

Creation, Growth, and Destruction

The Life-Cycle Impact of Enforcing Covenants Not to Compete on Spin-Outs and other New Ventures

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The story of David Neeleman and Jet Blue

- CEO of Morris Air from 1988 to 1993
- Morris Air acquired by Southwest in 1993
- Neeleman signed a 5 year non-compete with Southwest
- Left shortly after signing
- Moved to Canada to avoid violating his non-compete
- Started Jet Blue in 1999, after the expiration of his non-compete

Covenants Not to Compete

Definition: A post employment restraint that prohibits a worker from competing against his/her former employer for a certain amount of time, in a certain geographic region, or from doing a certain activity.

Process:

- ① Employee signs non-compete at firm
- ② Employee and firm separate
- ③ Employee works for competitor or starts competing firm
- ④ Prior employer learns of this
- ⑤ Prior employer files suit against former employee and/or former employee's new employer
- ⑥ Litigation/Arbitration (Usually seeking preliminary injunction)
 - Substantial variation in state-level enforcement

Research Question

What is the impact of state-chosen non-compete enforcement policies on the life cycle of spin-outs and other new ventures?

Motivations:

- New venture creation, innovation, job growth, are crucial for economic success.
- CA prohibition vs MA enforcement \implies Silicon Valley $>$ Route 128 (Gilson 1999, Fallick et al. 2006).
- Only one study of firm starts (Samila and Sorenson 2011)
- No studies of effect on growth, survival.
- Debate on efficacy of Non-Competes, with little empirical evidence

How?

- ① Create list of new ventures and spin-outs using LEHD and LBD
- ② Generate non-compete enforcement index (Bishara 2011)
- ③ Estimate pooled OLS and DD models on new venture/spin-out:
 - Creation
 - Survival
 - Employment Growth

Results Summary

Non-Competes

How Common are Non-Competes?

Most litigated portion of employment contracts (Stone 2002)

- 70-80% of CEOs (Bishara 2012 and Garmaise 2011)
- 45% of Physicians (Lavetti et. al 2012)
- 40% of Engineers (Marx et al. 2011)
- 760 Published Cases in 2012 (Angus and Simon WSJ 2013)
- Manicurists, carpet installers, liquor deliverymen, bartenders, cosmetologists, pest exterminators, garbage collectors, janitors, night-watchmen, undertakers, and security guards (Stone 2002)

What do we know about Non-Competes in Practice?

Marx et al. (2011): Survey of 1,000 Engineers

- 40% have signed non-competes.
- 70% of non-competes are not mentioned in employment offer
- 45% of workers who sign do so on first day
- 30% who quit after signing take career detours to avoid potential litigation

Takeaway: Firms use them strategically. Effects are big.

How are Non-Competes Enforced?

- ① States determine policy. Judges follow state precedents.
- ② Most states use “Rule of Reason”, which balances
 - protecting firm investments (R&D, Trade Secrets)
 - harm to worker’s livelihood
 - harm to society

