Keep Increasing Pressure Against Noncompetes

By **Eric Posner** (May 7, 2019)

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The noncompete clause, a familiar piece of contract boilerplate that employers have used for centuries, has come under withering scrutiny in recent years. The last few months alone have witnessed several dramatic developments.

Several prominent organizations, including the anti-monopoly Open Markets Institute and the AFL-CIO, filed a petition with the Federal Trade Commission seeking a flat ban on noncompetes in employment contracts on the ground that they are unfair trade practices.[1]

Senators from both parties sent a letter to the U.S. Government Accountability Office asking it to investigate corporate reliance on noncompetes, and several Democratic senators, including two presidential candidates, sent a similar letter to the FTC.[2] Various Democratic senators have proposed bills to restrict noncompetes, and so has Sen. Marco Rubio, R-Fla.[3] And in recent years many states have passed, or seriously considered, bills that restrict noncompetes.

The pressure against noncompetes is intense, and will not go away soon. Nor should it.

As most lawyers know, a noncompete is a clause in an employment contract that forbids employees to work for competitors after leaving their current employer. In most states, an employment noncompete is legal as long as it protects a legitimate business interest — usually goodwill or trade secrets, and occasionally investment in training — and the duration and geographic scope of the noncompete are no broader than necessary to protect that interest. While jurisdictions vary in their stringency, noncompetes are frequently enforced. However, a few states, including California, ban employment noncompetes.

The modern groundswell against noncompetes originated with the Jimmy John's scandal. In 2016, the sandwich chain settled lawsuits brought by the Illinois and New York attorneys general, who accused it of imposing noncompetes on its low-wage sandwich makers. Since it was unlikely that these employees possessed valuable trade secrets or advanced the firm's goodwill, the hardship that these non-competes imposed on vulnerable workers could not be justified.

But while the Jimmy John's scandal brought the issue to public attention, the policy debates have drawn heavily on academic research by University of Maryland economist Evan Starr and his various coauthors. They discovered that the noncompete is not, as one might have thought, a rather specialized term reserved for executives and workers with sensitive positions.

About 20% of American workers are bound by noncompetes; even more surprising, about 12% of low-income workers are bound by noncompetes.[4] Other suggestive (but not yet definitive) evidence uncovered by these and other scholars indicates that noncompetes are generally not bargained over but imposed on workers (often after they have started working); and that noncompetes reduce worker mobility (as, indeed, they are intended to do), may (but do not always) push down wages, and do not seem to enhance employers' investment in their workers.[5]

Defenders of noncompetes argue that noncompetes serve important business purposes. In one classic setting, the employer shares a secret customer list with a new hire. Over years of hobnobbing, the employee earns the trust of the customers, who transfer their loyalty from the employer to the employee. The noncompete blocks the employee from taking those customers to a competitor. Noncompetes also help employers protect trade secrets they share with employees. And some commentators argue that employers will not train their workers in general skills if they cannot use noncompetes to block those workers from working for others.

All these old arguments turn out to be less plausible that they might seem at first. They are based on assumptions about labor markets that economists used to hold but have, in recent years, begun to abandon.

The old assumption was that labor markets are "competitive" — economic jargon for the idea that employees are paid wages equal to their marginal productivity. Imagine that Jane, an accountant, is paid $80,000 per year when she generates $90,000 in value for her employer. Another firm ought to be willing to pay her to leave the first firm and come work for it — and indeed to pay her up to $90,000.

Accounting firms will thus worry that if they train employees or give them access to intangible assets like trade secrets, they will not recover their costs or may lose their assets.

Imagine an accounting firm pays $10,000 to train its employees to use accounting software that is used throughout the industry. To recover this investment, the employer must be able to pay the employees a bit less than their marginal productivity for a period of time. But this means that the employees could offer their services to competing employers who will bid for them by offering a higher wage. To ensure that it recovers its investment, the original employer must be able to block the employee from leaving the firm — and the noncompete serves this function.

But the assumption about competitive labor markets is wildly inaccurate. In fact, even employees who are not bound by noncompetes are reluctant to quit because of serious imperfections or "frictions" in the labor market.

First, new research has revealed that most labor markets are not competitive but in fact highly concentrated.[6] Outside densely populated areas, few employers compete for workers in any given occupation. This phenomenon is known as "labor monopsony," and it reduces labor mobility because an employee cannot leave her current employer for another employer if no other employer exists.

Second, what economists call "search costs" reduce the ability of workers to find new jobs. Most workers must take time off to search for a new employer and to interview, and not all of them can afford the lost wages. Instead, they stay with the original employer — even if wages stagnate and working conditions worsen.

Third, jobs are highly differentiated, which further increases the employer's bargaining power. Different employers offer different working conditions and amenities — including shift flexibility, benefits and location, which can matter a lot for the commute. Because workers tend to self-segregate among employers that offer the conditions and amenities that are best for them, their outside employment opportunities are correspondingly limited.

Fourth, employers have information advantages over competing employers, which gives them further advantages over their own workers. Research has shown that an employer can obtain returns on training their workers because as workers become more specialized, competing employers have more difficulty evaluating them, and thus are less able to offer them a higher wage.[7]

These frictions reduce employee mobility, and thus protect employers from the prospect of losing their employees to competitors. This means that employers should generally not worry about training their employees, or giving them access to valuable intangible assets like trade secrets and customer lists. The noncompete just piles on yet another friction — usually unnecessary — on top of all the others.

