Non-Compete and Independent Contractor Laws

A Comparison between Massachusetts and California

January 2016
California Non-Compete

A non-compete clause (NCN) in contract law is an agreement between an employee and an employer in which the employee agrees not to enter into or start a similar profession in competition with the employer. The purpose of an NCN is to give some protection to the employers. Hiring an employee is an investment and employees could potentially reveal confidential information and trade secrets. Employees also have access to sensitive information that could be exploited such as a business’s customer/client list, business practices, upcoming products, and marketing plans.

If a former employee is found to be in violation of a non-compete agreement, then the former employer may bring the former employee to civil court in the state in which the wrongdoing has occurred. For example, an employee originally signs an NCN in Massachusetts. If the employee leaves the firm he is at and begins a new job in violation of his NCN, he may be taken to court wherever the new job is located, not where the NCN was originally signed. Therefore, an employee may move to a state, such as California, that has virtually no non-compete laws and a lawsuit would prove to be unsuccessful.

Since Californian courts will almost always rule against non-compete clauses, employers will often include choice-of-law clauses in their non-compete agreements. Choice-of-law clauses specify which jurisdiction applies in the event of a contract dispute. However, Application Group v. Hunter, California established that Californian courts may rule choice-of-law contracts invalid (Application Group v. Hunter Group, 61 Cal. App. 4th 881, 887 (1998). However, this decision appeared to conflict with The Full Faith and Credit Clause of the Constitution. Intending to ensure that states validate and enforce agreements made in other states, the clause states, “Full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state.” California’s attempts to invalidate
agreements in other states may be challenged on Constitutional grounds. “Contrary to the choice of law
provision specifying that Maryland law would apply to the non-compete case, Californian court chose to
invalidate the non-compete agreement under California law rather than to uphold it as would be required
under the laws of Maryland.”

The discrepancy between the Full Faith and Credit Clause, intended to preserve the legality of other states’ provisions, and
California’s decision in Application Group appear to conflict. This led Californian employers to file anti-
suit injunctions, which are court orders that prevent litigants from filing parallel claims in other courts. In
*Medtronic v. Advanced Bionics*, the California Supreme Court ruled that anti-suit injunctions may not be
used to decide choice-of-law matters (*Medtronic Inc v. Advanced Bionics Corp.*, 630 N.W.2d 438 (Minn.
Ct. App. 2001)).

As a result, non-compete disputes are currently decided via parallel litigation. Employees in
California race to achieve a court ruling that nullifies their non-compete agreement as their employers in
other states file in non-Californian courts in order to validate non-compete agreements. “those who seek
to enforce-- or to avoid-- such provisions may engage in a ‘race to the courthouse,’ typically one located
in a forum perceived as friendly to their position. For example, an out-of-state employer might try to
enforce a valid non-compete agreement in its ‘home’ forum, or in the court specified in a contract
containing a forum selection clause. Similarly, as occurred in *Application Group v. Hunter Group*, an
employee seeking to avoid a non-compete agreement may file a lawsuit in a California court, seeking a
declaratory judgment invalidating the same provision”

This legal “race” becomes significant due to the Full Faith and Credit Clause of the US
Constitution. The Ninth Circuit has recognized “it has long been established that a final judgment
rendered under the laws of one state must be enforced by a sister state under the Full Faith and Credit
Clause, even though the underlying action may be against the public policy of the state in which
enforcement is sought” (*Harrah’s Club v. Van Blitter*, 902 F.2d 774, 777 (9th Cir. 1990). Therefore, in
instances of parallel litigation, the first court ruling becomes binding under the Full Faith and Credit
Clause.

This analysis suggests that California’s economic advantage caused by non-compete avoidance
may not be as strong as it was before the Advanced Bionics decision. Since out-of-state employers now
have the ability to enforce non-compete agreements in California, the potential brain drain effect is
mitigated. Firstly, the risk that non-competes can be enforced in California will likely disincentivize
individuals from leaving their original firms. Workers who have the option to quit their jobs and move to
California likely require a high degree of certainty before they make this life-changing decision. The
uncertainty of the complicated non-compete enforcement process is sufficient to induce many workers not
to migrate to California since their financial well-being would be compromised if the courts rule against
them. Additionally, even if employees were confident that a non-compete agreement would be rendered
void, employees may be deterred by the time-consuming legal battles they would face. Lastly, employers
from non-California firms now have the legal tools to craft superior agreements and ensure faster court
procedures. Firms have the resources to hire expert legal teams with technical knowledge about specific
choice-of-law clauses will be able to target jurisdictions that are known for favorable and speedy rulings.
“Employment lawyers used to advising clients that non-competition agreements are unenforceable in
California may wish to consider whether wise litigation strategy affects that analysis. An out-of-state
employer’s efforts to enforce non-compete agreements in courts outside California may well be rewarded.
The drafters of restrictive covenants must give due consideration to forum selection and choice-of-law
clauses to maximize the enforceability of these agreements.”

(http://www.shawvalenza.com/pubs/NonCompete.pdf)

Even with the basic prohibition of non-competition provisions in California (with some
exceptions such as the sale of entire businesses and similar situations), the state does protect trade secrets
and many confidentiality clauses.

