

Non-Competes Are a Double-Edged Sword

Cassandra Torgnes (Norwegian School of Economics)

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Non-compete agreements, or non-competes, are clauses in employment contracts designed to restrict employees from working for or starting a competing business for a certain period after exiting their current employment. They primarily function as a defense mechanism, shielding a business's proprietary information, trade secrets, and customer relationships from potential exploitation by former employees.

While their purpose is protective, non-competes have ignited substantial debate because they can hurt employees' career mobility, wage growth, and entrepreneurial initiatives and regional innovation. The rising prevalence of non-competes, coupled with recent research findings underscoring their adverse effects, has prompted a global regulatory response, including a proposed federal ban on non-competes by the US Federal Trade Commission (FTC).

What should entrepreneurs and small business owners know about non-competes?

First, as a business owner, you need to understand the legal status of non-competes in your jurisdiction. In the US, laws governing the use of non-competes in employment contracts vary by state. For example, California and North Dakota ban non-competes in almost all situations. Other states, such as Washington and Oregon, prohibit non-competes for low-wage workers, while Hawaii bans non-competes for tech workers. However, most jurisdictions in the US and abroad enforce non-competes to some extent, provided the non-compete is reasonable in scope and duration and there is a legitimate business reason for its use, like protecting trade secrets, confidential information, or special customer relationships.

Regardless of the legality, nothing stops you from asking your employee to sign a non-compete. In fact, roughly 19% of employees in the non-enforcing states of California and North Dakota report having a non-

compete in their contracts, which is higher than many of the high-enforcing states. The legality, or lack thereof, does however prevent you from actively enforcing a non-compete and pursuing legal action should your employee move to a competitor.

Are non-competes cost-free?

Many companies view non-competes as low-cost insurance policies. These companies have no intention of actively enforcing them against their employees, assuming there is no harm in having the non-compete sitting there, passively waiting for a bad enough situation that warrants aggressive enforcement.

But even this benign use comes with costs. The greatest costs are borne by employees who, when tempted by other opportunities, consult their employment contracts only to find they are bound by a non-compete and forgo these opportunities. Sure, in the short run, this might benefit your company, especially if your star employee is contemplating moving to a rival. But in the long run, missed opportunities for your employee are often missed opportunities for your business in terms of regional knowledge spillovers and reverse knowledge spillovers. Employee mobility makes this knowledge possible.

For example, consider the thriving tech hub of Silicon Valley -- an ecosystem fueled by knowledge spillovers, often generated when employees transition between firms. A salient example is the so-called "PayPal Mafia," a cohort of former PayPal associates who, following the company's acquisition by eBay in 2002, propelled a number of the most influential tech startups.

Among these luminaries, Elon Musk pioneered SpaceX and assumed leadership at Tesla. Reid Hoffman established LinkedIn, while Steve Chen, Chad Hurley, and Jawed Karim collectively gave rise to YouTube. Although PayPal did not directly profit from these entrepreneurial endeavors, the company has nonetheless reaped indirect rewards. The remarkable



achievements of the "PayPal Mafia" have significantly elevated the stature of Silicon Valley's tech ecosystem. As an active participant, PayPal benefits from this.

Non-competes also may deter talented job candidates. Although most prospective employees do not read their contracts thoroughly, the brightest and promising ones might. If prospective employees see that you're asking them to sign away future career options, they might be deterred and opt for another competitor who is not asking for such a commitment. Stated differently, perhaps the most creative potential employees will decline to accept employment at firms that use non-compete agreements to define the employment relationship.

So, should you never use non-competes?

Non-competes come with costs but also benefits. If you are dealing with high-stakes, human capital-intensive innovation, such as industry-specific software development for a concentrated market, you might want to keep non-competes in your strategy toolbox. In fact, despite early empirical research indicating that non-competes stifled innovation, the newest empirical studies suggest that non-competes can increase overall innovation.

Compared to other types of intellectual property protection mechanisms, non-competes are indeed low-cost. Tracking employee movements to competitors is much easier than tracking patent infringements or proving that the knowledge your former employee shared was truly a trade secret. However, non-competes are not cost-free.

Should we reject the FTC's proposed ban?

The early empirical research on non-competes unanimously found that non-competes hinder wage growth, innovation, and entrepreneurship. However, recent research using more fine-grained data paints a more nuanced picture: non-competes can improve wage outcomes and innovation in some circumstances. The early studies on innovation have also been heavily criticized. Despite these nuanced findings and criticism, it's clear that the overuse and abuse of non-competes doesn't help anyone.

Unfortunately, the proposed ban, like most other state-

level and country-level bans, takes away a legitimate tool for small businesses and entrepreneurs who can't afford the more costly legal mechanisms. Simultaneously, these bans do not go far enough to curtail the overuse and abuse of non-competes.

The rule of reasonableness already means that non-competes for low-level office clerks or fast-food restaurant employees are unlikely to hold up in court. The "need" to use non-competes to curb turnover costs or to protect investments in general human capital is not, and has never been, deemed sufficient under the laws of most non-compete enforcing jurisdictions. So these overly oppressive non-competes are not likely to hold up in court.

Another issue is that legality does not equate with use. Non-competes are used just as frequently in California, despite the ban. Given employee ignorance about non-compete laws, and new research suggesting that firms are often ignorant about these laws and slow to react to non-compete policy changes, firms are likely to continue to put non-competes in their contracts and employees are likely to continue to sign them. Employees will continue to believe they are enforceable, and the negative effects of non-compete use will likely persist.

If legislation does not include fines for asking employees to sign legally unenforceable non-competes, their adverse effects on employees will likely continue. At the same time, we might see shifts away from investments in high-risk, human capital-intensive ventures.

Regardless of the outcome of the proposed FTC ban, entrepreneurs and business owners need to acknowledge the hidden costs of non-competes. These include decreasing knowledge spillovers and deterring potential talent due to the atmosphere of distrust that non-competes can create. It is crucial to assess whether a non-compete is truly necessary for each employee. Thoughtful consideration, and *selective* application of non-competes, might be more effective in mitigating the adverse effects associated with these agreements than an outright ban.

Takeaways

1. **Understand the Law:** Before incorporating a non-compete clause into your employment contracts, understand the specific laws of your jurisdiction, as these can vary significantly

across different regions.

2. **Consider the Costs:** While non-competes are often viewed as low-cost insurance policies, they can have hidden costs, including limiting employee opportunities and potential opportunities for knowledge exchanges and network development for your business.
3. **Assess the Benefits:** In specific high-stakes scenarios, especially those involving human capital-intensive innovation, non-competes can serve a beneficial purpose. Recent studies even suggest that they can foster innovation under certain conditions.
4. **Reflect on the Implications of Bans:** A blanket ban on non-competes may limit small businesses and entrepreneurs who can't afford more costly legal mechanisms. However, such bans might not be sufficient to prevent overuse and misuse of non-competes.
5. **Apply Judiciously:** Rather than implementing non-competes universally, consider their appropriateness on a case-by-case basis. Invest in team morale and internal opportunities for advancement, saving non-competes for situations where they are genuinely required.

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