Insight

Noncompete Agreements: Have Employers Gone Too Far?

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Executive Summary

- An explosion of state laws curtailing the use of noncompete agreements (NCA) and President Biden's July 2021 executive order, which highlighted the negative effects of NCAs, has sparked a renewed interest in addressing the damaging effects NCAs can have – especially on low-wage workers.
- NCAs contractually prohibit employees from actions including working for a competitor, starting a competing business, developing a competing product or service, and hiring former colleagues for a specified number of years in a certain geography upon separation from the employer.
- While employment contracts that include NCAs were historically reserved for C-suite executives and employees with knowledge of trade secrets, these agreements have trickled down the organizational chart to include even entry-level employees – limiting worker mobility and suppressing wages.
- Federal legislation can incrementally or aggressively reform NCAs to promote a more dynamic employment market by removing barriers to employee mobility and fostering competition for talent among employers.

Introduction

Noncompete agreements (NCA) are contracts between employer and employee signed at the onset of employment. These contracts prohibit the employee from competing with their former employer upon separation. Prohibited activity defined in NCAs can include working for a competitor, starting a competing business, developing competing products or services, and hiring former colleagues, among other actions. NCAs often include a geographic

component and are valid for a specific amount of time.

Countless studies show that NCAs can stifle employees' wages and limit job mobility. NCAs can also harm employers by limiting the talent pool available for hire.

A series of state legislative actions to curb the use of NCAs, and President Biden's July 2021 executive order, which directed the Federal Trade Commission (FTC) to use its rulemaking authority to address NCAs, has sparked interest in addressing noncompete laws at the federal level.

Federal legislation could incrementally or aggressively reform NCAs to promote a more dynamic employment market by removing barriers to employee mobility and fostering competition for talent among employers.

The Renewed Interest in Noncompete Agreements

In recent years, there has been an explosion in state legislative action curbing the use of NCAs, with much of it targeting low-wage earners. Additionally, President Bident's Executive Order on Promoting Competition in the American Economy made NCAs a priority and directed the FTC chair to "exercise the FTC's rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that unfairly limit worker mobility."

These actions were catalysts behind a series of federally proposed legislation in 2021, including the Workforce Mobility Act of 2021, Freedom to Compete Act, and Employment Freedom for All Act.

Then, in 2022, Colorado, Washington, and New York all signed legislation limiting NCAs or instituted criminal penalties for violating existing NCA prohibitions. Interest in the issue at the federal level has also continued, with the recent introduction of the Restoring Workers' Rights Act of 2022 which prohibits future NCAs and voids existing ones for lower- and middle-income workers.

The Current Landscape of Noncompete Agreements

Historically, NCAs were reserved for C-suite executives and employees with high levels of education, specialized skill sets, or those whose jobs include knowledge of trade secrets. While a recent study (Starr et al.) found a higher incidence of NCA applying to traditionally targeted employees, it also found a prevalence of NCAs among less-educated, low-wage employees.

The study estimates that 18 percent of workers, approximately 28 million people, are

currently bound by an NCA, and that 38 percent of workers have signed at least one in the past. Furthermore, more than one in 10 employees earning less than $40,000 per year is currently subject to an NCA, with 33 percent reporting that they have signed one in the past.