In a handful of cases, non-competition clauses are allowed and enforceable in California. These
include:
1. Any person who sells the entirety or a business

2. Any shareholder of a corporation transacting the sale of a large percentage of their operating assets along with the goodwill of a corporation or a subsidiary of the corporation

3. Any partner in the case of the dismantling of the partnership

4. Any member who sells his or her interest in a limited liability company

Any owner of any of these situations listed above are subject to the legal enforcement of non-compete clauses in California. These exceptions represents a significant caveat to the common assumption that California laws create an absolute prohibition over the enforcement of any state's’ non-competition clauses, often creating legal ambiguity and case reviews debating the legality of non-compete clauses in complex situations.

Furthermore, the distinction between non-compete and non-disclosure agreements must be made when considering the laws governing California. Non-disclosure agreements (also known as NDA’s or confidentiality agreements) protect the trade secrets and many of the operational techniques of companies. The definition of “trade secret” encompasses any information, such as a mechanism, process, formula, program, data, or method that contains economic value from being unknown to the general public or derives economic value from its disclosure and is “subject of efforts that are reasonable under the circumstances to maintain its secrecy.” (Civil Code Statute 3426. 1(d), or California’s own version of the Uniform Trade Secrets Act). The Uniform Trade Secrets Act, or UTSA, protects trade secrets even in the circumstance where there is no written agreement if the information was acquired through means that present an obligation to “maintain its secrecy or limit its use.” Such individuals that are susceptible to non-disclosure agreements include employees or officers who have the implicit obligation to maintain the secrecy of trade secrets to their company; moreover, a written agreement creates more security and enforceable protection under the law.

However, another complication exists with the discussion of non-disclosure agreements in California: the “inevitable disclosure” doctrine. In the legal doctrine, an employer has the ability to use trade secret laws to discourage or in some cases prohibit a former employee from working in a job that
would inevitable result in the use of trade secrets acquired from the employee’s former company. California, on the other hand, has completely rejected the doctrine and prohibits employers from discouraging past employees from participating in jobs that may result in the inevitable disclosure of trade secrets. Therefore, though the concept of non-disclosure agreements in the short term cases are enforceable in California and employees are prohibited from openly disclosing trade secrets, employers are unable to prohibit former employees from participating in jobs that might result in the inevitable disclosure of such secrets.

With the absence of any written agreement between employer and employee regarding non-disclosure agreements and trade secret protection, several components of trade secret law in California may be difficult to enforce as the definition of what constitutes confidential material and other concepts may be subject to interpretation under the circumstances of each case. More specifically, employers cannot make trade secrets valid by contract, so written agreements between employers and employees must establish a degree of confidentiality prior to employment.

In the case of employee inventions, California Labor Code Section 2870 mandates that inventions developed entirely on an “employee’s own time without using the company’s equipment, supplies, facilities, or trade secret information” cannot be property of the employee’s company if it does not relate to the business of the company. As such, many employees in the Silicon Valley area develop projects on their own and their projects cannot be legally seized by the employee’s current employer.

California’s unique absence of non-compete laws allows the state to benefit from an intellectual brain drain. Since California is the only state? that doesn’t enforce non-compete agreements, workers from across the US that wish to change their firm are drawn to California. If employees who signed non-compete agreements become unsatisfied with the policies or conditions of a particular firm, they may only be able to receive a job in a completely different field unless they move to California. Additionally, California provides an opportunity for employees who seek more competitive positions after they have received training and experience in a particular field. These factors contribute to a significant brain drain effect that draws talent, ideas, and human capital to California. The brain drain occurs not only in the
number of workers that move to California but also in the *types* of workers. “Non-compete enforcement drives away inventors with greater human and social capital, while retaining those who are less productive and less connected.” (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1654719).

Due its refusal to enforce non-compete agreements, California achieves a comparative advantage in attracting creative, trained and well-connected human capital from other states. Massachusetts and other states may choose to adopt similar policies in order to attract experienced talent from neighboring regions. California currently enjoys monopoly over the labor market of individuals seeking to escape non-compete agreements; adopting a similar stance would likely make Massachusetts a more appealing location for potential employees but a less appealing location for new start-ups or employers. While the networks, connections, and culture of Silicon Valley are strong enough to promote employers to engage in start-ups despite the lack of non-compete protection, it is possible that Massachusetts employers would become disincentivized by looser non-compete laws. In order to evaluate the desirability of removing non-compete laws in Massachusetts, it is essential to view the effects of current policies on the Massachusetts economy.

**Massachusetts Non-Compete**

California’s refusal to enforce non-compete agreements is by no means a ubiquitous attitude throughout the United States. Many states enforce them relatively strictly, while still others adopt a case-by-case approach in the vast gray area in between. Massachusetts best fits under the latter grouping, looking to case law and individual circumstances as the biggest determinants of a noncompete clause’s validity but frequently enforcing them nonetheless. This policy disparity between Massachusetts and California has prompted debate over the economic value or detriment that noncompete agreements really pose. And because noncompete
agreements are often most controversial in sectors with high intellectual property values and fluid labor forces like the innovation industry, a sector increasingly central to economic growth in both states, the debate has encouraged comparisons in policies and results between Massachusetts and California. An analysis of noncompete case law and legal precedent in the Commonwealth, combined with an evaluation of the innovation industry’s importance to the state, reveals that state government should approach noncompete clause issues with an open mind to its ultimate priorities - a growing economy and improving quality of life for Massachusetts residents. And as was revealed in the California analysis, rigid noncompete enforcement is not necessarily correlated with these objectives.

