

TO: The Massachusetts Joint Committee on Labor and Workforce Development
FROM: Matt Marx, Assistant Professor, MIT Sloan School of Management
RE: House Bills H1794 and H1799, Acts Regarding Noncompetition Agreements
DATE: October 7, 2009

Summary of research findings (based on engineers, inventors, and other knowledge workers):

- One-third of non-competes last for more than one year; nearly 15% extend beyond two years.
- Non-competes are usually requested after an offer is accepted, often on the first day at work.
- Less senior employees are half as likely to seek legal advice before signing a non-compete.
- Non-competes discourage interfirm mobility; many who change jobs take “career detours.”
- Non-competes act as a brake on entrepreneurial activity. Arguments that non-competes are essential for R&D investment are not supported by data.

I write in support of House Bills H1794 and H1799, Acts relating to the use of employee non-competition agreements. I am currently an Assistant Professor of Technological Innovation, Entrepreneurship and Strategic Management at the MIT Sloan School of Management. Earlier in my career, I was involved with startup companies in Boston as well as Silicon Valley and hold seven patents. As both an inventor and an executive, I have experienced non-competes from both sides: I’ve asked new employees to sign them, and I’ve signed them myself.

I originally became acquainted with non-compete agreements at my first job following graduate school. On my first day at work, and without prior notice, I was asked to sign a contract in which I promised not to work for any competitor for a period of two years after leaving the company. I was struck by how this provision in my employment contract could constrain my future occupational opportunities, particularly because my technical skills were rather specialized. Yet having already turned down other employment offers to accept the job, and as a young engineer without much bargaining power, I signed the agreement that same day and without having a lawyer review it. I later left the firm to attend business school, with the expectation that I would either change industries or that my non-compete would expire near graduation. As it turned out, I left business school to join another company in the same industry, which I was able to do in part because the company was located in California (where non-compete agreements are not enforced). When I returned to Boston to complete my graduate studies, I was invited by an ex-employee of my former employer to do some consulting on the side but felt I had to turn down the opportunity for fear that the non-compete I had signed at the California company might be enforceable in Boston.

My current research focuses on the use of non-compete agreements as well as their implications for innovation, entrepreneurship, and the careers of scientists, engineers, and other creative professionals. I will primarily describe my own work but also will refer to studies by other professors.

Trends in the use of non-compete agreements

Of particular relevance to the proposed bill is a survey I conducted in conjunction with the Institute of Electrical and Electronics Engineers (IEEE), a non-profit professional association founded in 1884 and with approximately 215,000 members in the U.S. In August 2008, we surveyed a group of 5,000 randomly selected members and received responses from 1,029 of them (a 20.6% response rate). The survey results speak directly to three provisions of the bill: length of term, advance notice, and the differential treatment of less senior employees.

Term. Most survey respondents indicated that their non-compete lasted no longer than one year. More than one-third of respondents, however, (35.0%) claimed that the non-compete they signed was for a duration of more than one year. Moreover, 14.4% of non-competes in the survey were longer than two years. Some non-competes (2.3%) even exceeded five years in duration.

Notice. Especially given the extended term of many employee non-compete agreements, it might seem reasonable that potential employees be made aware of non-compete requirements when considering a job offer. However, the survey suggests that such notice is the exception rather than the rule. More than two-thirds of respondents (69.5%) reported that the request for a non-compete came after the offer letter, with nearly one-quarter (24.5%) being shown the non-compete on their first day at work. The lack of notice contributes to the fact that barely one in ten (12.6%) of those who signed a non-compete sought legal advice before doing so; in fact, less than one in twenty (4.6%) of those who signed the non-compete on their first day of work sought legal advice. Of those who did not seek legal advice, nearly half reported either that they felt time pressure to sign or that they were told the non-compete was non-negotiable.

Seniority. Compared to more senior workers, junior employees were less than half as likely to refuse to sign a non-compete agreement, whether measured by age (11.2% of older workers refuse, compared with only 3.7% of young workers) or years of experience (10.4% vs. 5.0%). Moreover, junior employees are less than one-third as likely to seek legal advice. Perhaps this partially due to younger workers seeing the non-compete with the job offer less often (24.6% vs. 36.2%) and are considerably more likely to be asked to sign the non-compete on their first day of work (30.5 vs. 18.1%).

These findings are summed up the experience of a worker who felt blindsided by a non-compete request at his first job: *“I never received any information ahead of time. And then it was the first day when I had all the paperwork in front of me: health insurance, 401(k), and the non-compete. It was either ‘sign it and work here or don’t sign it and don’t work here.’”*

The impact of non-compete agreements on individual careers, innovation, and entrepreneurship

The results of the IEEE survey paint a picture in which younger, less experienced workers are more likely to sign non-compete agreements when asked, and that they often appear to sign under duress. Given that the term of such contracts routinely extends beyond a year, in order to evaluate whether the use of non-competes should be restricted it is critical to understand how non-competes impact individual careers as well as broader outcomes including innovation and entrepreneurship.

