

## KEEPING SECRETS?

### How non-compete agreements for low-wage workers hurt business hiring and hold down wages

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**WHO KNEW** that preparing sandwiches for \$8 an hour involves trade secrets, or that cleaning apartments for even less requires proprietary knowledge about key customer accounts? Yet such is the reality for a growing segment of North Carolina's economy, where employers in low-wage, low-skill industries are increasingly asking their employees to sign non-compete agreements as a condition of their hiring or continued employment—a trend that warps the free market and reduces businesses' freedom to hire, customers' freedom to shop, and workers' freedom to negotiate a higher wage.

A non-compete agreement, or a covenant not to compete, is a signed contract between employer and employee that limits the ability of the employee to work for a competitor or start their own competing business for a specified amount of time (typically less than five years). Historically common in high-skill industries like software, or for certain positions requiring significant proprietary technical expertise like design engineers, non-compete agreements are now becoming more common across the economy. Only this time it's in traditionally low-wage industries like housecleaning, food service, and home maintenance and for mid-level, non-technical positions in manufacturing that do not require significant outside education or training.

Although non-compete agreements may have a role to play in protecting trade secrets for technical or knowledge-economy industries and certain key, high-skill positions, there is clearly little public benefit for requiring frontline workers in low-wage industries to sign them, or for suing them to enforce their compliance. Increasingly, courts are siding against the employers in such cases and state governments are seeking to limit enforcement against low-wage workers. North Carolina should follow suit and enact policy changes reining in this abusive practice that hurts competing businesses, workers, and the overall economy.

### Non-compete agreements boom in low-wage industries

In principle, the non-compete agreement is intended to protect the employer's proprietary trade knowledge, avoid the loss of high-skill (and expensive-to-train) labor, and safeguard key customer accounts. If the employee violates the agreement—for example, by going to work for a competitor—the employer can bring legal action in the courts that can result in the termination of the former employee from his or her new job.

As this suggests, the **non-compete agreement was originally developed to prevent competitors from unfairly acquiring another business's proprietary technical and**

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**A NON-COMPETE PROFILE:****Julia**

Julia, a resident of Carrboro, makes her living cleaning houses. Little did she know that a short-term stint working for a housecleaning company would follow her for three years after she quit.

About six months after Julia left the company due to poor treatment, she was served with a lawsuit. Julia was sued along with 15 other former employees for breaching a covenant not to compete that was included in her employment contract.

“I was very afraid,” Julia says, thinking back on that day. “I haven’t had normal work since.”

Not only did the non-compete agreement mean Julia could not work on her own cleaning houses, but she was abruptly fired from the work she did find with another cleaning service when the owner learned about the litigation.

“It is not just. I didn’t even know what I was signing,” Julia says about the non-compete agreement. “I’d like to tell [the company owner] to her face about the harm she has caused me.”

Julia and many of the other employees were represented by the NC Justice Center. They recently settled with the cleaning company, which agreed to remove the non-compete clause from their employment agreements and to pay back wages to some of the workers.

**intellectual property by poaching its key employees**—examples might include senior engineers in an aerospace manufacturing facility or programmers for a software company.

**Yet during the last 15 years, the use of these agreements has expanded to include frontline workers in low-wage industries.**<sup>1</sup> One fairly common example is the non-compete agreement that the sandwich chain Jimmy Johns asked its frontline sandwich preparers to sign. This prohibited their employees from leaving their jobs and going to work for any similar sandwich shop, like Subway, within three miles of the Jimmy Johns location where they worked for a period of three years.<sup>2</sup>

Similarly, a case recently litigated by the NC Justice Center involved a housecleaning company named Custom Maid, LLC, whose owner required her workers to sign non-compete agreements that barred them from starting their own housecleaning businesses or working with former Custom Maid clients.

In both cases, there were no reasonable trade secrets, proprietary expertise, or unique customer accounts involved—just workers who had nothing to sell but their own labor and business owners who wanted to restrict their ability to start their own businesses.

There are similar examples in medium-wage trade occupations like plumbing, carpentry, and electrical wiring, where it has long been common for tradespeople to open their own businesses after starting out at another company. In these cases, the workers have significant skills, so they have considerably more to offer than just their labor. But there are no genuine trade secrets or proprietary expertise involved, and customers have historically had the freedom to shop between different tradespeople, regardless of their career history. So it is difficult to understand what legitimate business interest is served by non-compete agreements in these occupations.