Many recent developments and trends have shaped the way that noncompetition agreements have been enforced in Massachusetts. In some cases, a precedent has been set for the predicted outcome of rulings deciding whether a noncompetition agreement will be enforced, but in a majority of the following categories, variables such as the ambiguity of the wording of the clause, the type of industry, and the conditions of employment have resulted in a degree of unpredictability regarding the enforceability of noncompetition agreements.

A common theme in noncompetition agreements deemed unenforceable by courts is a lack of specific definitions of words that can be subject to broad interpretations. For example, in *FLEXcon, Co. v. McSherry*, the court ruled that terms such as “territories” and “activities” were not well defined and the clause was described as “ambiguous and poorly drafted,” resulting in the agreement being deemed as unenforceable (D. Mass., 2000). Similarly, in *Norton, Co. v. Hess*, the usage of the word “access” would have allowed the agreement to include all of the employer’s confidential information, rather than limiting the agreement to include the information that was actually gained or used by the employee (Mass. Super. Ct., Sept. 27, 2001).
Therefore, noncompetition agreements are vulnerable to unenforceability if the employer does not carefully phrase the wording of the clause and include reasonable definitions of the restrictions that the employee will face.

Moreover, if the agreement is deemed to be too broad with regards to time, geography or subject matter then the consensus is that the agreement can only be enforced to a reasonable extent. Over the past decade, it has been evident that Massachusetts courts have regularly enforced noncompetition covenants that last one or two years. However, it is interesting to note that some similar decisions in New York have suggested that for the Internet industry specifically, one year is too long (Mass Bar, 2003). Taking the great growth of Internet industries into account, it can be predicted that courts will likely investigate the duration of such covenants quite closely given the fast-paced nature of the industry. Additionally, general guidelines often used by the courts to determine reasonability consider the nature of the business, the character of employment, situation of the parties involved in the agreement, the necessity of such restriction for the protection of the business, the right of the employee to work and earn a livelihood, and lastly, the length of agreements for similar employees in comparable situations (Mass Bar, 2003). For example, when the court considers a salesperson, his or her appropriate geographic area would logically be the assigned sales territory. However, complications arise when the company’s dealings span national and international regions. Yet, there seems to be a degree of liberality in the decision of enforceability across geographic regions. For example, in Cereva Networks Inc. v. Lieto the covenant was ruled to be enforceable worldwide and in Philips Electronics North America Corp v. Halperin, the agreement was ruled to be enforceable across the country (Mass. Super. Ct., Oct. 12, 2001). Thus, the globalization and expansion of
companies has lent a degree of malleability to the question of reasonable scope in noncompetition agreements.

Furthermore, a key deciding factor of the whether the agreement is ruled to be enforceable involves the court’s decision about whether the former employee is actually competing with the former employer. In *Cereva Networks v. Lieto*, it was ruled that the two companies were in direct competition on the basis of “the consumer and to whom the product is marketed” (Mass. Super. Ct., Oct. 12, 2001) Conversely, in *Cambridge Tech. Partners (Massachusetts), Inc. v. Sims*, both companies had a platform involving planning for the “New Economy,” but it was ruled that regardless of the usage of similar language for the description of the companies’ purposes and offerings, they did not provide similar services and thus were not in direct competition (Middlesex Super. Ct. Aug. 15, 2000). Additionally, a relevant angle on this issue involves the technology industry. In *Marcam Solutions v. Sweeney*, despite the contestation that the two companies utilized differing approaches to software, it was deemed by the court that both companies were considered competitors in the industry (Mass. Super. Ct. Mar. 25, 1998). Another interpretation in *EMC Corp v. Allen*, ruled that both companies fulfilled “the same need in the same marketplace.” Another important aspect of this issue involves the question of research and development on products still in development. In *CR Bard v. Intoccia*, it was ruled that products in development were still competing, as the race for development is a form of competition (D. Mass. Oct. 13, 1994). Therefore, it seems that the general parameter for enforceability of the agreement based on competition involves an economics-based approach, addressing the questions of whether the two companies’ products are nearly substitutable and what constitutes zero-sum competition in the particular industry in question.
However, another issue directly correlates with the question of competition, and this involves the issue of who is entitled to the customer good will. The general legal logic and possible consensus regarding this issue is as follows. If there is the question of a customer that was serviced before commencement of new employment, then the employer had no good will interest. This conclusion would be due to the fact that the objective of a reasonable agreement is to protect the employer’s good will not appropriate the goodwill of the employee (Mass Bar, 2003). In order to hold more credence, the noncompetition agreement should not include pre-existing customers. Additionally if the customers had established relationships with the employer before the employee’s employment or the employer introduced the employee to a customer during employment, the employer has clear goodwill interest. The last question involves customers developed by the employee during employment. There is no outright consensus on this issue, because with this situation it becomes a question of whose good will is at stake. One ruling is that the employer has no good will interest because the good will involved was of the employee’s own making. However, a majority of court rulings have decided that this goodwill belongs to the employer (Mass Bar, 2003).