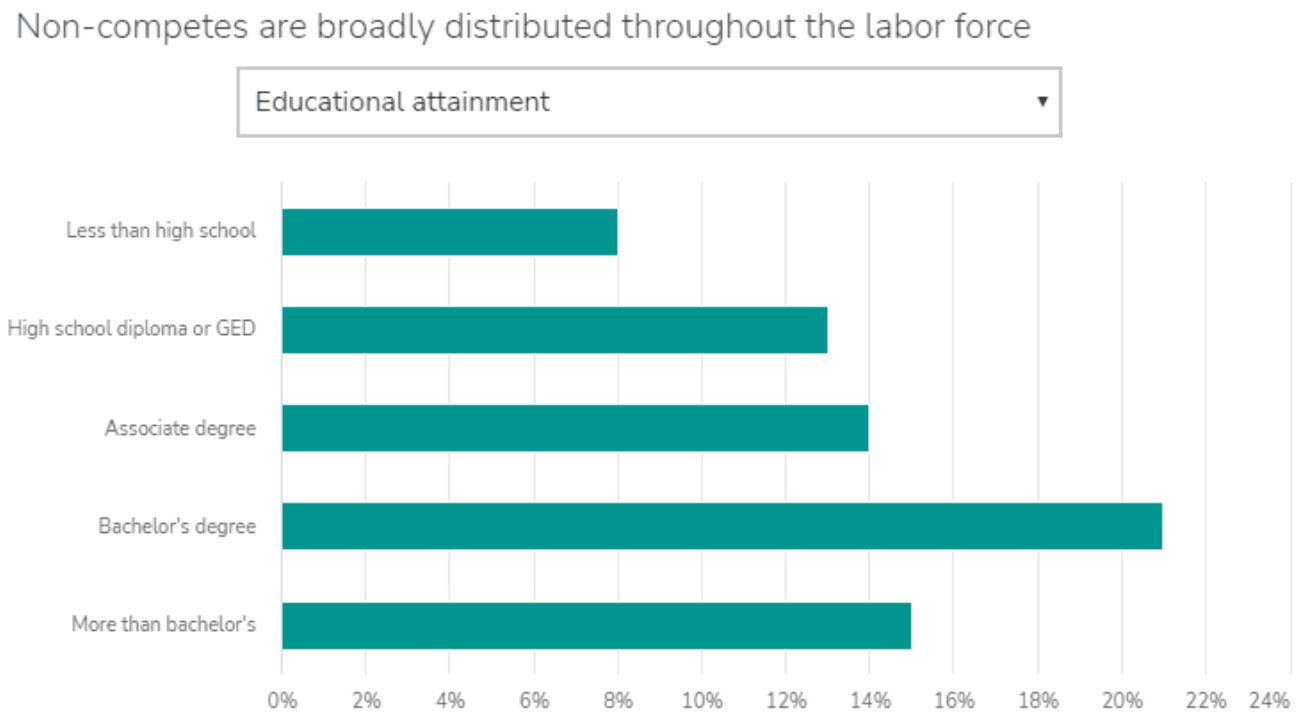
Distribution of Noncompete Agreements

Theoretically, the likelihood of being bound by an NCA is correlated with a combination of age, education, job function, and earnings, meaning that employees with seniority, advanced degrees, and a highly sought-after skill set are more likely to have an NCA than those with little education and experience. The results of the study, however, suggest a more wholesale application of NCAs rather than a directed targeting of specific employee qualities.

The study found that employees 18–22 years old have a 16 percent likelihood of having an NCA – the same probability as those aged 54–59. The probability peaks at 24 percent for those aged 35–40. A similarly narrow variation in probability was found across levels of education. The probability that an employee with some high school education has an NCA is 20 percent, just one percentage point less than those with a doctoral degree. The probability increases to 25 percent for those with a bachelor's degree and is increasingly likely – 39 percent probability – for employees with a professional degree. These relatively flat distributions indicate that some employers are instituting NCAs as the standard for all employees, irrespective of seniority, skill set, or education.

Another study found a similarly flat distribution of NCAs by educational attainment found in *Figure 1*.

Figure 1



Graph taken from The Federal Reserve Bank of Minneapolis.

Starr et al. found that an employee without a bachelor's degree, earning an hourly wage, working for a for-profit firm, earning $50,000, and with no access to trade secrets has a 13 percent probability of being bound by an NCA. Historically, this employee profile was not the intended target of NCAs.

Noncompete Agreements and Asymmetric Information

Asymmetric information – a situation in which one party in a transaction has more information than the other – between an employee and employer regarding an NCA can negatively affect employee wages and mobility. The timing of when an employee is notified of the NCA often determines the extent to which information is asymmetric between employee and employer.