**When added together across the entire economy, examples like these tell a very compelling story about the prevalence of non-compete agreements in our economy.** According to economists at the University of Maryland, almost four out of every 10 workers in the United States have signed a non-compete agreement at some point in their careers; one in five are currently working under such an agreement. And their presence in low-wage industries is indisputable—14.3 percent of workers without a college degree and 13.5 percent of workers earning less than \$40,000 per year have signed these agreements.<sup>3</sup>

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## Non-compete agreements in low-wage industries: Bad for business, bad for workers

In evaluating non-compete agreements, courts have ruled that these contracts must serve a legitimate business interest (e.g., protect confidential information and customer contacts) and cannot cause unreasonable hardship for employees. They must also be reasonable in terms of the restrictions on the geography involved and the length of time the agreement is in effect.<sup>4</sup>

Non-compete agreements were primarily justified in terms of keeping skilled employees from taking proprietary knowledge from one employer to a competitor, giving the competitor an unfair competitive advantage. These agreements were also intended to protect a company's often costly investment in the training of its employees by limiting their ability to leave their jobs for similar positions at comparable firms. In fact, courts have agreed that these justifications are legitimate business interests when they occur in high-wage industries and for certain high-skill positions—once again, as long as they are “reasonable” in their limitations on time and geographic limits.

There are no trade secrets to protect in sandwich preparation or proprietary expertise to safeguard in housecleaning.

In contrast, however, **most non-compete agreements in low-wage industries could not and should not be considered reasonable**—they frequently do not serve legitimate business interests and arguably cannot be implemented in any way without causing unreasonable harm to employees.

There are several reasons for this. **First, there is almost never any confidential information involved in these industries**—there are no trade secrets to protect in sandwich preparation or proprietary expertise to safeguard in housecleaning. These jobs do not require significant company-specific training or education, and indeed, employers in these industries rarely invest in any training whatsoever. As a result, it's difficult to see a compelling business interest related to protecting confidential information in these industries.

Similarly, while middle-wage workers in these trades do in fact have significant skills, they essentially use a shared body of expertise about their specific trade, so employers in these occupations have a harder time claiming their workers have confidential knowledge about the trade that would not otherwise be available to competitors.

Secondly, **using non-compete agreements in low-wage industries to shield customers undermines the basic principles of the free market**—that businesses should remain free to recruit employees of their choice without hindrance<sup>5</sup> and entrepreneurs with innovative ideas should remain free to leave their employers and start their own businesses. By effectively limiting the pool of labor available in specific geographies, these types of agreements hurt other businesses in the same industry by holding them back from recruiting the labor they need. Moreover, these agreements can limit new business formation by prohibiting employees from starting a new competitor.

# 40%

of workers in the United States have signed a non-compete agreement at some point in their careers

# 20%

of workers are currently working under such an agreement.

# 14%

are workers without a college degree

# 14%

of workers earning less than \$40,000 per year have signed these agreements

**A NON-COMPETE PROFILE:****Daniel**

Daniel is a 34-year-old single dad living in a small town outside of Asheville, NC. He worked as a top fitting plumber for a mechanical contracting business for eight years. During that time his workload increased significantly without a meaningful increase in pay, and he accepted a competitive offer for a similar job with another company. Months later, Daniel received a letter from his former employer informing him that they were suing him for violating their non-compete agreement.

“At that point, I felt like I had to prove my innocence,” Daniel said. “It was a real headache dealing with a lawsuit. The company wanted a lot more money than I could afford, but we finally settled on a payment of about \$5,000. They also placed restrictions on which aspects of my new job I am allowed to do, which companies I can apply to work for, etc.”

Like many workers, Daniel says he didn’t understand the implications of the agreement when he was hired. “When I was filling out the paperwork, it included a sheet that I signed that I didn’t really understand. I was 25 at the time, and didn’t know a lot.”

“I’m lucky my current employer stood by me and worked with me,” Daniel said. “I was worried they’d decide it was too much trouble and let me go. According to the non-compete agreement, I wouldn’t have been able to apply for a new job anywhere in my field for five years. This work is all I know, so I would have been flipping burgers or doing some other low-wage entry level job again. I would have had to start all over from square one.”