Additionally, many former employees claim that duress during the signing of the agreement voids its enforceability and there has been variable ruling on this question. In Browne v. Merkert Enterprises, Inc., the claim of duress was ruled invalid because the employee had negotiated the agreement and used an attorney to do so (Mass. Super. Ct. Mar. 30, 1998). Additionally, in HealthDrive Corp v. Chall, the defendant remained employed at the company in question for five years following the signing the agreement, showing that the idea of duress had little credence due to the employee’s choice to stay at the company (Middlesex Super. Ct. Feb. 9, 2000). Conversely, the claim of duress has succeeded in some cases. In First Eastern Mortgage
Corp v. Gallagher, the employee was coerced to sign the agreement much after he commenced his employment at the company, so the agreement was deemed unenforceable (Mass. Super. Ct. July 21, 1994). Similarly, in FLEXcon Company Inc. v. McSherry, the noncompetition agreement was not included in the original offer letter of employment, and thus the covenant was ruled as not enforceable (D. Mass. 2000). Thus, it is apparent that such questions of duress can be averted through the employer ensuring that the employee is aware of the noncompetition agreement prior to accepting employment at the company.

An additional factor that has affected noncompetition rulings involves the issue of whether the agreement is complies with public interest. The Supreme Judicial Court has stated that the public has an interest in "every person carrying on his trade or occupation freely" and that contracts restraining freedom of employment can be enforced only when they are "not injurious to the public interest" (Mass. Super. Ct. Nov. 25, 1997). However, in many cases, "public interest” is ill defined. This issue commonly comes up when financial advisors attempt to take existing clients with them when they switch firms and the success of this claim is variable. In American Express Financial Advisors Inc v. Walker, the one-year agreement was ruled to be too long (especially since the client was not informed about this prohibition) and additionally, the advisor-client relationship was deemed as a “valuable and important personal and financial relationship” which should be afforded some protection (Mass. Super. Ct. Oct. 28, 1998). Conversely, in McFarland v. Schneider, the covenant was upheld as the relationship between the fund manager and the investment advisor was deemed to require trust and confidence, but not to the parameter of the trust required for the intimate relationship between a doctor and a patient or a lawyer and a client (Mass. Super. Ct. Feb. 17, 1998). Similarly in Salomon Smith Barney Inc. v. Wetzel, the court equated the stock broker role to that of a salesperson, not characteristic of the
previous examples of intimate business relationships (Mass. App. Ct. Jan. 29, 2001). There have many similar decisions since then regarding business relationships involving financial advisors, and the legal world seems to have a propensity for the idea that the relationships involving financial advisors lack the degree of intimacy that would void restrictive noncompetition agreements.

Furthermore, the legal consensus seems to be that if the noncompetition agreement has been executed before or at the start of employment, it will be supported by consideration. However, problems of enforceability arise if the agreement is put into place much after the commencement of employment, as it is questionable whether the idea of consideration still holds. Since 1991, there have been three cases that have resulted in a ruling that continued employment results in sufficient consideration, and more recently, court rulings seem to agree (Mass Bar, 2003). It is also important to note that additional consideration resulting in a higher degree of enforceability for the agreement may come in the form of a raise, bonus and/or promotion in the case that the employee is asked to sign the agreement following the start of employment. Thus, the time at which the agreement is signed greatly influences its enforceability.

Similarly, the question of whether the covenant holds in the case of a change in the employer-employee relationship affects court decisions. However, there seems to be a stable precedent regarding this issue. In both FA Bartlett Tree Expert v. Barrington and IONA Tech. v. Walmsley, the previous noncompetition agreement was deemed to be unenforceable after factors such as a change in the employment situation and a leave of absence (Mass. Super. Ct. Aug. 8, 2000). Although this question of novation does come up in court rulings, the general legal consensus seems to be that an unchanging employment relationship is a requisite for an
agreement to be valid. Furthermore, the question of material breach has arisen in some court cases regarding noncompetition agreements. In these precedents, a similar outcome is apparent. In both *Lantor Inc. v. Ellis* and *Karns v. Folio Exhibits, Inc.*, an employer unilaterally changed the terms of employment, which was ruled to have resulted in a material break of the noncompetition clause (Mass. Super. Ct. Oct. 2, 1998). Thus, the legal consensus seems to imply that a lack of consultation in any changes made to the terms of employment directly negates the enforceability of the noncompetition clause, which relied on the previous conditions of employment.

Given the many variables in a noncompetition agreement, the problem of such a covenant’s enforceability is more understandable. Although rulings about some of the aspects of noncompetition agreements have gravitated towards a general precedent and legal consensus, it is apparent that a majority of the facets of noncompetition clauses possess nuances unique to different industries. Additionally, specificity regarding wording, definitions, and the time of the agreement’s signing seem to factor into enforceability. Thus, if the hope is to further enforce noncompetition agreements, companies must carefully craft the phrasing of the agreements and clearly communicate with the employee in order to encourage negotiation that would minimize legal troubles. More importantly, the Massachusetts government may want to consider the possibility of creating different parameters for the enforceability of noncompetition agreements for different industries. Creating such industry-based distinctions would foster appropriate levels of restriction given the specific nature of the industry and allow accurate evaluations of specific court cases, giving way to a higher degree of consistency in legal discussions and court rulings regarding noncompetition agreements.
High tech industries are crucial to the Massachusetts economy, primarily because of the high wages garnered by employees in these industries. While private sector wages grew by 24.4 percent between 2001 and 2009, a period encompassing both the dotcom burst and the Great Recession, average wages in high-tech industries rose by 29.6 percent, 5.2% above average.

