

Using the Resource-Based Theory to Determine Covenant not  
to Compete Legitimacy

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*USING THE RESOURCE-BASED THEORY TO DETERMINE  
COVENANT NOT TO COMPETE LEGITIMACY<sup>+</sup>*

By

Norman D. Bishara and David Orozco \*

*ABSTRACT*

This paper addresses the legitimacy of competing interests involved in the enforcement of covenants not to compete (“noncompetes”). To date, the courts and legislatures have not relied on a principled theoretical framework to identify and assess the competing interests between firms and individuals in this setting. This paper fills the research void by providing a theoretical framework that identifies the legitimacy of these competing claims. The framework integrates managerial research involving the resource-based theory of the firm and the knowledge-based perspective of competitive advantage with the legal analysis and enforcement of noncompete terms. A descriptive framework of the parties’ competing interests provides four discrete scenarios, which formalizes the types of legitimate interests a court must balance when asked to enforce noncompetes. From this descriptive account, a prescriptive analysis is advocated that uses an ownership approach to assess the legitimacy of an employer’s claim to knowledge covered by a noncompete.

*JEL Area Codes: J2; K1; K12; K2; L2; M1; M12; M5; M51; M55; O15*

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## I. INTRODUCTION

When a product manager at Google told his bosses this year that he was quitting to take a job at Facebook, they offered him a large raise. When he said it was not about the money, they told him he could have a promotion, work in a different area or even start his own company inside Google. He turned down all the inducements and joined Google's newest rival.

'Google's gotten to be a lot bigger and slower-moving of a company,' said the former manager, who would speak only on the condition of anonymity to protect business relationships. 'At Facebook, I could see how quickly I could get things done compared to Google.'<sup>1</sup>

The stories of the meteoric rise of high-tech companies in Silicon Valley like Facebook and Google are well known. These companies – and others like Apple, Inc., (and Microsoft and IBM before them) – are celebrated as the best recent examples of innovative firms in a new knowledge economy where a company's assets and potential are no longer measured in terms of factories or accounts receivables, but rather in their potential to continuously grow through new ideas that spawn marketable innovations.

At the same time the acceleration of globalization and new technologies have “undermined the long-term employment relationships and brought the market into the firm in ways that have not been previously experienced”<sup>2</sup> and that relationship is now “governed by international labor markets in a decentralized managerial structure.”<sup>3</sup> As one newspaper article about employee mobility from Google to Facebook put it, “[m]uch of Silicon Valley's innovation comes about as engineers leave companies to start their own.”<sup>4</sup>

However, the free flow of talented workers between existing firms or to startups – and thus, the useful knowledge and experience they carry innately into each new job – cannot be a

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<sup>1</sup> Claire C. Miller, *Google Grows, and Works to Retain Nimble Minds*, N.Y. TIMES, Nov. 28, 2010, at A1 (also finding that “142 of Facebook's 1,700 employees came from Google”).

<sup>2</sup> Kenneth G. Dau-Schmidt, *Employment in the New Age of Trade and Technology: Implications for Labor and Employment Law*, 76 IND. L.J. 1, 1 (2001).

<sup>3</sup> Kenneth G. Dau-Schmidt & Timothy A. Haley, *Governance of the Workplace: The Contemporary Regime of Individual Contract*, 28 COMP. LAB. LAW & POL'Y J. 313, 313-14 (2007) (citing Dau-Schmidt, *Employment in the New Age of Trade and Technology*, *supra* note 2).

<sup>4</sup> Miller, *supra* note 1, at A1.

foregone conclusion in most U.S. jurisdictions. On the contrary, other high profile cases demonstrate that the employment contract provisions known as covenants not-to-compete (“noncompetes”)<sup>5</sup> are used to inhibit the mobility of former employees and, thus, knowledge spillovers that result from employees moving between firms. These restrictive covenants have always created tension between “the reasonableness of the employer’s interest in maintaining proprietary information and the employees need to earn a living,” but that tension is exacerbated by disruptive and fast-moving technological innovations, such as the internet.<sup>6</sup> For instance, noncompete enforcement or threatened enforcement has been used to attempt to restrict a top Microsoft manager from going to Google’s China-based operations<sup>7</sup> and to stop a former Time Warner, AOL Internet unit chairman and CEO from joining Yahoo’s Board of Directors.<sup>8</sup>

## **A. IMPLICATIONS OF EMPLOYEE MOBILITY AND KNOWLEDGE TRANSFER**

Despite these current high-tech instances where a firm’s fortunes are so clearly tied to its employees’ intellectual capital, the law of restrictive covenants has not evolved to integrate the new concepts of boundary-less commerce and knowledge assets into how noncompetes are evaluated by state courts and legislatures. There are, for example, consistent calls for

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<sup>5</sup> For purposes of this paper we focus on contract-based post-employment restrictions on employee behavior, particularly on the former employee’s ability to start a competing venture or work for a competitor. These sorts of restrictions may be part of a larger employment agreement as a single clause or may exist as a separate agreement. While other restrictions are sometimes included in covenants not to compete, such as a restriction on competition following the sale of a business, this paper is concerned with role of noncompetes in restricting the flow and use of knowledge-based assets developed or shared within the employer-employee relationship.

<sup>6</sup> Joan T.A. Gabel & Nancy R. Mansfield, *The Information Revolution and its Impact on the Employment Relationship: An Analysis of the Cyberspace Workplace*, 40 AM. BUS. L.J. 301, 323 (2003) (providing a detailed view of the legal implications for employment relationships in a technology-driven work environment).

<sup>7</sup> Marisa Pagnataro, *'The Google Challenge': Enforcement of Noncompete and Trade Secret Agreements for Employees Working in China*, 44 AM. BUS. L.J. 603, 606-14 (2007) (discussing the details of Microsoft Corporations against Kai-Fu Lee, a former U.S.-based employee, and Google, Inc., Mr. Lee’s new employer in China).

<sup>8</sup> Miguel Helft & Laurie J. Flynn, *Time Warner Blocks a Yahoo Board Choice*, N.Y. TIMES, Aug. 2, 2008 (despite indications that Time Warner would waive enforcement of the noncompete, the former employee’s move to Yahoo’s effectively opposed prior to litigation).

jurisdictions to follow California's historical ban on noncompetes for employees.<sup>9</sup> However, the prospect of the majority of U.S. jurisdictions that enforce noncompetes changing course and embracing California's total ban on these restrictive covenants in the near future seems remote. This seems particularly the case in light of the American preference for freedom of contract and because of the potential usefulness of noncompete restrictions to firms that wish to have an additional way to stop business knowledge from leaving with a departing employee.<sup>10</sup>

Yet, if noncompetes are here to stay for the foreseeable future and are enforceable in most jurisdictions, then the question becomes: how can courts better interpret and enforce noncompetes to address the issue of knowledge ownership when employee mobility is concerned? This article addresses this key issue in employee-employer contracting and competitive advantage in several ways. The article argues that the traditional reasonableness test for evaluating noncompete enforcement can be preserved, but also reenergized, by demonstrating the usefulness of conceiving the issue of employee mobility as a knowledge ownership dispute between employers and employees. We further suggest a framework for courts to adjudicate this dispute. This framework is based on concepts of human capital and strategic knowledge assets within a competitive advantage framework known as the resource-based theory.

