Innovation Ventures Paves the Way for Stronger Commercial Noncompete Agreements

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Whether it's a manufacturer working closely with suppliers to create new products or a pizza franchisor sharing its 100-year-old secret recipe with franchisees, one thing is clear: companies that work together must share valuable information to make their relationship fruitful. But these relationships do not last forever, leaving open the possibility that one company will take information learned through the relationship and use it to compete directly against the other. To avoid this, many commercial agreements include a noncompete clause.

In Michigan, it has been difficult for attorneys to recommend being aggressive when negotiating commercial noncompete clauses because of uncertainty about how state courts would analyze the clauses. That uncertainty, combined with the threat of treble antitrust damages, pushed companies that otherwise would have sought to protect themselves more completely to err on the side of caution. All too often, this caution resulted in commercial noncompete clauses in Michigan being patterned after employer-employee noncompetes instead of being tailored to the specific relationship between the parties and realities of the industry. The Michigan Supreme Court's unanimous decision in *Innovation Ventures, LLC v Liquid Manufacturing, LLC*,[1] holding that "a commercial noncompete provision must be evaluated for reasonableness under the antitrust rule of reason,"[2] has eliminated the uncertainty over how commercial noncompetes are judged, allowing companies to benefit from stronger commercial noncompetes.

This article explores the Court's decision, explains the rationale for the application of different principles to determine the reasonableness of noncompetes in the commercial and employer-employee contexts, and analyzes why companies should now feel more comfortable using aggressive commercial noncompete clauses to protect themselves.

As is clear from the name itself, the general effect of a noncompete clause is to limit actual or potential competition. In Michigan, the validity of any type of agreement restraining competition is evaluated under the Michigan Antitrust Reform Act (MARA), MCL 445.771 *et seq.*, and noncompete agreements are no exception.[3]

The reasoning set forth by the Supreme Court in *Innovation Ventures* for applying the rule of reason to commercial noncompete agreements makes the issue seem straightforward. Under MCL 445.772, "[a] contract, combination, or conspiracy between 2 or more persons in restraint of, or to monopolize, trade or commerce in a relevant market is unlawful."[4] MCL 445.784(2) instructs courts to give deference to federal court interpretations of the Sherman Act.[5] Federal courts assessing commercial noncompetes generally apply the rule of reason to determine their validity.[6] Thus, courts applying MARA should evaluate commercial noncompetes under the rule of reason as well.[7]

If the Supreme Court's holding originated from such straightforward reasoning, where did the Court of Appeals go wrong

in its decision below? The simplest answer is that it relied on MCL 445.774a(1), which sets forth the following reasonableness test for employer-employee noncompetes:

> An employer may obtain from an employee an agreement or covenant which protects an employer's reasonable competitive business interests and expressly prohibits an employee from engaging in employment or a line of business after termination of employment if the agreement or covenant is reasonable as to its duration, geographical area, and the type of employment or line of business.[8]

While MCL 445.774a(1) applies a four-factor reasonableness test to determine the validity of employee noncompete clauses, the express terms of the statute apply this test only in the employer-employee context after the employee's termination.[9] The Supreme Court in *Innovation Ventures* identified the Court of Appeals' reliance on two earlier decisions in the employer-employee context applying MCL 445.774a(1) as the source of the lower court's error.[10]

While this may be sufficient to explain the lower court's error in *Innovation Ventures*, the Supreme Court did not mention the earlier cases that also incorrectly applied MCL 445.774a(1) to commercial noncompete clauses. For example, the Sixth Circuit Court of Appeals misapplied MCL 445.774a(1) to a commercial noncompete clause in a franchise agreement in *Certified Restoration Dry Cleaning Network, LLC v Tenke Corp.*[11] There, the Sixth Circuit even acknowledged that the statute applied only "to non-competition agreements between employers and employees" but nonetheless claimed that "Michigan courts generally examine" noncompete clauses for reasonableness under the four MCL 445.774a(1) factors, even in the commercial noncompete context.[12] It was precisely these types of opinions that muddied the waters enough to prohibit counsel from recommending aggressive commercial noncompetes in the past. As an attorney, even if you believed that the rule of reason applied to commercial noncompete agreements, there was a reasonable likelihood that your client would foot the bill for years of litigation and appeals before you would have the opportunity to find out if you were right.