Though high tech sector employment has been declining as a percentage of total employment in the state, from 11.2 percent in 2001 to 10.0 percent in 2009, gross total high tech wages rose from $24.6 billion to $27.6 billion, currently representing 18 percent of total Massachusetts private wages. Wage growth has been driven by both increasing demand for and decreasing supply of workers with the advanced skills necessary for high tech occupations. Significantly, employment in the software publishing, computer systems designing, and data processing industries within the high-tech sector saw employment decreases by 10.3 percent, 8.2 percent, and 32.5 percent, respectively. Those three industries represent fields often characterized by significant employee mobility and start-up culture, and they could be especially influenced by incentives and disincentives posed by noncompete legislation.

The decreases in raw employment numbers suggest that supply has decreased at greater magnitude, possibly due in part to the allure of more attractive tech development opportunities in states like California, which refuses to enforce non-compete agreements (Gillham). Nonetheless, Massachusetts remains a national leader in terms of high tech sector activity concentration and income, though California’s weighted mean hourly wage has begun to surge ahead.
It must be made very clear, however, that proving specific cause and effect relationships between economic changes (migration of entrepreneurs and startup firms, reallocation of investment capital) and the nature of non-compete law in Massachusetts is difficult and near impossible to achieve with certainty. What can be quantified, though, is the condition of the innovation economy in Massachusetts; an analysis of this sector reveals that its health is of great concern to state government, and legislators should take deliberate actions to preserve and foster its growth. In particular, an analysis of innovation concentration in Massachusetts relative to the nation, the employment and growth of economic sectors correlated statewide concentration, and the employment growth of innovation sectors relative to other leading innovation states establishes the innovation economy’s need for significant attention in the Commonwealth.

Many of the occupations that are growing in Massachusetts, that are more highly concentrated in the state than the nation, and/or that pay above average wages are those that
usually benefit from the high competition and employee fluidity associated with weak or unenforced noncompete agreements. Conversely, many of the occupations that are shrinking in employee numbers, are less concentrated in the state than in the nation, and/or pay below average wages are those established industries that have traditionally favored low employee turnover, protected investments in human capital, and strictly enforced noncompetition agreements (See graph below). As a result, as it decides how to approach noncompetition agreement enforcement, Massachusetts legislators should consider the economic direction in which the state is headed.

As is evident from the above graph, occupations like Computers and Math offer above average wages, are uniquely concentrated in the Commonwealth, and are growing, while the complete inverse is true for occupations like Construction & Maintenance and Sales & Office. Noncompete agreements, though, are most controversial in Computers and Math fields which involve high entrepreneurial value and human capital investment, generally impose a barrier to the growth of highly entrepreneurial and innovative fields like Computers and Math while they

Also, where innovation and talent at the individual level are key to success in Computers and
Math fields, organization and business strategy at the administrative levels are more important for success in Construction and Office fields. The current support for noncompete agreements in Massachusetts, then, In considering its future stance on noncompete agreements, Massachusetts legislators must decide whether they wish to maintain noncompete agreement recognition in order to aid those industries which are falling behind (those in orange in the graph above) or they wish to support those industries which are emerging as drivers of future growth (those in green in the graph above).

However, important deviators from this clear-cut binary are the Business, Financial & Legal occupations. These occupations record the highest incomes for Massachusetts residents and they are growing in the state, but established business operations are often strongest supporters of well-enforced non-compete agreements. Where start-ups, small businesses, and venture capitalists favor the employee mobility encouraged by a lack of noncompete agreements, established firms, large corporations, and existing equity holders favor guarantees of stability and a safe return on investment in human capital (including training and sharing of trade secrets). While the former segment is increasingly valuable to Massachusetts, the latter is undeniably at the core of consistently high wages and growth in the Commonwealth. It is not definitive, then, that reduced governmental recognition of noncompete agreements will in fact be in the best interest of Massachusetts’s best performing and most promising economic sectors.

In addition to growth, concentration, and pay between economic sectors, comparing employment changes in the industries of the innovation economy with the ten Leading Technology States puts Massachusetts’ conditions in perspective. Analyzing the graph below reveals that Massachusetts and California have very similar growth / contraction trends, with only two diverging industries: in the 2012-2013 business year, California saw employment
reductions in Defense Manufacturing & Instrumentation while the Commonwealth saw increases, but in Diversified Industrial Manufacturing Massachusetts employment grew (actually posting its highest growth rate of all the industries measured), while California’s employment shrank.

It is significant that in most of the innovation economy industries where Massachusetts employment grew, employment in California grew more, and in innovation economy industries where Massachusetts employment shrank, employment in California shrank more. There seems, therefore, to be a correlation between decreased non-compete enforcement and increased magnitudes in employment gains and losses; whether a causation relationship exists is unclear. In any event, though, California’s innovation economy employment grew 2.9% during the 2012 fiscal year, second only to Texas at 3.0% and significantly besting Massachusetts at 1.2%. Whether California’s innovation employment growth at a rate more than double that of Massachusetts’s may certainly be a function of its more lax non-compete atmosphere, as more fluid movement into the innovation economy from other sectors likely exists in such an environment, this cannot be concluded for certain.
The debate over non-compete agreement enforcement in Massachusetts is inevitably a produce of both large, institutional businesses (typical non-compete agreement proponents) and small, start-up ventures and venture capitalists (typical non-compete agreement opponents) growing and discovering value in the state. In this light, the problem being brought into public discussion is not a terrible one to have. Nonetheless, in light of the policies being undertaken by fellow Leading Technology States, most notably California, Massachusetts legislators must consider whether its existing case-by-case policy on and significant support for non-compete agreements is in the Commonwealth’s best interest. Economic trends indicate that the innovation economy, precisely the sector thought to most benefit from reduced barriers to employee movement such as the absence of non-compete enforcement, is an increasingly integral component of the overall Massachusetts economy. But established companies continue to be the state’s largest overall employers and wage-providers. Future data may more clearly indicate whether California’s refusal to enforce non-compete agreements generates a superior economic environment overall.