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<sup>9</sup> An example is the recent work of Professor Alan Hyde, who has long been a proponent of the economic benefits of free employee mobility. See Alan Hyde, *Should Noncompetes Be Enforced?: New Empirical Evidence Reveals the Economic Harm of Non-compete Covenants*, 33 REGULATION 6 (Winter 2010-2011), available at <http://www.cato.org/pubs/regulation/regv33n4/regv33n4-2.pdf> (adapted from a chapter in MICHAEL WACHTER & CYNTHIA ESTLUND, eds., RESEARCH HANDBOOK ON THE LAW AND ECONOMICS OF LABOR AND EMPLOYMENT LAW) (forthcoming, Edward Elgar, 2011).

<sup>10</sup> See Larry A. DiMatteo, *Strategic Contracting: Contract Law as a Source of Competitive Advantage*, 47 AM. BUS. L.J. 727, 765 (2010) ("The often litigated covenant not to compete in the employment setting serves two strategic purposes: proprietary protection and strategic coercion"). In Professor DiMatteo's assessment of noncompetes in a strategic contracting context:

The first [reason for seeking noncompete enforcement] relates to the employer's proprietary property that has been disclosed to the employee and that the employer seeks to protect. The second purpose seeks to deter employee movement to a competitor. The first purpose is best served by drafting a covenant that is likely to be enforced by the courts. The employer shows that there is some proprietary interest trade secrets, knowhow, client contacts, access to key employees, specialized training, databases, and compilations that are susceptible to being harmed if used or disclosed to a new employer.

*Id.*

## B. NONCOMPETES AND THE RESOURCE-BASED THEORY

Noncompetes and their possible impact have received attention from a broad range of researchers. For instance, recent articles from a range of disciplines debate their role, if any, in impacting employee mobility in high-tech regions such as Silicon Valley in California<sup>11</sup> or concentrated industrial regions such as Michigan.<sup>12</sup> Additional research has included other business activity phenomena such as the areas of entrepreneurial activity,<sup>13</sup> executive compensation,<sup>14</sup> and human capital investment.<sup>15</sup> However, little of this growing body of research has focused on providing a principled legal and strategic justification for when, how, and why the decision makers – i.e., the state courts in conjunction with legislatures – should evaluate and enforce these important agreements. In other words, there is much discussion of the possible influence of noncompetes on business activity, but little in the way of proposals for how the modern courts should prioritize and balance the increasingly important issue of business-related knowledge as a resource with the question of competing claims to that resource. Moreover, the important and rich stream of research on the role of the resource-based theory that we explore in this article has only just begun to influence legal scholarship.<sup>16</sup>

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<sup>11</sup> Bruce Fallick, Charles A. Fleischman & James B. Rebitzer, *Job Hopping in Silicon Valley: Some Evidence Concerning the Micro-Foundations of a High Technology Cluster*, 88 REV. ECON. & STAT. 472 (2006) (finding greater mobility in the computer sector of Silicon Valley, California when compared to other California industries or other states where noncompetes are enforced).

<sup>12</sup> Matt Marx, Deborah Strumsky & Lee Fleming, *Mobility, Skills, and the Michigan Non-Compete Experiment*, 55 MGMT. SCI. 875 (2009) (finding evidence of a lower rates of mobility under a policy of noncompete enforcement compared to a previous status quo of non-enforcement).

<sup>13</sup> Toby E. Stuart & Olav Sorenson, *Liquidity Events and the Distribution of Entrepreneurial Activity*, 48 ADMIN. SCI. Q. 175 (2003) (using noncompetes as variable in assess the propensity of employees to become entrepreneurs when a business undergoes dramatic change).

<sup>14</sup> Mark J. Garmaise, *Ties that Truly Bind: Non-competition Agreements, Executive Compensation and Firm Investment*, J. LAW, ECON. & ORG Nov. 3, 2009, available at <http://jleo.oxfordjournals.org/content/early/2009/11/03/jleo.ewp033.full.pdf> (finding that noncompete enforcement in a jurisdiction can negatively impact employee pay and employer investment).

<sup>15</sup> Norman D. Bishara, *Balancing Innovation from Employee Mobility with Legal Protection for Human Capital Investment: 50 States, Public Policy, and Covenants Not to Compete in an Information Economy*, 27 BERKELEY J. EMP. & LAB. L. 287 (2006) (assessing the benefits and costs of enforcement with regard to certain classes of workers and arguing that disincentives to invest in workers can be moderated by policymakers to accentuate positive knowledge spillovers associated with employee mobility).

<sup>16</sup> While the Resource-Based view was initially confined to the management literature, it has more widely appreciated as a tool for understanding the strategic business uses of law and has been applied to specific

This paper aims to address these shortcomings in the resource-based theory research and application by the courts by identifying several competing claims to the knowledge resource, which can accrue to employers, employees, and the public. In effect, this paper acknowledges that noncompetes have a legitimate role in ensuring the fair and appropriate allocation of knowledge ownership rights in pursuit of sustainable competitive advantage, but argues that the current approach to noncompete enforcement is inadequate – and perhaps even harmful – to achieving that goal. The legitimacy of these claims is not currently part of the systematic decision-making analysis of courts,<sup>17</sup> nor is it apparent that legislatures have formalized the concept of knowledge ownership when articulating human capital law and policy related to noncompete enforcement. These policymakers have, thus, ignored questions of knowledge ownership when deciding the validity of noncompetes, even as these contracts have become fixtures of the employee-employer relationship<sup>18</sup> and when their use may even be on the rise.<sup>19</sup> Moreover, this is occurring when knowledge-based competitive advantage without geographic restrictions is increasingly at the core of many U.S. businesses.<sup>20</sup>

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legal topics. *See, e.g.*, Constance E. Bagley, *What's Law Got to Do With It?: Integrating Law and Strategy*, 47 AM. BUS. L.J. 587 (2010); David Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, 47 AM. BUS. L.J. 687 (2010); D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1 (2009); Felix Oberholzer-Gee & Dennis A. Yao, *What Role For Strategic Management Expertise?*, 90 B.U. L. REV. 1457 (2010); David B. Lipsky & Ariel C. Avgar, *Toward a Strategic Theory of Workplace Conflict Management*, 24 OHIO ST. J. ON DISP. RESOL. 143 (2008); and Sanford M. Jacoby, *Employee Representation and Corporate Governance: A Missing Link*, 3 U. PA. J. LAB. & EMP. L. 449 (2001); Rangamohan V. Eunni, *Competing in Emerging Markets: Search for a New Paradigm*, 31 W. NEW ENG. L. REV. 611 (2009) (applying the resource-based view in the context of small and medium enterprises).

<sup>17</sup> *See Sunbelt Rentals, Inc. v. Ehlers*, 394 Ill. App. 3d 421 (Ill. App. Ct. 4th Dist. 2009) (where an Illinois appellate court states that Illinois does not require employers to prove a legitimate business interest in cases involving noncompetes).

<sup>18</sup> This sentiment that is widely shared several academic commentators. However, there is very sparse empirical support for this assumption. *See, e.g.*, Gillian Lester, *Restrictive Covenants, Employee Training, and the Limits of Transaction-Cost Analysis*, 76 IND. L.J. 49, 49 (2001) (stating that noncompetes “are an increasingly common feature of employment”).

<sup>19</sup> *See, e.g.*, Peter J. Whitmore, *A Statistical Analysis of Noncompetition Clauses in Employment Contracts*, 15 J. CORP. L. 483 (1990) (although not directly measuring the use of noncompetes, the author found an increase in appellate decisions concerning noncompetes). *But see*, Schwab and Thomas, *infra* note 83, and accompanying text (evaluating the contracts of top executives at publically traded US companies).