And this is a problem. By now, it is no longer a secret that American labor markets are in bad shape. Real wages at the median level and below have stagnated for decades. Labor mobility has declined over the same period. And low labor mobility is bad for the economy — bad because the most productive workers are not matched with the employers that value them most, and bad because the composition and geographic distribution of the workforce adjust more slowly to economic shocks, which can deepen recessions. Thus, the low level of economic growth in the United States may reflect the rising frictions in labor markets.

Many defenders of noncompetes argue that as long as noncompetes are negotiated between employer and employees rather than hidden in fine print, they should be respected under the principle of freedom of contract. While a noncompete can cause a temporary hardship, the employee is compensated with higher wages.

But this laissez-faire defense has never been accepted by courts, and for good reason. A noncompete imposes a cost on third parties who are not involved in the negotiation — third-party employers who cannot hire the worker, which in turn can hurt workers and consumers as well. This is why even common-law courts, despite their traditional orientation toward laissez-faire, called noncompetes "restraints of trade," and refused to enforce them unless narrowly tailored. The harm caused by a noncompete is a harm to competition.

What should be done? The Open Markets Institute, which led the FTC filing, advocates a national ban on noncompetes. It notes that the California economy has flourished despite the ban on employment noncompetes in the state, and points to research that argues that the ban stimulated the tech revolution by enabling the circulation of ideas as engineers moved from company to company.[8]

But political conditions are not ripe for such a radical proposal. In the meantime, smaller steps can be taken. State or federal legislation to ban noncompetes for lower-income workers seems like a good start.[9] And because policy toward noncompetes is mostly in the hands of state courts, lawyers can play a role by drawing judges' attention to the research I cited above. Courts should ask employers whether the noncompetes they use are really necessary given that so many other labor market frictions reduce worker mobility. Courts could even incorporate these frictions directly into their analysis. For example, noncompetes might be deemed presumptively illegal when the employer enjoys a monopsony in a labor market.

Defense lawyers can play a role as well. One gets the impression — though I cannot prove this — that the massive reliance on noncompetes by many corporations has not been driven by business necessity but by poor legal advice. One surmises that lawyers tell employers to add noncompetes to employment contracts because the clauses will counter problems with retention, while at worse they might not be enforced. Yet courts have always been skeptical when noncompetes are not tailored to the circumstances of specific employees. Overuse of noncompetes — like the overuse of antibiotics — may lower their effectiveness, by contributing to rising skepticism over their justification.

The advice is also unwise because noncompetes, as restraints of trade, expose employers to antitrust liability. Noncompetes can be used both to enhance power over labor markets, which results in wage suppression, and to prevent product-market rivals from obtaining enough employees to enter a market, which results in higher prices for goods and services.

For a long time, scholars have urged courts to take antitrust challenges to noncompetes more seriously than they have so far, and at least one recent case suggests that some high-powered litigators see promise in this direction.[10] Big firms with a considerable degree of market power should thus be cautious about using noncompetes outside the C-suite.

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[2] Letter from Senator Christopher Murphy et al., to the Honorable Gene Doraro, Comptroller General, U.S. Government Accountability Office (Mar. 7, 2019), available at https://www.tradesecretslaw.com/wp-content/uploads/sites/232/2019/03/letter-to-gao-on-non-compete-agreement.pdf; Letter from Senator Richard Blumenthal et al., to Joseph Simons, Chairman, Federal Trade Commission (Mar. 20, 2019), available at https://www.blumenthal.senate.gov/imo/media/doc/Sen%20Blumenthal%20et%20al%20re%20non%20competes_vF.pdf.

[3] David J. Clark, Of Non-Competes, Elizabeth Warren and Marco Rubio, Trade Secrets and Employee Mobility, Feb. 5, 2019, available at https://www.tradesecretsandemployeemobility.com/2019/02/articles/announcements/of-non-competes-elizabeth-warren-and-marco-rubio/.

[4] Evan Starr, J.J. Prescott and Norman Bishara, Noncompetes in the U.S. Labor Force (U. Mich. L. & Econ. Research Paper No. 18-013, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625714.

[5] Evan Starr, The Use, Abuse, and Enforceability of Non-Compete and No-Poach Agreements (2019), available at https://eig.org/wp-content/uploads/2019/02/Non-Competes-Brief.pdf.

[6] See, e.g., José A. Azar, Ioana Marinescu, Marshall I. Steinbaum and Bledi Taska, Concentration in US Labor Markets: Evidence From Online Vacancy Data (Nat. Bureau of Econ. Res. Working Paper No. 24395, 2019), available

at https://www.nber.org/papers/w24395.

[7] Daron Acemoglu and Jorn-Steffen Pischke, The Structure of Wages and Investment in General Training, 107 J. Pol. Econ. 539 (1999), available at https://economics.mit.edu/files/3904.

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[9] Alan Krueger and Eric Posner, A Proposal for Protecting Low-Income Workers from Monopsony and Collusion, The Hamilton Project, Feb. 27, 2018, available at http://www.hamiltonproject.org/papers/a_proposal_for_protecting_low_income_workers_from_monopsony_and_collusion.

[10] Ryan Boysen, 21st Century Oncology Blasts Noncompete Antitrust Suit, Law360, Apr. 9, 2019, available at https://www.law360.com/articles/1148000/21st-century-oncology-blasts-noncompete-antitrust-suit.