**Federal Independent Contractor Law**

1) Who are Employees and Independent Contractors?

The most significant laws concerning federal Independent Contract law are the IRC (Internal Revenue Code) and the FLSA (Fair Labor Standards Act). These laws create the overall distinctions of what are the obligations an employer has towards his employers or contractees. Employees enjoy: overtime/minimum wages laws, collective bargaining rights (NLRA or the National Labor Relations Act), protection from discrimination (Title VII Civil Rights Act), certain entitlements (Social Security Act & FMLA), retirement benefits (ERISA). On the other hand independent contractors enjoy copyright protections (Copyright Act) and more freedom from the employer.
There are tests that are used to distinguish employees and contractees. One such is the right to control test, which bases the distinguish on the extent of control an employer has over the worker. More control leans towards an employee and less control leans toward a contractee. This test arises from common law formed from past cases (Spirides v. Reinhardt). Factors that determine control include: control over the details of the work, whether the worker is engaged in a distinct business or occupation, whether the employer or the worker provides the tools, equipment, etc. for the job, length of employment, whether the worker does business with others.

The second test is economic reality test. This is the follow up test to the right to control test. It asks if a worker is economically dependent on his or her employer. Generally, if a worker isn’t controlled by the employer but depends on the employer, then that individual is entitled to coverage until laws protecting employees. The intent of this test is to protect those who are dependent on their employer and as a result will be protected by worker legislation.

Often, the hybrid test (which incorporates both of these tests) will be used for anti-discrimination statutes. When used, it’s found the right to control factor is the most important factor.

2) IRS and FLSA Law Pertaining to Employees & Independent Contractors

To protect employees who are misclassified as independent contractors, the IRS has defined 20 factors to guide businesses in classifying workers by compiling both its laws and previous case law into its IRC Revenue Ruling 87-41. Among these 20 factors include but aren’t limited to: worker instructions, training, whether services are integral to the business, set work hours, employer furnishes tools/equipment, worker can terminate employment. Furthermore, another guide to help elucidate the distinctions are three components for an employee: behavioral control (instructions and training), financial control (wages, limits on outside work, etc), relations of parties (contracts between the parties). Failure to be able to support an employer’s misclassification of a worker using these guidelines will result in fines and reimbursement to that worker of lost benefits.
The FLSA has a broader terminology and thus courts can interpret as case in which a worker is classified as an independent contractor under the IRC but as a worker in the FLSA. In 1968, the Department Labor commented on the FLSA stating that there were six factors that the courts found to be important in determining worker status including. The FLSA is primarily concerned with the economic realities of the job rather than the control that an employer has over the worker since the legislation is designed to ensure fair benefits for laborers.

Massachusetts Independent Contractor Law

According to Massachusetts, in order for a worker to be classified as an Independent Contractor, all three for the following elements must be met:

1. The individual must be “free from control and direction in connection ... with the service, both under his contract ... for the service and in fact.” (Massachusetts General Laws Chapter 149 Section 148B)

2. The service has to be performed “outside the usual course of the business of the employer.”
   (Massachusetts ... Section 148B)

3. The worker is required to be “engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.”
   (Massachusetts ... Section 148B)

As an overview, these criteria don’t differ from the federal definition of Massachusetts Independent contractors. When businesses classify workers as independent contractors, the burden of proof lies on the employer. Entities that misclassify individuals are often committing insurance fraud and depriving individuals of many benefits and legal protections from their employees.

The reason why it is important for improving independent contract law policy in Massachusetts is because in the Commonwealth, employees wages are taxed more than (via payroll tax) independent
contractors. Thus, because of misclassification, the Commonwealth loses out on tax money. (An Advisory from The Attorney General’s Fair Labor Division on M.G.L. c. 149 s. 148B 2008/11) In fact, in a 2013 study on the impact independent contract law found that Massachusetts loses $195 - $278 million a year in income taxes, unemployment insurance taxes, and workers’ compensation premiums due to misclassification. (Billions in Revenue Lost Due to Misclassification and Payroll Fraud)

Also, another reason why it is important to improve independent contract law policy is because businesses that do properly classify their workers as employees often are placed in a significant competitive disadvantage against other entities within the market. In some capacity, if Massachusetts does not properly enforce independent contract laws, then the state is subsidizing businesses that aren’t following the law.