<sup>20</sup> *See, e.g.*, E. Lee Reichert, *Mergers & Acquisitions in Cyberspace: Navigating the Black Holes*, 6 U.C. DAVIS BUS. L.J. 123, 133-34 (2005) (advising that “the traditional rules of interpretation might not apply



To address this void this article presents an operational framework that identifies the legitimacy of these competing claims and, ultimately provides guidance for policymakers and courts on how to improve noncompete enforcement request evaluations. In Part II, we discuss the current state of how noncompetes are evaluated by the courts, and the related drawbacks of this outdated approach, which lacks a coherent strategy to efficiently resolve disputes over knowledge ownership. Part III discusses knowledge development and ownership in the context of noncompetes, and presents the competing interests of the stakeholders involved – employers, employees, and the public. Part IV introduces the concepts of the resource-based theory of competitive advantage and utilizes this theory as a descriptive framework to assess the legitimacy of competing claims to noncompete enforcement. Part V expands the application of the resource-based theory to noncompetes using a prescriptive, unified decision-making framework for courts to fairly balance the competing interests among all the stakeholders. Part VI offers a brief conclusion.

## **II. NONCOMPETES, STATE POLICIES AND VARIOUS APPROACHES TO THEIR ENFORCEMENT**

This part first discusses the nature and status of noncompete enforcement in the United States, including an overview of the reasonableness test applied by the courts when reviewing these restrictive covenants. Next, this section presents a critique of the current noncompete enforcement regime in light of the evolving and growing nature of information in the knowledge economy.

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to companies operating in cyberspace” and concluding that “[b]ecause of the rapidly changing nature of the technology and the ability of the Internet to reach any jurisdiction from any location, courts have shown a willingness to apply different rules to cyberspace employees with regard to the geographic, time, and prohibited activity limitations”).

## A. THE USE AND ENFORCEMENT OF NONCOMPETES

In general, most states will allow some enforcement of non-compete agreements.<sup>21</sup> These agreements have a long history in English and American common law.<sup>22</sup> Restrictive covenants have long been reviewed with suspicion by the courts because of their tendency to reduce competition and restrain the freedom of individuals to practice their chosen profession.<sup>23</sup> Despite this long history there remains considerable variation<sup>24</sup> in how state courts and legislatures view these contracts,<sup>25</sup> as discussed in the next subsection. Initially, however, we briefly review the theoretical underpinnings of the use of noncompetes.

In their study of the dispersion of knowledge and its relation to the mobility of engineers in certain geographic regions, Professors Almeida and Kogut observed the following about the unique properties of knowledge as a resource:

Ideas, because they have no material content, should be the least spatially-bounded of all economic activities. Being weightless, their transport is limited only by the quality and availability of communication. Since ideas serve both as the inputs and outputs in their own production, their location need be constrained neither by the happenstance of the spatial distribution of raw materials, energy, and labor, nor by that of demand and markets.<sup>26</sup>

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<sup>21</sup> See generally BRIAN M. MALSBERGER, ED., COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY (2008 and cum. supp. 2009). See also Michael J. Garrison & John T. Wendt, *The Evolving Law of Employee Noncompete Agreements: Recent Trends and an Alternative Policy Approach*, 45 AM. BUS. L.J. 107 (2008).

<sup>22</sup> Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625 (1960) (the authoritative review of the extensive history of restrictive employment covenants and their origin in the sale of businesses and trade associations).

<sup>23</sup> See Terry M. Dworkin & Elletta S. Callahan, *Buying Silence*, 36 AM. BUS. L.J. 151, 169-71 (1998).

<sup>24</sup> See Reichert, *supra* note 20, at 132-33 (“noncompetition law can vary dramatically among jurisdictions,” but a reasonableness test is generally applied).

<sup>25</sup> See Norman D. Bishara, *Fifty Ways to Leave Your Employer: Relative Enforcement of Covenant Not to Compete Agreements, Trends, and Implications for Employee Mobility Policy*, 13 U. PENN. J. BUS. L. 753 (2011).

<sup>26</sup> Paul Almeida & Bruce Kogut, *Localization of Knowledge and the Mobility of Engineers in Regional Networks*, 45 MGMT. SCI. 905, 905 (1999).

In part, because noncompetes are blunt instruments for first determining and then protecting knowledge ownership, they have remained controversial. They are blunt in the sense that these contracts seek to restrict the transfer of information that is, arguably, rightfully rivalrous and excludible by the employer.<sup>27</sup> This aspect of noncompetes is among the most controversial.<sup>28</sup> This is, thus, consistent with the long-running skepticism of noncompetes from the courts because they are, on their face, restricting trade and freedom of employment.<sup>29</sup>

The free flow of information, particularly in the high-tech sector, has been a focal point for arguments concerning the economic influence, if any, of noncompete enforcement.<sup>30</sup> Most famously, California's well-known ban on restrictive covenants related to post-employment activities of employees<sup>31</sup> has been cited as one reason why Silicon Valley has seemingly prospered due to high levels of employee mobility in that sector.<sup>32</sup>

It is also important to note that noncompetes, where enforced, are only part of a toolkit employers have to protect information. These include the default rules of trade secret protection at the state and federal level,<sup>33</sup> opportunities to gain intellectual property protection in some instances (such as patent protection),<sup>34</sup> and confidentiality agreements (also known as nondisclosure agreements).<sup>35</sup> In particular, confidentiality agreements are “restrictions on access to information, rather than employee movement” and more easily enforced under a theory of

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<sup>27</sup> See Hyde, *Should Noncompetes Be Enforced*, *supra* note 9, at 8-9 (tying noncompetes to what he sees as improper attempts to restrict firm-generated information).

<sup>28</sup> *Id.*

<sup>29</sup> Dworkin & Callahan, *supra* note 23, at 156 (“Anti-competition covenants are legally disfavored because they restrain trade by inhibiting promisors’ freedom of movement among employment opportunities”) (citation omitted).

<sup>30</sup> See generally Hyde, *Should Noncompetes Be Enforced*, *supra* note 9.

<sup>31</sup> CAL. BUS. & PROF. CODE § 16600 (2010) (In full, the statute simply states: “Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void”).

<sup>32</sup> See Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U.L. REV. 575 (1999).

<sup>33</sup> See generally ROBERT P. MERGES & JOHN F. DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* (Lexis-Nexis Publishing, 4th ed., 2007).

<sup>34</sup> *Id.*

<sup>35</sup> See Dworkin & Callahan, *supra* note 23.

freedom of contract.<sup>36</sup> Thus, contract protection – by a confidentiality agreement and a noncompete – can be useful for employers.<sup>37</sup> Moreover, courts have traditionally balanced the rights of employers and employees when weighing the importance of equitable relief in noncompete disputes.<sup>38</sup>

Specifically, employers and sellers of a business will try to use noncompetes to restrict knowledge transfer to a competitor in several ways. Traditionally, a basic non-compete clause includes a limitation as to the geographic area and length of time a former employee is restricted from starting a competing enterprise or going to work for a competitor. The clause may also list specific competitors to whom the employee is prohibited from working for during the restriction period or restrictions as to soliciting clients of the former employer.<sup>39</sup>

Another common restriction embedded in a covenant not to compete disallows the former employer from soliciting other workers to leave the employer to join the competing enterprise, which could serve to drain further human capital resources and knowledge from the business.<sup>40</sup>

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<sup>36</sup> Dworkin & Callahan, *supra* note 23, at 157.

