to-ban-non-compete-agreements/. According to this argument, California companies and employees are "thriving" because of California's ban on non-compete agreements. They argue that "non-competes stifle movement and inhibit competition." http://www.boston.com/business/technology/innoeco/2013/09/big_shift_governor_patrick_now.html (citing testimony from Gregory Bialecki, Massachusetts Secretary of Housing and Economic Development); see also http://bostinno.streetwise.co/2014/05/28/why-employee-noncompete-agreements-stifle-growth-innovation/ (Guest post contributed by Bijan Sabet, a General Partner at Spark Capital, stating that non-competes stifle innovation). In other words, banning non-compete

agreements promotes "innovation."

However, notably and consistently absent from the "let's be like California" argument are the following facts and statistics about California:

- California has the nation's third highest unemployment rate – higher than Michigan, Washington and Massachusetts. See Bureau of Labor Statistics, Unemployment Rates for States – December 2014 http://www.bls.gov/web/laus/laumstrk.htm

- California was ranked dead last on the 2014 Best & Worst States for Business by Chief Executive Magazine. *See* http://chiefexecutive.net/best-worst-states-for-business-2014#ranking

- California has more than 30% of the nation's welfare recipients – even though California has just 12% of the nation's population. Further, California is the most regulated, highest-taxes most in-debt state in America and ranked number one in poverty. *See* http://www.forbes.com/sites/thomasdelbeccaro/2014/08/19/calfiornias-economic-collision-course-immigration-and-water/

- Business Insider ranked California as one of the worst states for small business in 2014, giving California an "F" for small-business friendliness. http://www.businessinsider.com/these-are-the-best-and-worst-us-states-for-small-business-2014-7

Apart from the nation's third highest unemployment rate, a well-publicized budget deficit, and being consistently ranked as one of the worst states for businesses, what leads anyone to believe California has done it right? Nothing. Why would a state like Michigan want to risk and potentially undo its recent economic success to be like California? Indeed, the following numbers indicate that Michigan (which currently enforces reasonable non-compete agreements and has routinely done so in employment settings since 1985) is doing much better than California:

- For two consecutive years, Michigan was ranked among the top five states for major new corporate facilities and expansions (by Site Selection magazine March 2014).

- Michigan is the most improved state of 2014 for facing challenges of 21st-century competition for jobs and business investment (American Economic Development Institute, July 2014).

- Michigan's venture capital community is outpacing the national trend, with 35 venture capital firms that manage $4 billion in capital (Michigan Economic Development Corporation, July 2014).

2. The Common Misconception about Non-Compete Agreements

Another basis for seismic change in the law related to enforcement of non-compete agreements is the common misperception that they completely bar individuals from earning a livelihood. That simply is not true. In order to be enforceable in most states, a non-compete agreement must be reasonably tailored as to its duration, geography, and scope of activity restricted and also 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 (1991); *Lowry Computer Products, Inc. v. Head*, 984 F. Supp. 1111, 1113 (E.D. Mich. 1997). To the extent a non-compete agreement is deemed unreasonable, a court will not enforce it.

During the recent Massachusetts debate, critics drew attention to *Zona Corp. v. McKinnon*, 28 Mass. L. Rptr. 233 (Super. Ct. Mar. 14, 2011) as a "prime example" of why non-compete agreements should be banned. However, this case actually shows how a *reasonably* tailored and effective non-compete can be used 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 non-compete agreement that prohibited him from competing against the salon (his former employer) within the salon's market area – a seven-town area - for a period of one (1) year after the end of his employment. The non-compete agreement does not completely prevent the employee from earning a livelihood. The employee only has 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.").

More recently, the Jimmy John's experience is looked to for support for banning or limiting non-compete agreements. In this example, fast food sandwich shop Jimmy John's has asked its sandwich makers and delivery personnel to sign a very broad, two year non-compete agreement. In connection with the roll out of that restrictive agreement, Jimmy John's has been subject not just to a public relations nightmare for requiring its low wage employees to sign such agreements, but it has also been the subject of a Congressional investigation and a similar proceeding in New York.

The Jimmy John's example is not a good one in these authors' views. In fact, we believe that the company was simply wrong in using the restrictive agreements at issue and should not have rolled out any such agreement with its lower level employees. Realistically, if Jimmy John's wanted to protect itself, we believe that a confidentiality or non-disclosure agreement as to these lower level employees would have sufficed. Had it used such an agreement instead, Jimmy John's likely would not have met any criticism, much less government investigation.

Our view is one supported by the practical reality involving enforcement of non-compete agreements-- ones that are reasonably tailored do not completely restrain an employee's ability to earn a livelihood; rather, they are reasonably limited in duration, geography, and scope.

3. Non-Compete Agreements are Voluntary

States vary widely in their enforcement of non-compete agreements. Regardless of the state, signing a non-compete agreement is voluntary. An employer may require that certain employees sign a non-compete agreement 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) (In 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, you can leave it.

4. The Claim that Non-Compete Agreements Hinder and Chill Innovation also Ignores what they Foster – Entrepreneurship and Investment.

Another argument advanced by critics of non-compete agreements is that by restricting employee mobility, non-compete 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 speculative argument focuses only on the would-be innovator, and completely overlooks the established entrepreneur. Any discussion of non-compete agreements requires the consideration of each perspective.

