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POLICY NOTE

From sandwich maker to CEO: The effect of non-compete agreements on Washington workers

By Quillan R. Robinson, Research Assistant January 2019

Key Findings

1. Non-Compete agreements are contracts between companies and employees that delay an employee's ability to work for competing companies.
2. In an economy that is increasingly technical and knowledge-based, employers' desire to protect their property and costly investments is understandable.
3. According to the U.S. Treasury, many workers are not aware that they were hired under a non-compete agreement and approximately 18 percent of U.S. employees are currently working under one.
4. Washington state is among the majority of states which have a "blue pencil" doctrine, meaning a judge can modify the language in an employment contract to make certain provisions comply with state law, while leaving the rest of the contract unchanged.
5. In several states, non-compete agreements as a whole must comply with state law in order to be enforceable.
6. In California non-compete agreements are unenforceable. Experts believe this may be a factor in the innovation, rapid growth and flexibility in recruiting talent in Silicon Valley.
7. Non-compete agreements have a role in protecting trade secrets and intellectual property, but they should not be overly used to unreasonably restrict normal movement in the labor market or to stop workers from finding future job opportunities.

Introduction

In 2016, the sandwich chain Jimmy John's Gourmet Sandwiches stopped requiring employees to sign non-compete agreements. Under the agreements, employees had agreed not to accept employment for at least two years at any company that derived more than 10 percent of its revenue from the sale of sandwiches and which was located within three miles of an existing Jimmy John's restaurant.

After significant public outcry and intense pressure from state governments, the company dropped non-compete clauses from its employee contracts.

The practice of requiring non-compete agreements severely limits the mobility and flexibility of labor in the fast food sector, where many young, low-skilled, and part-time workers find employment. While the Jimmy John's case is an interesting example of how binding non-compete agreements can go too far, it indicates a growing problem for many workers in particular economic sectors.

Non-compete agreements meant to protect ideas and innovation

Strong laws on intellectual property are necessary to promote entrepreneurship and innovation. Without sufficient patent enforcement, drug companies would balk at the massive investment required to develop and deliver life-saving drugs to market. Without protecting the ownership and property rights of companies that create ideas, many technologies and devices that make the modern world possible would not exist.

Non-compete agreements are intended to serve the same purpose. They play an essential role in protecting less tangible investments that companies make in people, training and research in order to develop intellectual capital.

Broadly, non-compete agreements are contracts between companies and employees that delay an employee's ability to work for competing companies. Every day, top executives, engineers and other highly-skilled workers leave their employers, taking along years of training and proprietary information in their heads. In an economy that is increasingly technical and knowledge-based, employers' desire to protect their property and costly investments is understandable.

Extended to low-skilled workers

So when did the use of standard non-compete agreements spread from CEOs, top executives and engineers to ordinary sandwich makers?

According to a report by the U.S. Treasury, many workers are not aware that they were hired under a non-compete agreement, and approximately 18% are currently working under one.[1]

While executives and engineers still represent a large portion of those subject to such agreements, cases of low-skilled workers being presented with them has gained significant attention in recent years. In short, as companies recognize the utility of non-compete agreements in retaining employees and staving-off competition, their use has become more common.

Enforcing non-compete agreements

When considering the use of non-compete agreements, it is important to consider how and to what degree they are enforced. In Washington state, judges consider the following points when assessing the reasonableness and enforceability of a non-compete agreement:

1. Whether a restraint on employees is necessary for the protection of the business value or market goodwill of the employer;
2. Whether the agreement imposes on the employee any greater restraint than is reasonably necessary to secure the employer's business value or market goodwill, and;
3. Whether the degree of injury to the public interest is such that the loss of the service and skill of the employee warrants non-enforcement of the agreement.

In addition, there are key factors that the courts look at when determining whether a non-compete agreement is enforceable: first, its duration; second, its geographical limitations; and third, the employment activities it prohibits.

Judges can sometimes change employment contracts

Washington is among the majority of states which have a "blue pencil" doctrine, meaning a judge can modify or edit the language in an employment contract to make certain provisions comply with state law, while leaving the rest of the contract unchanged.

In several states, non-compete agreements as a whole must comply with state law as written in order to be enforceable. Under North Dakota, Oklahoma, and California law non-compete agreements are unenforceable. California has

1 "Non-compete Contracts: Economic Effects and Policy Implications, Office Economic Policy, United States Treasury, March 2016, at https://www.treasury.gov/resource-center/economic-policy/Documents/UST%20Non-competes%20Report.pdf.

considered non-compete agreements unenforceable for over a century. Experts often point to the absence of restrictive employment contracts in California as one factor in the innovation, rapid growth and flexibility in recruiting talent in Silicon Valley.

An outright ban is unlikely

Such an outright ban on non-compete agreements is unlikely to be enacted in Washington. As firms compete for top talent, particularly in the fields of aerospace, communications, medical research and high technology, business leaders say it is important that they have mechanisms to prevent their star employees from being drawn away by other companies.

At the same time, technology firms have come down on both sides of the debate, depending on their experience with individual cases. The business community in general believes that non-compete agreements are an important tool that should remain available to employers. Business groups, like the Association of Washington Business, would likely oppose a ban on non-compete agreements.

Still, some employees, particularly those who work in high-turn-over, low-wage industries, like hotel and food-service work, continue to be limited by non-compete agreements.

Reform in other states

Other states have taken action to limit or reform their laws regulating employee non-compete agreements. In 2016, Illinois banned the use of non-compete agreements for workers earning less than $13.50 an hour.

Taking a slightly different approach, Idaho passed a law limiting enforcement of non-compete agreements to one year. Idaho also requires former employers who lose a lawsuit involving enforcement of a non-compete agreement to pay the legal expenses of the challenging former employee.

A recent study by the Brookings Institution's Hamilton Project outlines several directions for reform, including mandating sufficient notice for prospective employees of non-compete clauses and providing greater flexibility for judicial modification.[2]

During the 2018 legislative session, efforts to prohibit certain classes of employees from being subject to non-compete agreements were introduced but failed to pass.[3]

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2 "A Proposal for Protecting Low-Income Workers from Monopsony and Collusion," by Alan B. Krueger and Eric A. Posner, The Hamilton Project, The Brookings Institute, Policy Proposal 2018-05, February 2018, at http://www.hamiltonproject.org/assets/files/protecting_low_income_workers_from_monopsony_collusion_krueger_posner_pp.pdf.

3 HB 2903, An act relating to protecting workers from work restrictions, introduced by Representative Derek Stanford (D-Bothell), Washington State Legislature, January 23, 2008, and SB 6526, An act relating to noncompetition agreements, introduced by Senator Conway (D- South Tacoma), January 22, 2018.

Conclusion

As Washington's economy continues to grow and diversify, the goal of lawmakers should be to foster a dynamic and competitive labor market as a way to serve the public interest of all citizens.

Public policy should encourage and enable the creation of as many work opportunities as possible. Policies that provide low cost job-creation, easy training and hiring terms, flexible work hours, minimal restrictions on labor, and minimal professional licensing requirements encourage work, saving and investing in ways that help all Washington communities.

Non-compete agreements have a role in protecting trade secrets and intellectual property, but they should not be overly used to unreasonably restrict normal movement in the labor market or to stop ordinary workers from finding future job opportunities.

Limiting the opportunity barriers of non-compete agreements, while at the same time protecting low-skilled and entry-level workers, would make the career path from sandwich-maker to company CEO that much easier.

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