<sup>37</sup> Kristen Osenga, *Information may Want to be Free, but Information Products do not: Protecting and Facilitation Transactions in Information Products*, 30 CARDOZO L. REV. 2099, 2117 (2009) for a discussion of options for protecting rights in information products (“Contract law certainly provides an appealing alternative to traditional intellectual property protection. Like intellectual property regimes, contracts carry the force of law. Businesses are comfortable and familiar with contracts, probably even more so than intellectual property”).

<sup>38</sup> T. Leigh Anenson, *The Role of Equity in Employment Noncompetition Cases*, 42 AM. BUS. L.J. 1, 54 (2005) (advocating that a court’s enforcement analysis “be industry-specific in order to best assess the benefits of knowledge spillover, incentives for innovation, and whether economic efficiencies may be outweighed by other interests”).

<sup>39</sup> See, e.g., *Victaulic Co. v. Tieman*, 499 F.3d 227 (3d Cir. Pa. 2007) (the non-compete clause listed nine competitors and “and any and all of their subsidiaries, affiliates and successors” to which the employee could not seek employment as well as a 12 month agreement to not “contact or solicit any past or present [Victaulic] customers on behalf of any business in competition with [it]”). *Id.* at 230.

<sup>40</sup> See, e.g., *Cont’l Group, Inc. v. KW Prop. Mgmt., LLC*, 622 F. Supp. 2d 1357 (S.D. FL. 2009). In *Continental Group* the district court found the plaintiff’s former employer had:

shown a legitimate business purpose for this prohibition under Fla. Stat. § 542.335 due to the loss of goodwill of clients by having TCG on-site property managers switch to KW. Property managers are the on-site representatives at these condominium buildings who develop positive relationships with the governing boards of the condominium, a critical consideration when these governing boards vote to extend or terminate a management contract.

*Id.* at 1375.

Also, sometimes a noncompete may be used in conjunction with other theories of knowledge ownership, such as alongside related trade secret and patent protection litigation against a former employee-owner.<sup>41</sup> In the case of a state that has a statutory public policy in favor of noncompete enforcement such as Florida, an employer can seek to protect all of these business interests, including an investment in training provided to the employee.<sup>42</sup>

## **B. COVENANT NOT TO COMPETE ENFORCEMENT IN THE US: THE CURRENT STATE OF AFFAIRS**

Again, while the majority of states will enforce noncompetes to some extent,<sup>43</sup> there are a few high-profile instances where, on the margins, states essentially ban the use of employee noncompetes.<sup>44</sup> In those state the courts consistently uphold the ban based on public policy grounds.<sup>45</sup> However those that do allow some sort of post-employment noncompete enforcement

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<sup>41</sup> See, e.g., *Hickory Specialties, Inc. v. Forest Flavors Int'l, Inc.*, 2000 U.S. App. LEXIS 11786 (6th Cir. Tenn. May 19, 2000) (a Tennessee liquid smoke manufacturer sued a former employee-owner and family member to enjoin defendant from starting a compete enterprise based on theories including a noncompete enforcement, theft of trade secret, and patent protection).

<sup>42</sup> For a description of the breadth of the Florida policy, see *AutoNation, Inc. v. O'Brien*, 347 F. Supp. 2d 1299, 1304 (S.D. Fla. 2004), where the court stated:

Pursuant to Florida's statute, "legitimate business interests" include: trade secrets, valuable confidential business information, substantial relationships with specific prospective or existing customers, customer goodwill, and extraordinary or specialized training. Fla. Stat. 542.335(1)(b). Moreover, courts are statutorily required to construe a restrictive covenant in favor of providing reasonable protection to all legitimate business interests established by the person seeking enforcement. Fla. Stat. 542.335(1)(h) (other citations omitted).

<sup>43</sup> See generally MALSBERGER, *supra* note 2.

<sup>44</sup> The two states with near complete bans on covenants not to compete are North Dakota and, famously, California, although there restrictions on post-employment competition related to an owner's sale of a business is permissible. See Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15, at 294 n.19.

<sup>45</sup> The most recent California Supreme Court case on this addressing the public policy implications of the state's statutory ban on noncompetes is *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937, 949-50 (Cal. 2008) (reiterating California's strong public policy against enforcing contractual restraints on employment and rejecting calls for a "narrow restraint" exception).

will apply a reasonableness test coupled with an evaluation of the stakeholders' interests.<sup>46</sup>

Thus, consensus among enforcing states centers on the reasonableness test to balance the rights of several stakeholders: the parties to the contract (i.e., employees and employers), as well as considering the policy impact and the public interest.<sup>47</sup>

The legal reasoning restated by the Massachusetts Supreme court in *Boulanger v. Dunkin' Donuts, Inc.*<sup>48</sup> is typical of how enforcing states begin to review the terms of a challenged employment-related noncompete. There the court stated, "a covenant not to compete is enforceable only if it is necessary to protect a legitimate business interest, reasonably limited in time and space, and consonant with the public interest."<sup>49</sup> Covenants not to compete are valid if they are reasonable in light of the facts in each case."<sup>50</sup> There is also a trend among many states to codify their noncompete policy.<sup>51</sup> This process often translates to the legislature clarifying that the test the courts should apply is the reasonableness test.<sup>52</sup> Other states are

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<sup>46</sup> See Gabel & Mansfield, *supra* note 6, at 321-22. See also Reichert, *supra* note 20, at 132-33.

<sup>47</sup> See, e.g., *Johnson Controls, Inc. v. A.P.T. Critical Sys.*, 323 F. Supp. 2d 525 (S.D.N.Y. 2004). In *Johnson Controls*, the court commented that:

In fashioning the [reasonableness] analysis, New York courts have endeavored to balance public policy concerns relating to the benefits of competition and the unfettered flow of talent and ideas in our economy with employers' legitimate right to protect the fruits of their labor [citation omitted], the idea being that the proper balancing of these factors will produce the most wealth and innovation...for society. It is important to keep in mind, however, that on a less grand scale the interests to be balanced are those of the individual employer and employee.

*Id.* at 533-34.

<sup>48</sup> 442 Mass. 635, 815 N.E.2d 572 (Mass. 2004), *cert. denied*, 544 U.S. 922 (2004).

<sup>49</sup> In some states this element is sometimes phrased as "not injurious to the public." See, e.g., *Ashland Mgt. Inc. v. Altair Invs. NA, LLC*, 869 N.Y.S.2d 465, 472 (N.Y. App. Div. 1st Dep't. 2008).

<sup>50</sup> *Boulanger v. Dunkin' Donuts*, 442 Mass. 635, 639-40 (Mass. 2004) (citations omitted).

<sup>51</sup> As of 2009, eighteen states have enacted some form of legislation addressing the enforceability of covenants-not-to-compete. See Bishara, *Fifty Ways to Leave Your Employer*, *supra* note 25. These states are: Alabama, California, Colorado, Florida, Georgia, Hawaii, Idaho, Louisiana, Missouri, Montana, Nevada, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Texas, and Wisconsin. Other states, such as Tennessee and West Virginia have basic antitrust statutes that are invoked when noncompetes are evaluated. See TENN CODE ANN. § 47-25-101 and 47-18-104 (disfavors any contract attempting to lessen competition) and W. VA. CODE 47-18-3(a) (the state's antitrust statute), respectively.