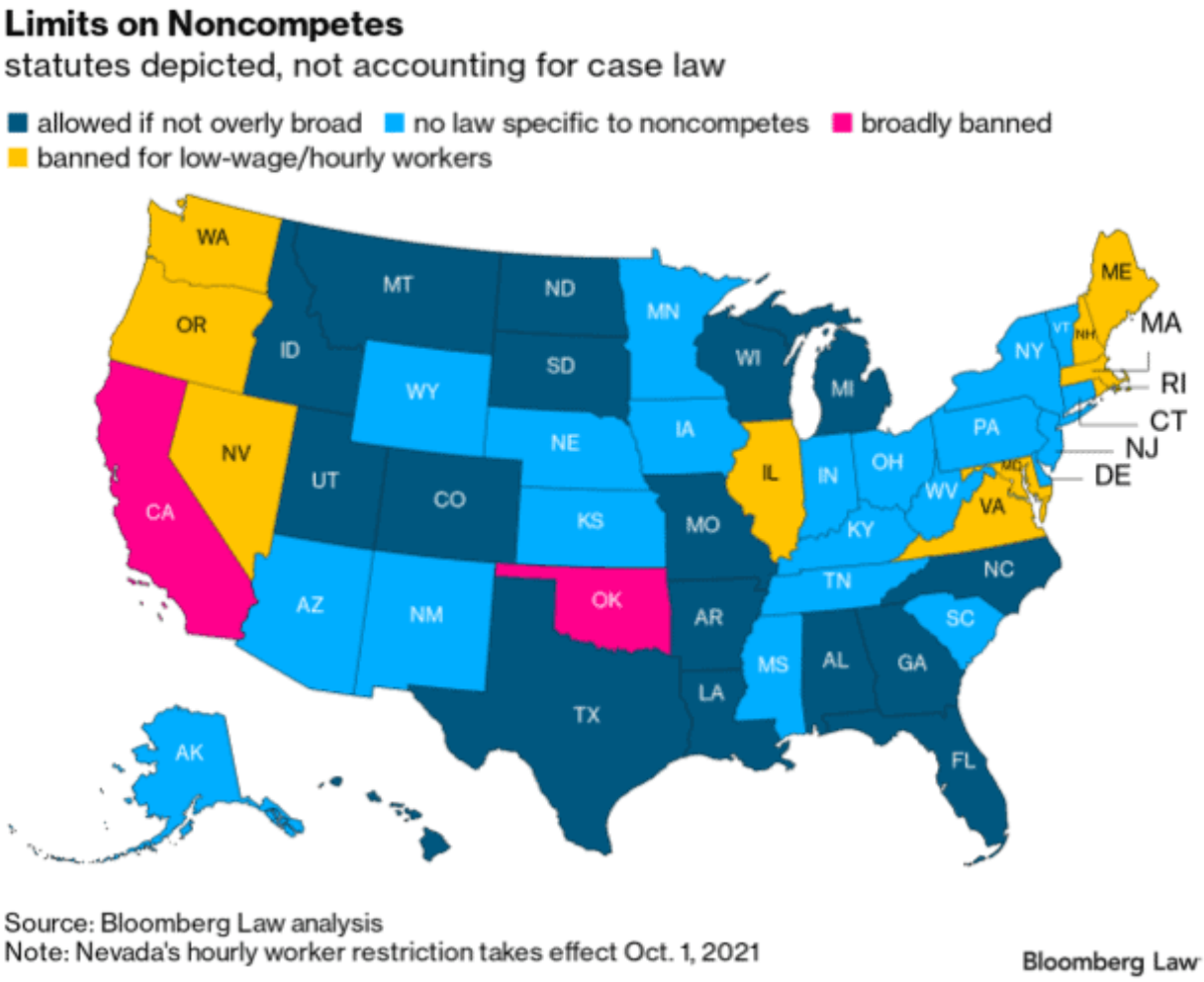
Starr et al. found that slightly over 29 percent of individuals subjected to NCAs were notified that signing an NCA was a condition of employment only after accepting the job offer, while 61 percent learned before. The timing of the notification had a distinct impact on the employee's willingness to negotiate the terms of their employment. Only 6 percent of those informed of the NCA after accepting the job negotiated the terms of their NCA compared to nearly 12 percent who knew before. Furthermore, 26 percent reported that they would have reconsidered accepting the job offer with prior knowledge of the NCA before agreeing to accept the position.