Currently, the Massachusetts Attorney General’s Office has noted that “enforcement over the last several years has been relatively or at least not well publicized” (Attorney General’s Office Issues Advisory on Massachusetts Independent Contractor Law). However, it’s important to note that Massachusetts’ state workforce agencies have been quite aggressive; Massachusetts reportedly audited more than 18,000 business in 2013 and recovered $15.6 million from companies found to have misclassified workers as independent contractors (2013 Annual Report of the Joint Enforcement Task Force on the Underground Economy and Employee Misclassification). However, despite the increase in workforce agencies, Massachusetts is still experiencing a growth in misclassifications over time.
according to Harvard report:

![Misclassification Rate by Time Period: Moderate Estimate/All Audits](image)

Source: [The Social and Economic Costs of Employee Misclassification in Construction](#)

As such, it’s clear that merely creating more task forces to increase audits isn’t resolving the misclassification issue. As such the policy and enforcement approach needs to be modified to better tackle the concerning rise in misclassification.

It’s important to note that while approaching misclassification of workers across industries would be ideal; certain industries and businesses are particularly at risk - courier, transportation and logistics industries; adult entertainment business; the cable installation industry; cleaning and sanitation
companies; and staffing and workforce management's business (2015 White Paper on Independent Contractor Misclassification: How Companies Can Minimize the Risks). In this part of the paper, we aim to elucidate the economic impact that poor enforcement has on specific industries and we ultimately suggest that enforcement of independent contract law should target industries with statistically high frequencies of employee misclassification as well as a clarification of independent contractor classification laws and ramifications for infractions.

Economic Impact by Industry: Construction

Historically, issues with Massachusetts independent contract law arose because of issues within the construction industry. Such issues continue to persist and the construction industry continues to remain as an industry that has a prevalence of employer misclassification relative to other industries and states:

<table>
<thead>
<tr>
<th></th>
<th>Low Estimate</th>
<th>Moderate Estimate</th>
<th>High Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All industries (9 states) 1/</td>
<td>5-10%</td>
<td>13-23%</td>
<td>29-42%</td>
</tr>
<tr>
<td>All industries (US) 2/</td>
<td></td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>All Industries ME</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction ME</td>
<td>14%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction MA</td>
<td>14%</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td>Construction (US) 2/</td>
<td></td>
<td></td>
<td>20%</td>
</tr>
</tbody>
</table>

1) All industries based on DOL/Planmatics state estimate ranges, ~1999
2) Based on 1984 Treasury Department estimate, cited by U.S. GAO. (1996)

(Source: The Social and Economic Harvard Paper Pg. 14)

From the data, it appears that regardless of low or moderate estimates, the prevalence of employer misclassification in the Massachusetts construction industry across Maine, Maryland, Washington, Colorado, Minnesota, Nebraska, New Jersey, Wisconsin, Connecticut, and California. At very conservative measures, at least 14% of Massachusetts construction employers misclassified their workers. Comparing that to the larger scheme of all industries in which experts expect that about 13.4% of Massachusetts employers misclassify their works, that is very significant. Even using moderate estimates
of 24% of construction employers misclassifying their workers, it’s clear that the construction industry is particularly unique in the prevalence of worker misclassification (Second Harvard Paper).

**Economic Impact by Industry: Transportation and Delivery Industry**

Unlike the construction industry, often workers within the transportation and delivery industry require less attention than the construction industry. According to a 2011 study, the Mack-Blackwell Rural Transportation Center found that “independent contract drivers operate in that status because they see more advantages than disadvantages” Approximately 85% had previously been company drivers” (Johnson 55). From this data, including from other other surveys, it appears as though, unlike the construction industry, independent contractors working with companies are purposefully employed as such under the workers’ prerogative. Because of the context of many workers in the transportation and delivery industry are documented to be as such, we advise that while it is important to focus on the transportation and delivery industry, less attention should be given to the transportation and delivery industry than the construction industry.

Even so, the media has highly caught issues with worker exploitation within this industry. In the past year, lawsuits facing Uber and Lyft have raised awareness with potential issues concerning especially in Massachusetts, as reported by the Boston Globe (Boston Globe Article). However, at the moment, because the courts have yet to decide the legal position on whether Uber and Lyft drivers are legally independent contractors or employees. So at the moment, the recommendation is to wait for the ruling from the courts until any policy action is taken.

**Policy Recommendations**

Independent contractor misclassification isn’t a uniquely Massachusetts-issue. In fact, many states have encountered similar issues and, to date, at least 21 states have created task forces designed to identify and remediate independent contractor misclassification (White Paper) including Massachusetts.
Our first recommendation is to focus effort on reviewing unemployment and workers’ compensation claims. According to private legal attorneys and consultant group, Pepper Hamilton LLP, “many workers who regard themselves as independent compensation are nonetheless applying for unemployment benefits - and more claims examiners are finding that such workers have been misclassified and are entitled to unemployment benefits as “employees.” As a result, it’s important to encourage all workers to go through the claims process so that the state can target audits on companies that have been found to be misclassifying their workers as well as document industries that have high prevalence of misclassification.

Speaking of locating industries that are at risk, Massachusetts should design laws designed to curtail misclassification. While states like California have enacted laws that apply generally to all industries, like the California’s 2012 Independent Contract Law, many states have approach worker misclassification by targeting specific industries. The construction industry, as demonstrated in this paper, is one such industry which has been the subject of new laws in Delaware, Illinois, Maine, Maryland, New Jersey, New York, and Pennsylvania (Pepper Hamilton LLP Research Paper).