<sup>52</sup> See, e.g., OR. REV. ST. § 653.295 (7)(a) (2009):

currently contemplating noncompete statutes of some kind, most notably the Commonwealth of Massachusetts<sup>53</sup> and the State of Illinois.<sup>54</sup>

The generalized and undefined notion of reasonableness, not surprisingly, does not give much guidance to the courts and, because the cases all address individualized facts, some courts have refined the reasonableness standard into a formal test. Essentially this allows for a more nuanced framework that balances the rights and interests of the stakeholders (i.e., the employee, the employer, and the public). For instance, the New York Court of Appeals presents the test this way:

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A. Competition by the employee with the employer is limited or restrained after termination of employment, but the restraint is limited to a period of time, a geographic area and specified activities, all of which are reasonable in relation to the services described in subparagraph (B) of this paragraph;

B. The services performed by the employee pursuant to the agreement include substantial involvement in management of the employer's business, personal contact with customers, knowledge of customer requirements related to the employer's business or knowledge of trade secrets or other proprietary information of the employer.

*Id.*

<sup>53</sup> See Will Brownsberger, *Reform Noncompete Contracts – News*, <http://willbrownsberger.com/index.php/end-noncompete-contracts> (last visited February 15, 2011) (Massachusetts State Representative Brownsberger's website detailing plans to resubmit his co-sponsored noncompete reform legislation to the Massachusetts legislature).

<sup>54</sup> See Winston & Strawn, "HB 0016 Introduced to Create an 'Illinois Covenants Not To Compete Act'" (Jan. 2011), [http://www.winston.com/siteFiles/Publications/Updated\\_HB0016\\_Briefing.pdf](http://www.winston.com/siteFiles/Publications/Updated_HB0016_Briefing.pdf) (last visited February 15, 2011). Like Massachusetts proposed legislation, Illinois version of noncompete reform seeks to formalize the bounds of the traditional reasonableness test by requiring the contract to be "narrowly tailored to support the protection of a legitimate business interest" and apply it to specific levels of employees. The proposal also provides for rebuttable presumptions:

that a restrictive covenant is not narrowly tailored to promote a legitimate business interest if (i) the covenant's duration exceeds one year; (ii) the covenant's geographic area extends beyond any region in which the key employee provides employment services during the one year preceding termination of the employment relationship; or (iii) the type of services covered by the covenant extends beyond the nature of the work performed by the key employee. (emphasis added).

*Id.*

The modern, prevailing common-law standard of reasonableness for employee agreements not to compete applies a three-pronged test. A restraint is reasonable only if it: (1) is no greater than is required for the protection of the legitimate interest of the employer, (2) does not impose undue hardship on the employee, and (3) is not injurious to the public [citation omitted]. A violation of any prong renders the covenant invalid.<sup>55</sup>

When the courts apply the reasonableness test, they are mindful of the anti-competitive nature of a noncompete and, accordingly, evaluate what legitimate interest, if any, an employer is attempting to protect by enforcing the contract.<sup>56</sup> Thus, the New York Court of Appeals also pointed out that, “[i]n general, we have strictly applied the rule to limit enforcement of broad restraints on competition” and in specific cases “limited the cognizable employer interests under the first prong of the common-law rule to the protection against misappropriation of the employer's trade secrets or of confidential customer lists, or protection from competition by a former employee whose services are unique or extraordinary.”<sup>57</sup>

As is the case in New York, some states will evaluate whether an employee possesses such an extraordinary skill and expertise that a strict imposition of post-employment restrictions is necessary to protect the employer from unfair competition.<sup>58</sup> Even where a court draws a distinction between fair and unfair competition instead of the simply applying the reasonableness test, problems with predictability and equal application of this standard remain. Like the reasonableness analysis, the use of an unfair competition standard does not alleviate the concerns with unpredictable outcomes that are addressed by a resource-based view of the firm analysis of knowledge-ownership rights. This criticism is initially discussed in the following section.

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<sup>55</sup> *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 388-89 (N.Y. 1999). The court went on to write that, “New York has adopted this prevailing standard of reasonableness in determining the validity of employee agreements not to compete. ‘In this context a restrictive covenant will only be subject to specific enforcement to the extent that it is reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee’” [citing *Reed, Roberts Assocs., Inc. v. Strauman*, 40 N.Y.2d 303, 307 (N.Y. 1976)]. *Id.* at 389.

<sup>56</sup> See *Dworkin & Callahan*, *supra* note 23, at 169-170.

<sup>57</sup> *BDO Seidman*, *supra* note 55, at 389, citing *Reed, Roberts Assocs., Inc. v. Strauman*, *supra* note 55, at 308).

<sup>58</sup> *Karpinski v. Ingrasci*, 320 N.Y.S.2d 1 (1971) (oral surgeon skills in a rural upstate New York community were not sufficiently unique and valuable to justify a refusal to enforce the contractual protection of employer); see also *BDO Seidman v. Hirshberg*, *supra* note 55 (accountant's services and skills not sufficiently extraordinary).



### C. PROBLEMS AND CRITICISMS OF THE CURRENT APPROACH TO NONCOMPETE ENFORCEMENT

Although most courts across the United States will employ a reasonableness test to evaluate the propriety of a request to enforce a non-compete agreement, outcomes will vary because of the unique nature of each case and the inconsistencies inherent in the common law process. The variance of noncompete enforcement across jurisdictions – and even within states – has drawbacks for business and innovation because of the undefined and unpredictable nature of the reasonableness test.<sup>59</sup> Accordingly, we assert that this variance across jurisdictions and unpredictability of what states or a given court will consider a legitimate interest results from a doctrine based on a vague reasonableness standard that is incoherent in application. In other words, the means for enforcing a noncompete (the reasonableness analysis) is sometimes an uncertain standard for reaching the end goal (enforcing reasonably limited restrictions to promote a legitimate business interest), which also often has underlying policy differences in each state.

Beyond the obvious problem that a reasonableness analysis applied by trial courts will create uncertainty, an initial criticism of the general approach is that it lacks grounding in solid principle. In other words, the reasonableness approach can be vague and uncertain because it tries to be accommodating in balancing conflicting stakeholder interests without a guiding principle that defines the preferred outcomes. As it stands, noncompete enforcement policy is merely based on balancing the interests of parties to the contract without a broader articulation of *why* that balancing matters.

An example of the inherent failing of the reasonableness approach is that the overlay concern of anti-competitive contracts and the related inquiry into whether the employer is seeking the court's help to retain a protectable business interest yields inconsistent outcomes. Courts in different jurisdictions disagree about what constitutes a protectable interest, with states falling along a spectrum of weak to strong enforcement. Weak enforcement states, for instance, will protect only confidential information and customer lists that the employer expended effort to

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<sup>59</sup> See, e.g., Reichert, *supra* note 20, at 131-37 (discussing the unpredictability of enforcing noncompetes following a merger or acquisition in the context of the changing technologically-driven economy).

develop, while strong enforcement states will protect those employer investments as well as the firm's goodwill, the non-solicitation of other employees, and employer-provided training.<sup>60</sup>

However, in both the case of weak or strong enforcement, there is no clear unifying theoretical thread used by the courts to determine exactly *why* those aspects are indeed protectable interests. In fact, the indications that more states are moving slightly toward greater enforcement<sup>61</sup> suggest that employers are, perhaps based on a superior bargaining position and litigation resources, unconsciously working toward greater recognition of noncompetes, even if there is a lack of obvious evidence that there is not widespread lobbying for these changes. Another concern is that employers may tend to exploit their superior bargaining position at the start of employment to negotiate onerous non-compete terms.<sup>62</sup> Part of the problem is that a piecemeal, case-by-case evaluation of these agreements is not grounded in the business principles of competitive advantage, even though the business goal is implicit in the reasonableness test.

Another explanation for why the current reasonableness evaluation applied by most courts is an inadequate and outdated method for evaluating noncompetes is that modern business and employment realities are not fully addressed by the reasonableness approach. This is related to two developing trends in business and employment: the nature and value of knowledge and the increased mobility of skilled labor.

