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Enforceability of non-compete covenants, discretionary investments, and financial reporting practices: Evidence from a natural experiment☆

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A B S T R A C T

Non-compete covenants are widely used in employment contracts to promote employee stability. Using legal amendments of non-compete enforceability as a natural experiment, we find that as non-compete enforceability increases, firms display an increased likelihood of meeting short-term earnings benchmarks, lower discretionary expenditures, and declining future performance. These effects are more pronounced when CEOs have lower ability or shorter tenures, and when firms have more growth opportunities or operate in localized industries. Our results suggest that managers actively adapt investment and financial reporting practices to the changing environment that affects their contractual relations with firms.

1. Introduction

Contract enforceability is vital in shaping contractual relations and influencing the behavior of contracting parties. This study explores how exogenously increased enforceability of non-compete clauses in employment contracts affects managers' incentives and behavior. In the U.S., non-compete clauses are widely used to forbid employees—particularly high-level executives and specialized technicians—to undertake jobs with competing firms following termination of current employment, and are regarded as one of the most useful mechanisms to safeguard employers' proprietary information and investment in

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human capital (Gilson, 1999).[1] Since non-compete clauses constrain opportunities for future employment and thus increase the cost of dismissal and job switching for managers, we expect them to have a significant impact on managers' investment and financial reporting practices (Graham et al., 2005).

The study makes use of a quasi-experiment, whereby three states (Texas, Florida, and Louisiana) amended non-compete enforceability between 1992 and 2004, to examine how constraints in the labor market affect managers' investment and reporting choices. As Garmaise (2011) indicates, these state-level legal changes address potential endogeneity problems in that they are initiated by state governments or court rulings and are not driven by firm- or manager-specific factors. An assumption maintained in this study, as in prior research (e.g., Garmaise, 2011), is that contracts require external institutions such as laws and courts to enforce. As the level of enforceability changes, the intended equilibrium under the original contact is no longer optimal, leading to adjustments in managers' behavior (as well as in contractual terms).

We first posit that tighter non-compete enforceability makes managers more attentive to accounting earnings that they report. Increased non-compete enforceability inhibits managers' mobility, thereby reducing their opportunities in the labor market. When facing greater career concerns, managers would make more efforts to avoid reporting poor performance (e.g., missing earnings targets) that could cause them to be dismissed from their jobs (e.g., Stein, 1989; Matsunaga and Park, 2001). By achieving performance targets, managers not only make their current jobs more secure but also enhance potential employment opportunities in industries not subject to the non-compete provisions (Brickley et al., 1999). Consistent with our prediction, we find that subsequent to increased non-compete enforceability, firms display an increased likelihood of meeting or beating earnings targets.

Next, we examine whether managers adjust discretionary expenditures as a means to attain performance targets. We envisage two possible reasons for managers doing so. One is managerial myopia. Strict enforcement of non-competes causes managers to place a greater emphasis on short-term performance. To boost reported earnings, managers may cut R&D, advertising, and other SG&A expenses, even to the extent of sacrificing long-term profitability, which is a form of real earnings management (Stein, 1988, 1989; Roychowdhury, 2006; Bhojraj et al., 2009).[2] The other reason is interest alignment; that is, when faced with higher costs of dismissal, managers are under greater pressure to work hard and make efficient use of resources. In this latter scenario, managers may also cut discretionary expenditures, but the aim is to eliminate wasteful projects and increase efficiency rather than to boost reported earnings per se.

In both scenarios above, firms are expected to reduce discretionary expenses as a way to meet earnings targets when non-competes become more strictly enforced. Consistent with our prediction, we find that upon tightened enforcement, firms significantly reduce the level of R&D, advertising, and other discretionary expenses.

The two reasons for cutting discretionary spending, while having similar implications for current earnings, lead to sharply differing consequences for future firm performance. In the managerial myopia scenario, cutting back on discretionary spending is suboptimal and is detrimental to innovation and long-term profitability. In contrast, in the interest-alignment scenario, restrictions on external employment opportunities act as a threat that propels managers to work more diligently and spend resources more efficiently; this helps to reduce agency costs and increase firm value.

To distinguish between the alternative forces that might be at work, we next examine future firm performance, and find the following results. First, as the enforceability of non-competes increases, cutting discretionary expenses leads to declining performance at the operational level. More specifically, we find that reductions in R&D expenses lead to lower innovation output (in terms of the number of patents granted, patent scopes, and citations per patent), reductions in advertising expenses lead to reduced market shares, and ROE goes down following reductions in (other) SG&A expenses. Second, cutting discretionary expenses also adversely affects future stock returns. On the whole, our results are more supportive of the notion that an exogenous increase in non-compete enforceability engenders myopic reporting through reducing discretionary expenditures, which sacrifices future firm performance, rather than the notion that it fosters closer interest alignment and reduces agency costs. In supplementary analysis, we find corroborative evidence that firms also manage earnings through other real activities (e.g., overproduction) and, to a lesser extent, accrual manipulation.

In the cross-section, the effect of non-compete enforceability is more pronounced for firms that have more growth opportunities and firms that operate in more localized industries, consistent with the conjecture that non-competes are more binding on executives who face a heavier punishment from the stock market for failing to meet earnings targets or have more difficulties in finding out-of-state jobs. We also find that CEOs of lower ability and those with shorter tenures with their current employers react more strongly to increased non-compete enforcement, suggesting that non-competes are more costly for managers facing more limited external opportunities and managers who have yet to establish a personal reputation.

[1] Garmaise (2011) finds that of the 500 firms randomly drawn from Execucomp, 70.2% have non-compete agreements with upper-level managers. Likewise, Bishara et al. (2015) find that 80% of the 874 CEO employment contracts from S&P 1500 firms, initiated between 1996 and 2010, contain such provisions. The actual numbers could be higher since firms are not required by regulation to disclose such agreements. Companies do indeed enforce non-competes against departing employees. One example is Microsoft's lawsuit against Kai-Fu Lee and Google in 2005, in which Microsoft asserted that Google's recruitment of Lee violated the non-compete clause in his employment contract with Microsoft. Another is Capital One Financial Corp's lawsuit against John Kanas and John Bohlsen (former employees who joined BankUnited, a Florida-based bank, as the CEO and the Chief Lending Officer in 2009) when they attempted to acquire New York-based Herald Nation Bank for BankUnited in 2011. Capital One asserted that Kanas and Bohlsen violated the geographical restriction in their non-compete clauses.

[2] While we focus on discretionary expenses in the main tests, we also consider other forms of earnings management in supplementary analysis such as over-production and accounting accruals.

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