**Both of these trends can generate negative consequences for the broader economy.**

Economists have found that even “reasonable” non-agreements in high-wage industries can hamper regional innovation, job creation, firm profitability, and wage growth.<sup>6</sup> The classic contrast involves Silicon Valley, which almost never saw the use non-compete agreements and has far surpassed in terms of innovation the technology region along Route 128 in Massachusetts where non-competes are regularly used.<sup>7</sup> Although more research needs to be done, it is likely that similar limitations in low-wage industries would also have a similarly negative impact on a state’s economy.

**Finally, non-compete agreements cause unreasonable hardship for workers in low-wage industries in several ways.**

Most importantly, these agreements—and the threat of litigation— weaken the ability of workers to use the opportunity of taking a different job as a bargaining chip for negotiating a raise with their employer. Moreover, the geographic limitations embedded in the agreement can place a special burden on low-wage workers, who may not have access to a car or public transportation. The mismatch between available jobs and affordable housing is already making it harder for workers to find jobs in the places they can afford to live.<sup>8</sup> By requiring additional limitations on where employees can work, non-compete agreements would only make the problem worse.

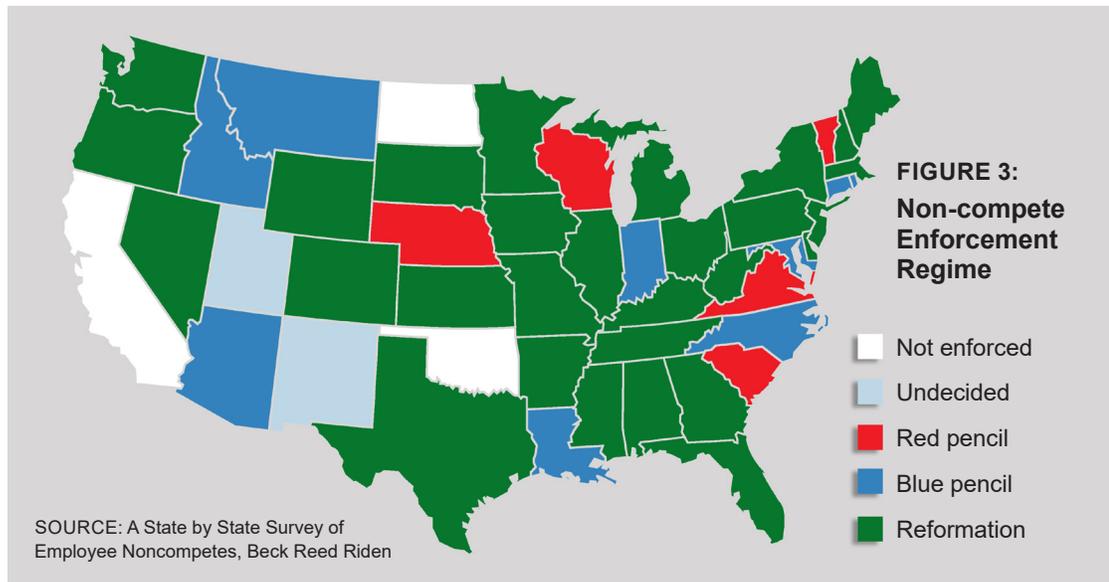
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Using non-compete agreements in low-wage industries to shield customers undermines the basic principles of the free market.

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**How other states are reining in Non-Compete agreements**

The courts are the ultimate deciders over whether non-compete agreements between employers and employees are reasonable and should be enforced. **State legislatures, however, have the statutory authority to set guidelines for court enforcement of these contracts,** and these guidelines tend to fall within four different categories or frameworks (see Figure 1, page 5).<sup>9</sup>



Some states—*the non-enforcers*—will not enforce any sort of non-compete agreements for any reason. Examples of these non-enforcers are California, home to Silicon Valley, and North Dakota, home to a booming oil and natural gas industry. In both cases, state governments argued that non-compete agreements would cripple their most innovative industries. Utah, Michigan, and Massachusetts are considering similar proposals.

At the opposite end of the enforcement spectrum, the majority of states use a **Reformation Doctrine** that allows courts to completely rewrite non-compete agreements to make them legally permissible. This could involve both deleting defective text— e.g., it fails to protect legitimate business interests or places unreasonable hardship on the employee—and adding new language that is legally appropriate. Employees would then be bound by a contract written in some part by the court on their behalf but which they did not sign.

In between these extremes is the **red-pencil doctrine**, which requires courts to throw out an entire non-compete agreement if at least one provision is found to be legally defective. In contrast, **blue-pencil doctrine** states allow their courts to delete defective provisions while keeping the remaining legally permissible provisions in effect.