In terms of the importance of knowledge, as has been long recognized in the last few decades, the U.S. economy is moving from a goods-producing to a service-based economy.<sup>63</sup> There has been, essentially, a shift in business focus to information and knowledge creation and protection as a source of competitive advantage in a knowledge-based economy. This is

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<sup>60</sup> Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15, at 315.

<sup>61</sup> See Garrison & Wendt, *supra* note 21. The drift toward greater enforcement and formalization of noncompete policy among enforcing states is also addressed in Bishara, *Fifty Ways to Leave Your Employer*, *supra* note 25.

<sup>62</sup> For a discussion of how rent-seeking behavior by employees or overreaching by employers may reduced the expected competitive advantage gains and payout to shareholders see Russell W. Coff, *When Competitive Advantage Doesn't Lead to Performance: The Resource-Based View and Stakeholder Bargaining Power*, 10 ORG. SCI. 119 (1999).

<sup>63</sup> See, e.g., Katherine V.W. Stone, *Knowledge at Work: Disputes over the Ownership of Human Capital in the Changing Workplace*, 34 CONN. L. REV. 721, 721-730 (2002) (discussing the rising importance of knowledge and the "changing nature of the employment relationship" in the last decades).

evidenced by the acknowledgment in the management literature that human resources are an important source of competitive advantage for firms, as is the development and retention of tacit knowledge within teams of employees.<sup>64</sup> Moreover, the management literature has also squarely put a knowledge-based analysis at the forefront of theoretical discussions of the nature of the firm.<sup>65</sup>

Legal scholars have also begun to formally address the role of law in achieving competitive advantage over business rivals in both the management<sup>66</sup> and legal literature.<sup>67</sup> Specifically, the strategic use of the law has been called “the last great untapped source of competitive advantage.”<sup>68</sup> This trend continues with a recent recognition by legal and business academics that legal knowledge is useful source of business advantage for managers and teams within organizations.<sup>69</sup>

Similarly, the economic value of the individual workers’ human capital, particularly in sectors such as high-tech where these workers develop and utilize knowledge in the production process, are obvious sources of competitive advantage for firms.<sup>70</sup> Therefore, legal mechanisms such as covenants not to compete which aid employers in retaining control over knowledge assets are increasingly important to modern business activity.<sup>71</sup> The fact that employee-based

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<sup>64</sup> See generally IKUJIRO NONAKA & HIROTAKA TAKEUCHI, *THE KNOWLEDGE CREATING COMPANY* (1995). See also Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>65</sup> The groundbreaking article on this topic is Robert M. Grant’s, *Toward a Theory of the Firm*, 17 *STRAT. MGMT. J.* 109 (1996).

<sup>66</sup> Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 *ACAD. OF MGMT. REV.*, 378 (2008). See also Constance E. Bagley, *WINNING LEGALLY: HOW TO USE THE LAW TO CREATE VALUE, MARSHAL RESOURCES, AND MANAGE RISK* (Harv. Bus. School Press, 2005); and GEORGE SIEDEL & HELENA HAAPIO, *PROACTIVE LAW FOR MANAGERS: A HIDDEN SOURCE OF COMPETITIVE ADVANTAGE* (Gower Publishing, 2011);

<sup>67</sup> See Robert C. Bird, *Pathways of Legal Strategy*, 14 *STAN. J.L. BUS. & FIN.* 1 (2008).

<sup>68</sup> Robert C. Bird, *The Many Futures of Legal Strategy*, 47 *AM. BUS. L.J.* 575 (2010).

<sup>69</sup> See Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>70</sup> For a discussion of the importance of various forms of human capital investment by firms related to service and creative workers in a knowledge economy and the implications of noncompete enforcement, see Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15.

<sup>71</sup> Evidence of this trend is found in Stone, *Knowledge at Work*, *supra* note 63, at 738-39 (showing an increase in the reported trade secret and noncompete litigation at the state and federal level over various periods from 1970-1999).

knowledge can “walk out the door” and move to a competitor is particularly a concern for businesses.<sup>72</sup> Subsequently, employee non-compete agreements have become highly attractive, low cost and popular ways for employers to restrict harmful knowledge spillovers that benefit rivals.

In conjunction with the increased importance of knowledge assets for competitive advantage, the increased mobility of workers also makes noncompetes attractive to employers as they attempt to stem the outflow of talent and knowledge. Coupled with the fact that knowledge is often expensive to produce initially, but easy to *reproduce* subsequently by competitors, firms may see their investments in human capital easily diffuse to competitors and other parties.<sup>73</sup>

This is also visible in employer’s interest in promoting knowledge creation and retention within a paradigm where more workers are employed on a shorter term or contingent basis.<sup>74</sup> This so-called high-velocity labor market<sup>75</sup> of the last decades means that American workers are not only more willing to move location for a career opportunity, but they are comfortable with shorter term work. Coupled with the greater mobility of firms across U.S. jurisdictions and around the globe, these trends in employee mobility and concerns of competition are even more pronounced because physical geographical distance is often irrelevant to defining a business competitor.<sup>76</sup> The variance in enforcement across jurisdictions and the valuable spillovers from employee mobility can have some benefits for employees or employers, and perhaps even the macro economy and innovation. For instance, the much-discussed success of the high-tech

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<sup>72</sup> For a discussion of the propensity of knowledge to be widely disbursed, see generally Osenga, *supra* note 37.

<sup>73</sup> See CARL SHAPIRO & HAL R. VARIAN, *INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY* 3 (Harv. Bus. School Press, 1999).

<sup>74</sup> See, e.g., Sharon F. Matusik & Charles W.L. Hill, *The Utilization of Contingent Work, Knowledge Creation, And Competitive Advantage*, 23 *ACAD. OF MANAGEMENT REV.* 680 (1998).

<sup>75</sup> See ALAN HYDE, *WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET* (M.E. Sharpe Publishing, 2003).

<sup>76</sup> See Stone, *Knowledge at Work*, *supra* note 63, at 741 (“some courts have restricted the time of an allowable covenant on the grounds that in today’s fast-moving and competitive environment, an employee’s knowledge loses its value quickly”) (citation omitted).

agglomeration economy of Silicon Valley has been linked to the fact that California law essentially bans post-employment restrictive covenants,<sup>77</sup> in addition to a range of other factors.<sup>78</sup>

Another relatively new wrinkle to the enforcement of noncompetes and particularly the proper scope and temporal length of a restriction has become apparent in instances in the context of the “internet age” and the so-called “cyberspace workplace.”<sup>79</sup> In the context of a high-technology economy knowledge may have a more limited time value than in the past. The well-known noncompete case of *EarthWeb, Inc. v. Schlack* illustrates this point.<sup>80</sup> In that case the court found that the noncompete’s restriction as to time was unreasonably restrictive and overreaching to protect the employer’s interests.<sup>81</sup> Accordingly the court found that the one year provision was too long under the circumstances.<sup>82</sup> In doing so the court recognized that knowledge, while a crucial asset worthy of contractual protection, can sometimes lose its value and profitability by the mere passage of time. Therefore, like geographic scope, modern courts have had to reevaluate the notion of reasonableness when it comes to reviewing time restrictions.<sup>83</sup>

In their attempts to minimize these risks, firms use various methods to reign in the possibility of unwanted human capital diffusion. The managerial literature discusses some ways

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<sup>77</sup> See Gilson, *supra* note 32 (arguing that California’s noncompete policy is a substantial factor in the high mobility of workers and knowledge transfer that is integral to the growth and success of Silicon Valley). Empirical evidence for Professor Gilson’s assertion has been found in recent years. See, e.g., Marx, et al., *supra* note 12; Fallick, et al., *supra* note 11.