FAST FACTS

Under the Michigan Antitrust Reform Act, commercial noncompetition agreements (unlike employer-employee noncompetes) must be evaluated under the rule of reason, which allows businesses to more aggressively protect themselves.

Michigan cases evaluating commercial noncompetes under any standard other than the modern rule of reason are no longer good law.

Innovation Ventures now clearly requires Michigan courts to look to modern federal court treatment of similar restraints to determine the standard for establishing the reasonableness of a restraint under MARA.[13] The Supreme Court even chastised the *Bristol Window & Door, Inc v Hoogenstyn* appellate court, which correctly settled on the rule of reason standard but did so by reviewing the treatment of commercial noncompetes in earlier Michigan cases instead of simply deferring to modern federal court treatment of this type of restraint.[14] Given this unequivocal rejection of looking at how Michigan courts treated commercial noncompetes in the past, it was surprising to see the Court's claim (albeit in dicta, in a footnote) that Michigan has applied the rule of reason to commercial noncompetes as far back as 1873 in *Hubbard v Miller*.[15] *Hubbard* was decided a full 25 years before federal courts applied a rudimentary form of the rule of reason in *United States v Addyston Pipe*.[16] And while *Hubbard* addressed the reasonableness of a commercial noncompete at common law, the standard it applied is a far cry from the modern rule of reason analysis.[17] Although this footnote could be read as an attempt to reconcile the body of Michigan's commercial noncompete law, it actually creates the potential for confusion once again should Michigan courts turn to the *Hubbard* standard as opposed to the current rule of reason analysis. If courts should look to modern federal court treatment of commercial noncompetes to determine which standard to apply under MARA—and *Innovation Ventures* is otherwise unequivocal in this regard—there is no reason to attempt to resolve any apparent conflict with standards applied in antiquated decisions. Every case not applying the modern federal court interpretation of the rule of reason to commercial noncompetes should be ignored, not reconciled.

The difference between the federal rule of reason analysis which courts must apply after *Innovation Ventures* and the four-factor reasonableness test in MCL 445.774a(1) is extremely important to practitioners. The rule of reason requires detailed analysis of the anticompetitive effect on the overall relevant markets. This should make it substantially more difficult for a party to successfully invalidate a commercial noncompete clause that excludes a single competitor from some or all of those markets. For example, a claimant asserting a rule of reason claim would likely have to identify a relevant affected product market (products or services that are reasonably interchangeable) and a geographic market (where consumers can reasonably turn for the product or services),[18] demonstrate antitrust standing (including antitrust injury),[19] and identify whether competition in the overall market has been harmed, which usually means the defendant has exercised market power that actually resulted in (or threatens to result in) an increase in prices or a decrease in output in a relevant market.[20] This is in stark contrast to evaluating the reasonableness of an employer-employee noncompete, which does not require this type of market-wide analysis.

Courts applying MARA will now use different tests to evaluate employer-employee noncompetes and commercial noncompetes, which makes perfect sense in the overall picture of antitrust law. Underpinning the whole body of antitrust law is the fundamental idea that these laws were enacted for "the protection of *competition*, not *competitors*…."[21] MCL 445.774a(1), on the other hand, was enacted to protect individual employees.

It could be difficult to claim that a restraint preventing one person from competing with his or her employer after termination will harm competition as a whole. A noncompete preventing a single employee from working in an industry may well have no effect on competition as a whole, but may significantly affect the employee's ability to earn a living in his or her profession of choice. To require the same type of detailed showing of harm to competition in the employer-employee context would hand employers essentially unlimited power to control the future of their employees. Accordingly, the MCL 445.774a(1) test thus protects employees by setting forth a limited, four-factor test to determine whether a noncompete is reasonable, making it easier to invalidate employer-employee noncompetes if one or more of those factors are not met. Conversely, in the commercial noncompete context, this level of protection is unnecessary, and therefore, application of the antitrust rule of reason makes it substantially more difficult to invalidate a commercial noncompete.