Another way in which states can curtail improper classification of independent contractors is to set forth more stricter and narrower definitions of independent contractor status. Massachusetts has already done such a test call the “ABC” test, in which all the prongs (and not just 1 or a few of the prongs like the federal IRS test) must be satisfied for a business to establish that a worker is an independent contractor. Often these statutory tests are regarded as very worker-friendly than “economic realities” tests used by federal courts and some state courts; yet at the same time, they restrict the classification of independent contractors when workers want to be classified as such.

Another way in which Massachusetts is to better enable and provide resources/tools or class or collective action lawsuits, because many workers push for redressments via this way. By strengthening the power of unions and workers rights within industries that are at risk of exploitation, the state can discourage misclassification. Specifically, as review of court papers in hundreds of class and collective lawsuits by Pepper Hamilton LLP reveal that the following industries have experienced the most lawsuits
of these natures: courier, transportation and logistics, adult entertainment, cable installation, cleaning and sanitation, staffing and workforce management. (Pepper Hamilton LLP Research Paper). Other industries include: the car rental, communications, financial services, insurance, car service, media, publishing, security, fashion, pharmaceutical, cosmetics, energy, sports, and national defense. We should also note that as of late, the food transportation industry composed of companies like Favor, Grubhub, Dashed, and Doordash is drastically growing. Much like Uber, these companies should be treated as a potential realm in which worker misclassification is highly possible (Fortune article). We suggest that selecting particular industries in which employees are exploited or in which Massachusetts has encountered issues with workers rights or classification and enacting laws that expand workers rights and empowerment.

Appendix:

Venture Capital Dollars Invested:

<table>
<thead>
<tr>
<th>Region</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Total</td>
<td>20,500,872,900</td>
<td>23,386,821,100</td>
<td>29,462,811,100</td>
<td>27,578,404,700</td>
<td>29,964,019,900</td>
<td>48,348,586,400</td>
</tr>
<tr>
<td>MA</td>
<td>2,360,395,700</td>
<td>2,421,402,100</td>
<td>3,132,535,100</td>
<td>3,345,403,800</td>
<td>3,057,235,800</td>
<td>4,678,599,700</td>
</tr>
<tr>
<td>CA</td>
<td>10,279,493,200</td>
<td>11,879,510,800</td>
<td>14,723,780,900</td>
<td>14,519,270,300</td>
<td>15,139,603,100</td>
<td>27,151,513,000</td>
</tr>
</tbody>
</table>

Number of Venture Capital Deals:

<table>
<thead>
<tr>
<th>Region</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Total</td>
<td>3,133</td>
<td>3,612</td>
<td>3,937</td>
<td>3,936</td>
<td>4,193</td>
<td>4,356</td>
</tr>
<tr>
<td>MA</td>
<td>342</td>
<td>372</td>
<td>395</td>
<td>427</td>
<td>379</td>
<td>396</td>
</tr>
<tr>
<td>CA</td>
<td>1,284</td>
<td>1,456</td>
<td>1,594</td>
<td>1,638</td>
<td>1,687</td>
<td>1,804</td>
</tr>
</tbody>
</table>

Average Value of each Deal:
<table>
<thead>
<tr>
<th>Region</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>6,543,528</td>
<td>6,474,757</td>
<td>7,483,569</td>
<td>7,006,709</td>
<td>7,146,201</td>
<td>11,099,308</td>
</tr>
<tr>
<td>MA</td>
<td>6,901,742</td>
<td>6,509,145</td>
<td>7,930,469</td>
<td>7,834,669</td>
<td>8,066,585</td>
<td>11,814,646</td>
</tr>
<tr>
<td>CA</td>
<td>8,005,836</td>
<td>8,159,005</td>
<td>9,237,002</td>
<td>8,864,023</td>
<td>8,974,276</td>
<td>15,050,728</td>
</tr>
</tbody>
</table>

From 2009 to 2014, the total amount of venture capital dollars invested in the United States increased by 136%. During the same time period, the amount of venture capital dollars invested within Massachusetts only increased by 98%, while the amount of venture capital dollars invested in California increased by 164%.

In between 2013 and 2014, there was a 61% increase of the total amount of venture capital dollars invested in the United States. During this same time period, there was a 79% increase of venture capital dollars invested in California, whereas there was only a 53% increase of venture capital dollars invested in Massachusetts.

The rate of change in the total amount of venture capital dollars invested between 2009 and 2014 represents a long-term rate of change, and the rate of change in the total amount of venture capital dollars invested between 2013 and 2014 represents a short-term rate of change. Although Massachusetts has had a substantial increase in the amount of venture capital dollars invested within the state, both the short and long-term rate of changes within Massachusetts fell short of the rate of changes within California. This suggests that the venture capital industry is growing quicker in California than in Massachusetts, and this growth is specifically due to the rise of thriving technology startups in California. Technology companies greatly benefit from
California’s lax non-compete laws, which make it possible for entrepreneurs to quickly begin a business after leaving their former place of employment.
Links Cited

Source: National Venture Capital Association/PricewaterhouseCoopers

http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1225&context=btlj


http://www.columbia.edu/~sc32/documents/IC_Study_Published.pdf

https://www.bostonglobe.com/business/2014/06/26/uber-hit-with-class-action-lawsuit/JFTJLMuBoXuEmMU3elTAI/story.html