<sup>78</sup> ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (Harv. Univ. Press 1996) (finding that a combination of factors such as networking, cultural, investment patterns, and proximity to certain universities helped Silicon Valley advance over Route 128 outside of Boston, Massachusetts, despite early similarities to the high-tech industries of both regions).

<sup>79</sup> For a discussion of the complications of utilizing non-compete agreements in a technology-based workplace, including the new tensions with time and geographic restrictions in this context, see Gabel & Mansfield, *supra* note 6, at 321-24.

<sup>80</sup> 71 F. Supp. 2d 299 (S.D.N.Y. 1999).

<sup>81</sup> *Id.* at 313 (“As a threshold matter, this Court finds that the one-year duration of EarthWeb’s restrictive covenant is too long given the dynamic nature of this industry, its lack of geographical borders, and Schlack’s former cutting-edge position with EarthWeb where his success depended on keeping abreast of daily changes in content on the Internet”). The *EarthWeb* court subsequently shorted the time limit of the restriction on competition, as allowed by New York policy of “blue pencil” contract reformation.

<sup>82</sup> *Id.*

<sup>83</sup> See Stone, *Knowledge at Work*, *supra* note 63, at 740.

firms can use organizational design and incentives to retain knowledge within the firm's administrative control. Firms, for example, use coping strategies to contain human capital that include retention incentives, symbolic gestures, control rights and shared governance.<sup>84</sup> Property rights and intellectual property laws may also offer a degree of appropriability to secure knowledge in the form of patents, trade secrets and copyrights.<sup>85</sup>

The resulting scenario is that noncompete litigation outcomes across jurisdictions and industry contexts are largely unpredictable, and appear to be guided by the court's intuitive and subjective preferences. These preferences give an overall impression of *ad hoc* decision-making. Compounding the problem is the fact that the courts cannot obtain useful guidance from the legislature since the language of noncompete statutes is often vague, thus still leaving much to a trial court's discretion.<sup>86</sup> As a matter of commercial policy and jurisprudence, the unpredictable result is a disturbing reality for the contracting parties, litigants, and society.

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<sup>84</sup> Coff, *supra* note 62, at 119.

<sup>85</sup> See MERGES & DUFFY, *supra* note 33.

<sup>86</sup> For example, the State of Wisconsin statute, WISC. STAT. § 103.465, sets the standard simply at the restrictions being "lawful and enforceable only if the restrictions imposed are reasonably necessary for the protection of the employer" and "[a]ny covenant . . . imposing an unreasonable restraint is illegal, void and unenforceable even as to any part of the covenant or performance that would be a reasonable restraint." See also *Star Direct, Inc. v. Dal Pra*, 767 N.W.2d 898 (Wis. 2009). In *Star Direct* the Wisconsin Supreme Court went on to state:

Restrictive covenants in Wisconsin are prima facie suspect as restraints of trade that are disfavored at law, and must withstand close scrutiny as to their reasonableness. They are not to be construed to extend beyond their proper import or farther than the contract language absolutely requires. Rather, they are to be construed in favor of the employee.

We have interpreted [the requirements of the statute] as establishing five prerequisites that a restrictive covenant must meet in order to be enforceable under Wisconsin law. A restrictive covenant must: (1) be necessary for the protection of the employer, that is, the employer must have a protectable interest justifying the restriction imposed on the activity of the employee; (2) provide a reasonable time limit; (3) provide a reasonable territorial limit; (4) not be harsh or oppressive as to the employee; and (5) not be contrary to public policy.

*Id.* (citations omitted).

Thus, a reasonableness test pervades, but by its nature of seeking to balance the rights of the individual employee, the employer, and even the greater public good on a case-by-case basis it is flawed when it comes to addressing controversies related to knowledge ownership. As discussed below in Part IV, an approach that uses a principle of knowledge and the resource-based theory is an antidote to many of these criticisms. In that section, which forms the core normative thrust of this paper, the logic of the resource-based theory of competitive advantage addresses these concerns. Accordingly, we present an alternative set of principles for evaluating noncompetes.

### **III. THE COMPETING INTERESTS OF STAKEHOLDERS IN THE NONCOMPETE ENFORCEMENT PROCESS**

In line with the central assertion of this paper – that the resource-based theory adds value and insight into the question of when and why noncompetes should be enforced – this section first presents a brief overview of the typical life cycle of a covenant not to compete, from inception to litigation. Next, the section proceeds with a stakeholder-centric view of the interests of the parties to a non-compete agreement, as well as the public policy interests at stake.

#### **A. BACKGROUND OF NONCOMPETE FORMATION AND ENFORCEMENT**

It is generally assumed (and often stated) that covenants not to compete are widely used across industries and throughout the U.S. where they are permitted, that they have been increasingly used in the last decades, and that that they are used for various types of employees, not just top talent or those with access to confidential information. While there are no central repositories for noncompetes or even much research leading to conclusive numbers on the systematic use and details of noncompetes in the U.S.,<sup>87</sup> these assumptions seem to be widely shared by researchers, businesses, and policymakers.<sup>88</sup>

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<sup>87</sup> One exception is a study of executive employment packages at publically traded companies, which found extensive use of noncompetes, where permitted, in the SEC filings where the executive contracts

A request from an employer for an employee to sign a noncompete comes at one of three junctions in the employment relationship: before the start of employment as a prerequisite to a job, at the start of the employment (for instance, during an employee orientation period), or sometime after employment begins (including, perhaps, right before the employee leaves and the employer exerts one final attempt at leverage), but obviously before the employment ceases by the election of either party.<sup>89</sup> One issue with the timing of the request to execute a noncompete is with the traditional contract requirement that the parties demonstrate the element of sufficient legal consideration to support the agreement.<sup>90</sup> If the contract is signed prior to the start of employment it is generally clear that the employer's consideration is the promise to hire.<sup>91</sup>

Controversy more often arises when an employer requests a noncompete after employment has begun, often because it is an afterthought or the employer wants to expose the employee to new confidential information or a promotion. If the employee is offered some tangible benefit such as a promotion or salary increase in exchange for the contract, the element of consideration is satisfied. However, sometimes the noncompete is requested merely as a requirement of *continued employment*.<sup>92</sup> Whether continued employment alone is legally sufficient consideration to support a noncompete after employment has begun varies by jurisdiction.<sup>93</sup>

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were disclosed. Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 254-57 (2006). Katherine Stone has also shown that there has been rise in reported noncompete litigation. See Stone, *Knowledge at Work*, *supra* note 63, at 738-39 (“Covenants not to compete and covenants not to disclose information have become commonplace in employment contracts over the past ten years”).

<sup>88</sup> While the use of noncompetes is hard to measure, the importance of knowledge assets to firms is clear and their use of the courts to enforce knowledge ownership appears to be growing, as is the case with trade secret litigation in the federal courts. See, e.g., David S. Almeling et al., *A Statistical Analysis of Trade Secret Litigation in Federal Courts*, 45 GONZ. L. REV. 291 (2010) (finding that federal trade secret litigation has experienced exponential growth in the last decades).

<sup>89</sup> See MALSBERGER, *supra* note 21, at xvii (and subsequent state chapters) (listing the employment relationship time periods where courts will evaluate to determine if under a state's policy there is sufficient consideration to support the non-compete contract).