This asymmetric information between the employer, knowing an employee will need to sign an NCA, and the employee – who is not made aware of the NCA prior to accepting the position – can have a negative effect on wages, training, and job satisfaction.

Compared to employees without an NCA, those with an NCA — and who were made aware of it before accepting a job — have 9.7 percent higher earnings, are 5.5 percentage points more likely to have received training in the last year and are 4.3 percentage points more likely to have information such as trade secrets shared with them. When comparing employees without an NCA to those with an NCA—but who were made aware of it after accepting the job the latter group has no measurable increase in wages or training and is 13.4 percentage points less likely to be satisfied with their employment.

The knowledge gap between employer and employee often extends to the enforceability of the NCA. In states where NCAs are prohibited (and thus unenforceable), there is still a 19 percent probability that an employee has an NCA—the same probability as in states with maximal enforceability. Employers are generally aware of whether an NCA is enforceable in their state, while employees are less likely to be aware of their state laws pertaining to NCAs. Thus, employers can leverage this asymmetric information to reduce wage competition and employee mobility. Analysis by Bloomberg Law depicts the current limits on NCAs as seen in *Figure 2*.

Figure 2



Graph taken from Bloomberg Law.

Effects on Wages and Mobility

A study by Lipsitz and Starr found evidence that NCAs diminished earnings and job mobility among low-wage workers. The research used evidence from Oregon's 2008 ban on NCAs for workers paid hourly.

Lipsitz and Starr found that banning NCAs for hourly employees increased hourly wages by 2–3 percent on average, with effects as great as 6 percent over a seven-year period. They also observed that monthly job-to-job mobility among hourly workers increased 12–18 percent.

Additionally, the study measured employer responses to the ban and found no evidence that they cut hours worked per week. It notes that firms could avoid the NCA ban by converting hourly workers to salaried workers, as long as the worker earned more than the median

household income of a family of four. They found that post-NCA ban, hourly workers in Oregon were more likely to be salaried.

Opportunities for Reform

There are many opportunities to reform the use of NCAs. Reforms range from incremental changes that increase transparency and limit employees eligible for NCAs, to sweeping legislative action such as the Restoring Workers' Rights Act of 2022, which would abolish all future use of NCAs and nullify existing contracts.

Ensuring NCA transparency could be an incremental step toward fostering a dynamic labor market. As noted previously, 29 percent of employees subjected to NCAs were notified of the agreement after they had already accepted the position. This practice leaves the employee with little bargaining power. Legislation mandating that an employer provide a prospective employee advance notice that signing an NCA is a condition of employment would put the employee in a better position to negotiate salary and benefits in exchange for signing the NCA, as well as the terms included in the NCA, itself.

Moreover, lawmakers could also consider banning the use of NCAs in states where they are not enforceable. Legislation could force employers only to include language in the NCA that is enforceable under state law or prohibit their use if the state does not enforce NCAs. This would help employees challenge the terms of the NCA in court.

Lawmakers could also limit the pool of workers eligible for NCAs as a condition of employment based on certain job function, wage rates, or education levels. Such action would stop the permeation of NCAs down the corporate ladder and revert the use of NCAs back to the historically intended targets: C-suite executives and other top talent.

While this list of incremental changes is far from exhaustive, such reforms could promote a more dynamic employment market by removing barriers to employee mobility and fostering competition for talent among employers.

Lawmakers could also pursue more aggressive legislation, such as the Restoring Workers' Rights Act of 2022, that bans the future use of NCAs altogether and retroactively nullifies existing agreements for certain non-exempt employees.

Conclusion

Employment contracts with NCAs were historically reserved for C-suite executives and employees with knowledge of trade secrets, but these agreements have trickled down the organizational chart to include even entry-level employees, limiting worker mobility and

suppressing wages.

An explosion of state laws curtailing the use of NCAs and President Biden's July 2021 executive order, which highlighted the negative effects of NCAs, has sparked a renewed interest in addressing the damaging effects NCAs can have – especially on low-wage workers – at the federal level.

While states generally govern and enforce NCAs, federal legislation limiting the scope of NCAs, ensuring greater transparency for employees, and enhancing employee mobility can promote a more dynamic and robust employment market.