The following findings are based on both qualitative and quantitative data. Along with Lee Fleming of the Harvard Business School, I undertook a study that examined the introduction of a law allowing firms to enforce non-compete agreements in the state of Michigan. Importantly, our study took advantage of the fact that the enforceability of non-competes was an inadvertent consequence of a Michigan revision of its antitrust statutes (this type of experimental design is referred to as a “natural experiment” in the social sciences literature). Additionally, each of the results I will describe concur with related studies in the literature, and are still present even when we account for potentially confounding factors—such as whether individuals worked in the auto industry so critical to Michigan’s economy. The before-and-after test using Michigan’s policy reversal is superior to simply comparing enforcing vs. non-enforcing states as other confounding factors may be at play (such as local culture). Our empirical research highlights three related findings:

Reduced job mobility. We found that once Michigan allowed companies to enforce non-compete agreements, job mobility dropped 8.1% compared with other states that continued to prohibit non-competes. Job mobility dropped nearly twice as far for workers with highly specialized skills, given the more limited external market for their expertise. Moreover, this results is not just idiosyncratic to

Michigan. Comparing job-mobility rates between enforcing and non-enforcing states yields similar results: individuals change jobs less often where non-competes are enforced.

“Career detours”. Not only do non-competes discourage employees from changing jobs; they also affect the career choices of those who do leave their employers. In a set of 50 randomly-sampled interviews in a single industry, I found that one-quarter of those who signed a non-compete and then left their jobs also left the industry due to non-competes. During these “career detours”, the individuals I interviewed often accepted lower compensation because they were unable to use their skills. One worker observed that the non-compete was particularly damaging to her because it precluded use not only of training from the firm where she signed the agreement, but all prior relevant expertise: *“I’ve been in this industry for 20 years. I have a Ph.D in the field. I walked in the door with an enormous amount of experience, and while I worked there for a year in a half they added maybe, what, 2% to that? And now they want to prevent me from using any of what I know?”* These results are corroborated both by the Michigan policy reversal and also by the work of UCLA economist Mark Garmaise, who found that compensation for executives who changed jobs in states that enforce non-competes is lower than in non-enforcing states.

Brake on entrepreneurship. Non-competes also act as a brake on entrepreneurial activity. I found that ex-employees subject to non-competes were scared to join small companies for fear that they would be vulnerable to legal action by their former employer. Said one, *“I consciously excluded small companies because I felt I couldn’t burden them with the risk of being sued. [They] wouldn’t necessarily be able to survive the lawsuit whereas a larger company would.”* Large companies not only can more credibly offer to indemnify individuals, but they can more easily offer a “holding tank” by having the employee work in an unrelated area during the period of the non-compete. Indeed, once Michigan began enforcing non-competes, those who changed jobs tended to join larger companies. A study in the biotech industry by Toby Stuart of Harvard and Olav Sorenson of Yale underscored this point: they found that more biotech startups sprang up in non-enforcing regions following IPOs and acquisitions, which presumably would give executives and key technical personnel the financial and reputational capital to consider starting a new firm.

Given the above findings, it is not difficult to see why established companies generally implement non-competes when they are allowed to do so. Non-competes make it easier to retain employees and pay them less, and they reduce the threat from new entrants within the industry. Yet these benefits to firms come at the expense of workers and not-yet-founded startups.

Also, it is important to note the “chilling effect” of non-competes. Although press coverage of the occasional high-profile non-compete lawsuit might suggest otherwise, the effects described above are by no means restricted to the courtroom. The decision not to leave one’s job is of course not driven by a lawsuit but rather the perception or threat of legal action. Interviewees in my study who reported taking “career detours” or avoiding small companies did so in most cases not because of an actual lawsuit or cease-and-desist letter, but rather due to their expectation that legal action would ensue if they violated the non-compete. One lawyer has suggested to me that many non-compete agreements as written would not stand up in court, but because employees don’t know this they obey contractual terms that are in fact unreasonable.

The likely impact of House Bills H1794 and H1799

The implementation of these Acts regarding non-competition agreements would lessen the abuse of such contracts, in four ways. First, the requirements for prior notice or 10% consideration will help to ensure that workers are not “blindsided” by non-compete agreements and left with little recourse but to sign them. Second, the possibility of recovering court costs will help to mitigate concerns over the cost of spurious lawsuits, although ex-employees are still at risk of being tied up in court with injunctions and

thus left unable to work in their field. Third, the \$75,000 salary threshold for non-competes may spare some junior employees from non-competes; it will be interesting to see whether entry-level salaries jump just above that figure following the passage of the bill. Fourth, the limits on term will lead to the shortening of many non-competes. The requirement for “garden leave” in agreements lasting more than one year will shorten many agreements; note that China implemented a similar stipulation for all non-competes (PRC Labor Contract Law of 1 January 2008, Article 23). The promise of presumptive enforceability for six-month non-competes will, I expect, lead to many six-month agreements. I doubt that the presumptive-enforceability clause will change the individual substantially, as I have found that many workers already treat such agreements as presumptively enforceable (i.e., the “chilling effect”)

However, not many employees can afford to last a year, or even six months, without income. As such, I would expect to even shortened non-compete agreements with advance notice to continue to have a “chilling effect” on job mobility and entrepreneurial activity. In other words, this bill will do much to curb the abuse, but not the use, of non-competes in Massachusetts.

Of course, established firms are interested in maintaining their ability to use non-competes (as the proposed bill continues to allow). A common argument in favor of non-competes—despite the availability of non-disclosure agreements and other tactics for protecting proprietary information—is that without them companies will be reluctant to invest in research and development. On this point, it is important to note that the UCLA study cited above also demonstrated that R&D investment per employee is lower, not higher, when non-competes are enforced. If non-competes were truly essential to R&D, one would have long since expected an exodus of technology firms from non-enforcing states such as California. Indeed, one need look no further than Silicon Valley to see that this is not the case—if anything, the stark opposite is true.

References

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