Many areas of innovation and business development take considerable amounts of time, trial and error and cost. Entrepreneurs (and their investors) invest time, blood, sweat, tears and a significant amount of money in taking an idea from conception to reality. There is no incentive for an entrepreneur to invest in an idea and train and develop employees if one of those employees can 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 the 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, 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 could be copied or otherwise undermined with abandon. Although investors complain about the lost opportunities that can result when an innovator is subject to a non-compete agreement, those same investors frequently (and hypocritically) require the use of non-compete agreements for employees of any project that they fund. *See* Alison Loborn, *Free Labor Market*, Commonwealth, Summer 2009, 35-36. Non-compete agreements provide an important incentive and a layer of protection for an entrepreneur (and his investors) to innovate. Banning non-compete agreements would remove that incentive and layer of protection for the entrepreneur and his investors and would instead stifle innovation by precluding the protection of innovation and investment in innovation.

5. Banning Non-Compete Agreements Would Negatively Impact the "Other" Employees

Critics of non-compete agreements also often fail to consider the potential more significant effect on the former employer and its other employees if non-compete agreements were banned. If a former employee is allowed to immediately go to a direct competitor, take the former employer's information or customer contacts or base, and then directly compete with the former employer because there is no non-compete agreement in place or if only a non-solicit or non-disclosure agreement was in place, what protects a business and its other employees from that loss of business? *See e.g. Lowry Computer Products, Inc. v. Head*, 984 F. Supp. 1111, 1116 (E.D. Mich. 1997) (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 non-compete protection, a company could lose business or go out of business and numerous employees could potentially be out of work; hence, a negative economic impact. Indeed, the founder of a Massachusetts electronics company 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.

6. Studies Suggesting a "Brain Drain" are not Conclusive

Critics of non-compete agreements have cited economic studies in support of their challenges to restrictive agreements. One such study "examined" the effect of non-compete agreements on employee mobility. *See* Marx, Strumsky, and Fleming, *Mobility, Skills, and the Michigan Non-compete Experiment*, 55 Mgmt. Sci. 875 (2009). The study focused on the effect of repealing/revising of the Michigan Antitrust Reform Act in 1985 ("MARA") (which removed restrictions on the enforcement of reasonable non-compete agreements in the employee setting) on employee mobility in Michigan. Much of

the study centered on **patent filings** in Michigan since 1985, suggesting that patent filings and non-compete agreements correlate with employee mobility or the lack thereof. The authors do note, however, that this statistical analysis was based on imperfect matching of inventors across patents and imperfect observations of job changes.

Based on that imperfect analysis, the study's authors "cautiously" concluded that non-competes discouraged employee mobility and states that allow the use of such agreements inadvertently created a "brain drain" of the workers needed to create and build successful new firms. Importantly, though, the study does not directly conclude that non-compete agreements thwart innovation and economic growth (only mobility). However, it appears to indirectly suggest just as much to the casual reader. *See e.g.*, Bluestein and Barrett, *Stop Enforcing Noncompetes*, Inc.com, 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 study is interesting and an admirable undertaking given the inherent difficulty in analyzing non-compete agreements and their effect on innovation and economic growth, the analysis has too many flaws to be instructive, much less convincing. First, using patent filings as a measurable basis for the effect of MARA on employee mobility is subjective at best and fails to account for a variety of other factors that could affect patent filings, such as the continuous outsourcing of the automobile business during the period of the study, for example.

Second, while non-compete 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 non-compete/trade secret cases and only a handful of them have directly involved a patent claim or issue.

Third, as the study recognizes, the economic effect of non-compete agreements on individuals must be considered along with the economic effect that such agreements have on employers. Apparently, this concern is lost on those that would use the study in efforts to bar non-compete agreements.

Lastly, the authors of this article would be interested in learning if the study's authors might find a different result today. We believe they might in light of the fact that as part of the America Invents Act, the United States Patent Office opened its first of four satellite offices in Michigan in 2012. The patent office did so for at least the following reasons:

> The City of Detroit is an important national innovation center and has a high percentage of scientists and engineers in the workforce. Detroit is also home to major resource institutions and leading universities which allows for recruitment of experienced patent professionals. The office also serves as a valuable resource to entrepreneurs and innovators throughout the Midwest.
>
> http://www.uspto.gov/about-us/uspto-locations/detroit-michigan

Non-compete agreements can protect confidential and proprietary business information, trade secrets and customer relationships in a variety of industries – many of which are not associated with patent filings. Patents are a form of protection for inventors/entrepreneurs, but they are not typically intertwined with non-compete agreements or disputes relative to such agreements. Accordingly, the suggestion that a significant correlation exists between patent filings, non-competes and employee mobility (and indirectly suggesting a correlation with innovation and economic growth) is misplaced. Frankly, more recent history seems to belie that claim of the study in any event.

CONCLUSION

Reasonably tailored non-compete 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 non-compete agreements fail to take into account the full economic effect of such agreements resulting in a flawed analysis and the empirical evidence used to support their argument is unconvincing. Reasonably tailored non-compete agreements do not prevent individuals from earning a livelihood, they are not mandatory and the potential outlawing or limitation of such agreements fails to account for the potentially larger effect on business and other employees. Further, any argument that California companies and employees are thriving as the result of a business climate free from non-compete agreements lacks merit in light of California's chronically woeful economic state. Non-compete agreements have played an important role in market economies for centuries and there is no legitimate basis to change the legal landscape in any state.

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