► Empirical Non-Compete

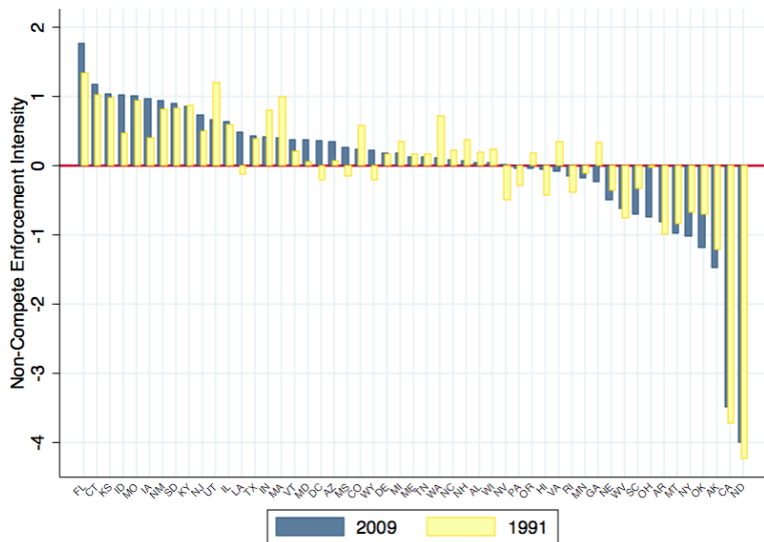
Quantifying Non-Compete Enforcement

- Malsberger series on state non-compete cases.
- Bishara (2011) scores six aspects of state enforcement laws from 0 (low enforcement) to 10 (high enforcement).
- Perform factor analysis on six components to generate one index.

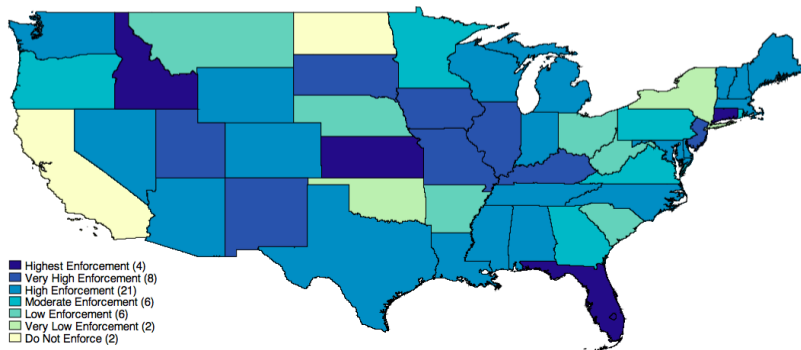
CFA Non-Compete Enforcement Weights

Question	1991	2009
Statute of Enforceability	0.14	0.10
Employer's Protectable Interest	0.10	0.21
Plaintiff's Burden of Proof	0.13	0.14
Worker's Consideration	0.14	0.08
Overbroad Contracts	0.05	0.04
Quit v. Fire	0.15	0.07
Correlation= 0.94		

Non-Compete Enforcement by State



Geography of Non-Compete Enforcement in 2009



Empirics

Empirical Approach

- Non-compete enforcement varies primarily in the cross-section.
- Cross-sectional regressions may be contaminated by OVB.
- DD? Compare affected and unaffected industries within a state.

Which Industry is Unaffected by Non-Competes?

Law:

- 1961 ABA Formal Opinion 300
- 1969 ABA adopted Disciplinary Rule (DR) 2-108(A)
- 1983, ABA solidified stance in Rule 5.6 of the Model Rules of Professional Conduct

“Restricting the rights of partners to practice after leaving a firm” is prohibited.

Empirical Model

Standard DID Model:

$$Y_{ijst} = \gamma_0 + \gamma_1 NL_i * Enfc_s + \gamma_2 * NL_i + \gamma_3 * \underbrace{Enfc_s}_{\text{Endogenous?}} + \phi Z_{ijst} + u_{ijst}$$

State, Industry Fixed Effects DID Model:

$$Y_{ijst} = \gamma_0 + \gamma_1 NL_i * Enfc_s + \underbrace{\lambda_i}_{\text{Industry FE}} + \underbrace{\theta_s}_{\text{State FE}} + \phi Z_{ijst} + v_{ijst}$$

Threats to Identification must

- be correlated with non-compete enforcement
- differentially affect Y between law and non-law industries.
- **within** a state.

Table: Summary Statistics

Table: Creation Results

Table: Survival Results

Table: Growth Results

Conclusion

Non-Competes in the Social Science Literature

- Lack of enforcement contributed to Silicon Valley's dominance over Route 128 (Hyde 1998, 2003, Gilson 1999)
- Signing non-compete reduces mobility (Marx 2009, Lavetti et al. 2012, Garmaise 2011)
- Mixed responses on wages (Lavetti et al. 2012, Garmaise 2011)
- Limits entrepreneurship and innovation (Samila and Sorenson 2012)

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