**North Carolina is a blue-pencil state, where courts tend to discourage broad enforcement of these agreements**<sup>10</sup> and generally give rigorous scrutiny to them, especially when there is a power differential between employer and employee. For example, as the North Carolina Supreme Court explained in 1940:

**[a] workman “who has nothing but his labor to sell and is in urgent need of selling that” may readily accede to an unreasonable restriction at the time of his employment without taking proper thought of the morrow, but a professional man who is the product of a modern university or college education is supposed to have in his training an asset which should enable him adequately to guard his own interest, especially when dealing with an associate on equal terms.**<sup>11</sup>

Historically, many of the court decisions across the country dealing with non-compete agreements have concerned high-skilled workers like IT professionals. Only a handful of cases to date involve challenges by unskilled or low-wage workers, possibly because the use of these agreements with unskilled workers is a new trend.

Where such rulings on low-wage non-competes have occurred, some courts noted the difference between the nature of the job duties in these different sectors and especially the equities of the situation when low-wage workers are involved in determining whether the agreement addresses legitimate business interests and the reasonableness of the hardship placed on employees. For example, the Delaware Court of Chancery noted:

**[Defendant employee] was an at will employee of Elite who did not have access to any sensitive information, received no training, and received compensation (without benefits) only slightly above minimum wage. Under these circumstances the balance of the equities weighs against enforcement of the noncompetition agreement. Enforcing the agreement would work serious hardship on [Defendant employee] and discourage him from seeking better employment and greater security for his family elsewhere.<sup>12</sup>**

Similarly, a 1998 Rhode Island decision noted that “[s]ingling out employees at relatively low levels of employment, such as that of the defendant, rather than those at the middle and upper levels, for post-employment non-competition agreements suggests that the purpose of those agreements is not so much to protect an employer’s trade secrets and confidential business information but rather to exercise economic control over certain classes of employees.”<sup>13</sup>

North Carolina is a blue-pencil state, where state law tends to discourage broad enforcement of these agreements.

**Although there have been fewer court challenges to non-compete agreements by low wage workers to date, workers have taken the fight against these agreements to the broader public.** In one example, Amazon quickly backed down from its practice of requiring non-competes from temporary and contract packaging worker staff after workers raised considerable negative publicity. Similarly, Jimmy Johns was excoriated in the press for the non-compete agreement they asked their sandwich makers to sign. The company claims to have abandoned the practice in 2015 and recently reached a settlement with the affected employees.<sup>14</sup>

In both of these cases, public pressure proved sufficient to protect low-wage workers. Yet given the growing use of these agreements in low-wage industries, **North Carolina needs a robust policy framework that addresses all low-wage workers affected by non-compete agreements, rather than simply asking courts to rely on the blue-pencil doctrine on a case-by-case basis.**

## POLICY RECOMMENDATIONS FOR LOW-WAGE WORKERS

Ultimately, non-compete agreements in low-wage industries limit the freedom of businesses to recruit the labor they want and limits the freedom of workers to negotiate the wage they deserve. Lawmakers should take several steps to restore economic freedom and protect workers.

- ▶ **Prohibit enforcement of non-compete agreements entered into by low-wage workers in North Carolina.** In a more targeted version of the blanket bans in California and North Dakota, the General Assembly could set a specific definition of low-wage worker as one who earns less than \$15 per hour or \$31,200 in annual salary; who is covered by the overtime provisions of the Fair Labor Standards Act; or who is laid off or fired. Several states, including Washington, are already considering a similar proposal, while Minnesota has proposed legislation calling for a study of the impact of non-compete agreements, particularly the impact on low-income workers.

- ▶ **Explicitly affirm the importance of economic freedom and create a tougher legal standard for all permissible non-compete agreements in North Carolina.** The General Assembly should declare that the public policy of the state is to allow the free movement of labor and to encourage entrepreneurship, and that the use of non-compete agreements should be subject to more rigorous scrutiny by the courts.
  
- ▶ **Strengthen federal rules on non-compete agreements for low-wage workers.** Congress should consider something similar to last session's Mobility and Opportunity for Vulnerable Employees (MOVE) Act. The bill, introduced in June 2015, prohibits covered employers from entering into non-compete agreements with low-wage workers. Employers violating the MOVE Act would be subject to a civil fine imposed by the US Department of Labor.

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