Innovation Ventures provides businesses with the freedom to craft far more aggressive noncompete provisions. This freedom, however, is not unlimited. First, if the noncompete is a naked restraint on trade that is not reasonably related to the purposes of the underlying business arrangement, there is still a risk that it would be considered per se illegal—that is, declared illegal whether or not it satisfies the rule of reason.[22] Second, even if ancillary, practitioners will still need to perform some degree of economic analysis based on the specific details of the industry, the parties involved, and the potential effect of the noncompete to ensure it would not be invalidated under the rule of reason. All practitioners negotiating commercial noncompete clauses would be wise to put away the boilerplate language and mindset of the past and reconsider the benefits they can obtain for their clients through more aggressive noncompete agreements. ■

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ENDNOTES

1. *Innovation Ventures, LLC v Liquid Manufacturing, LLC*, 499 Mich 491, 496; 885 NW2d 861 (2016).
2. *Id.* When interstate commerce is implicated, the validity of a commercial noncompete is also evaluated under federal antitrust laws. *Id.* at 513–514. And after *Innovation Ventures*, the analysis is the same. *Id.*
3. *Id.* at 512.
4. MCL 445.772; see also *id.* at 512 n 14 (noting the similarity to Section 1 of the Sherman Act, 15 USC 1: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.").
5. MCL 445.784(2) ("It is the intent of the legislature that in construing all sections of this act, the courts shall give due deference to interpretations given by the federal courts to comparable antitrust statutes, including, without limitation, the doctrine of per se violations and the rule of reason.")
6. *Innovation Ventures*, 499 Mich at 513–514 (citations omitted).
7. *Id.* at 515.
8. MCL 445.774a(1).
9. *Innovation Ventures*, 499 Mich at 513; see *Bristol Window & Door, Inc v Hoogenstyn*, 250 Mich App 478; 650 NW2d 670 (2002) (applying MCL 445.772 to a noncompete between an employer and independent contractor).
10. *Innovation Ventures*, 499 Mich at 506–507 (highlighting reliance on *St Clair Medical, PC v Borgiel*, 270 Mich App 260; 715 NW2d 914 (2006) and *Coates v Bastian Brothers, Inc*, 276 Mich App 498; 741 NW2d 539 (2007)).
11. *Certified Restoration Dry Cleaning Network, LLC v Tenke Corp*, 511 F3d 535, 546–547 (CA 6, 2007).
12. *Id.* at 546.
13. *Innovation Ventures*, 499 Mich at 513–514.
14. *Id.* at 515 n 18.
15. *Id.* at 514 n 17 (citing *Hubbard v Miller*, 27 Mich 15 (1873)).
16. *United States v Addyston Pipe & Steel Co*, 85 F 271 (CA 6, 1898). The full Supreme Court did not adopt the rule of reason in its early form until 38 years after *Hubbard* in *Standard Oil Co of New Jersey v United States*, 221 US 1; 31 S Ct 502; 55 L Ed 619 (1911).
17. Compare *Hubbard*, 27 Mich at 19 (considering whether "the restraint contracted for appears to have been for a just and honest purpose, for the protection of the legitimate interests of the party in whose favor it is imposed, reasonable as between them and not specifically injurious to the public"), with *Innovation Ventures*, 499 Mich at 514 ("When applying the rule of reason, a court must 'tak[e] into account a variety of factors, including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint's history, nature, and effect.'"), quoting *State Oil Co v Khan*, 522 US 3, 10; 118 S Ct 275; 139 L Ed 2d 199 (1997).
18. *Brown Shoe Co v United States*, 370 US 294, 324; 82 S Ct 1502; 8 L Ed 2d 510 (1962).
19. See, e.g., *Atlantic Richfield Co v USA Petroleum Co*, 495 US 328, 334; 110 S Ct 1884; 109 L Ed 2d 333 (1990); *Brunswick Corp v Pueblo Bowl-O-Mat, Inc*, 429 US 477, 489; 98 S Ct 690; 50 L Ed 2d 701 (1977).
20. See, e.g., *FTC v Indiana Federation of Dentists*, 476 US 447; 106 S Ct 2009; 90 L Ed 2d 445 (1986).
21. *Brown Shoe*, 370 US at 320 (emphasis added).
22. If not considered ancillary to the legitimate purposes of the agreement, a noncompete clause could be invalidated as a per se violation of the antitrust laws. *Texaco Inc v Dagher*, 547 US 1, 7; 126 S Ct 1276; 164 L Ed 2d 1 (2006).