<sup>90</sup> *Id.* (particularly the editors' questions 3a, 3b, and 3c address, on a state-by-state basis, what is deemed sufficient consideration to support the agreement).

<sup>91</sup> *Id.* (question 3c).

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*



The exact terms of covenants not to compete will vary widely based on obvious factors such as the individualized relationship of the parties and their respective bargaining power, the predictability of enforcement, and the interests that the employer is trying to protect. The unifying element is that, once the employment is ended (by either party and under any circumstances in some cases) the employee is, in theory, not allowed to compete against the former employer. This prohibited competition could take the form of either the entrepreneurial route of the former employee starting a competing business or that employee simply going to work for an existing competitor.

Professor Katherine Stone has formalized the tension in the new workplace by discussing what she calls the “New Psychological Contract” in the American workplace, where the traditional promise of long-term employment in exchange for employee dedication to a single employer is gone.<sup>94</sup> As an advocate for employee empowerment within this shifting employment dynamic, Professor Stone has focused attention on the issue of legitimate employer interests.<sup>95</sup> She first notes that, traditionally, to restrict the transfer of knowledge an employer would have to assert its interest in a trade secret or confidential information.<sup>96</sup> She goes on to discuss how two protectable interests now recognized by the courts – contact with customers and employer provided training – are in tension with the new psychological contract of employment because these demands on employees are not matched by some commitment on the part of the employer.<sup>97</sup>

There are, however, ways in which the legitimacy of a contractual constraint can be questioned. For instance, one commentator has identified a risk of “strategic coercion” when noncompetes are used even when known to be unenforceable.<sup>98</sup> This chilling effect, thus, has a purely impermissible, noncompetitive goal that will not be endorsed by the courts. There are other situations where employers, whether intentionally or unintentionally, overreach and extract expansive terms. In these cases the actual goal of the restriction may be permissible (i.e., to

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<sup>94</sup> See Katherine V.W. Stone, *The New Psychological Contract: Implications for the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519 (2001).

<sup>95</sup> See Stone, *Knowledge at Work*, *supra* note 63, at 746-756.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at 748.

<sup>98</sup> See DiMatteo, *supra* note 10, at 765.

protect a legitimate business interest), but the scope is too broad and can be cut back through the reasonableness analyses used by most courts.<sup>99</sup>

What type of employer business interests qualifies under a particular state's common law as a legitimate protectable interest that is permissible will vary. However, employers often insert protections in the contract related to trade secrets (even if those are arguably covered by state law already), various pieces of confidential information on processes and products, customer lists, non-solicitation clauses intended to keep a departing employee from raiding the ranks of her coworkers or the non-solicitation of customers, or provisions to recoup the cost of investing in employee human capital.<sup>100</sup> The contracts also contain an element of scope, in terms of the time and geographic limitations, which is subject to the scrutiny of traditional reasonableness inquiry by a reviewing court.<sup>101</sup>

An additional issue concerning knowledge control by a former employer is the contractual restriction concerning confidentiality related to the employer's business (also known as a nondisclosure agreement, or NDA).<sup>102</sup> In some situations courts will not enforce nondisclosure agreements because they are so broad they violate public policy in that they act as a boundless restriction on the individual employee.<sup>103</sup> There are also instances where courts will balance the conflicting public policy goals of the sanctity of a duty of confidentiality of an employee to her employer against concerns of protected activity, such as proving employment discrimination<sup>104</sup> or in a whistleblower situation.<sup>105</sup>

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<sup>99</sup> See, e.g., *EarthWeb*, *supra* note 80 (overboard restriction as to time was shorted by the court to make the scope of prohibited reasonable in light of the business context).

<sup>100</sup> See, e.g., Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15, at 315 fig.1A.

<sup>101</sup> See, e.g., DiMatteo, *supra* note 10, at 765.

<sup>102</sup> For a detailed discussion of the interplay of nondisclosure agreements and noncompetes, including judicial refusals to enforce NDAs or noncompetes on public policy grounds, see Dworkin & Callahan, *supra* note 23, 169-173.

<sup>103</sup> For example, in a recent Illinois Appellate Court decision, *Town of Cicero v. Wayne A. Johnson*, No. 06 L 13062 (Ill. App. Ct. 1st Dist. Sept. 28, 2010), the enforcement of a former municipal employee's nondisclosure agreement was denied because it was overly broad and in contravention of the public interest.

<sup>104</sup> See *Quinlan v. Curtiss-Wright Corp.*, 204 N.J. 239, 267 (N.J. 2010) (New Jersey Supreme court applies the six-part balancing evaluation present federal sixth circuit case of *Niswander v. Cincinnati Insurance Company*, 529 F.3d 714 (6<sup>th</sup> Cir. 2008) to determine when an employee's violation of their employer's confidentiality policy is permissible).

Once a former employer detects that a departing employee is in violation of the noncompete the first step is likely a letter from the firm's lawyers to the departing employee demanding that the restrictive covenant be honored. In the case of an employee going to work for a competitor, a demand letter giving notice of the alleged breach and threatening litigation against the new employer for tortious interference with contractual relations is common. At this stage, the former employer may receive the requested action or some assurance of compliance, perhaps out of fear of the downside risk involved with litigation. In some cases the former employer may see its demands satisfied when the new employer simply terminates the employee. As with other threatened or actual contract litigation, it is also possible that some combination of the three possible parties to a noncompete enforcement lawsuit reach a negotiated settlement to resolve the employees concerns.<sup>106</sup> The backstopping mechanism for enforcing noncompetes is, of course, a full adjudication of the dispute by the state courts.

However, because of the fear that irreparable harm will result if some equitable relief – in the form of a temporary restraining order (TRO) and perhaps a later permanent injunction – is not obtained, the former employer may opt to bring immediate suit against the employee and the competitor. If the former employer does not act quickly to win the TRO battle the confidential information may be leaked to the competitor and the entire equitable case may be effectively lost, leaving the employer in a situation where it is harder to allege that it is really harmed by a breach compensable by money damages at trial. The dispute may be decided at the TRO stage and, thus, act as a catalyst to promote some compromise by the parties once the each side's leverage becomes apparent.<sup>107</sup> Otherwise, the matter may be delayed for some time and,

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<sup>105</sup> See Dworkin & Callahan, *supra* note 23, at 174-79 (including the issue of motive in the public policy interest analysis for whistleblower laws).

<sup>106</sup> For a law and economics perspective of noncompetes, including the ex ante and ex post views of negotiation and later resolving noncompete-based disputes among workers, employers, and competitors, see Eric A. Posner & George G. Triantis, *Covenants Not to Compete from an Incomplete Contracts Perspective* (U. Chi. Working Papers 2d, Paper No. 137, 2001), [http://www.law.uchicago.edu/files/files/137.EAP\\_covenants.pdf](http://www.law.uchicago.edu/files/files/137.EAP_covenants.pdf) (last visited February 15, 2011).

<sup>107</sup> In the case of a corporate former employer suing a former employee to enforce a noncompete it is easy to imagine how the employer would have superior resources and litigation staying power to overpower the individual, regardless of the merits of the case. Where a firm is suing the employee and the new firm (competitor) there may be more equal leverage and resources devoted to the dispute, but in that instance the employee may be end up caught in the middle as a pawn in a larger competitive strategy of rival firms using noncompetes as “swords” as well as “shields.” For an interesting corollary from an

depending on the status quo of where the worker is currently employed, the noncompete may be essentially worthless and damage to the former employer may have already accrued.

## **B. NONCOMPETE ENFORCEMENT AND THE RELEVANT STAKEHOLDERS**

To fully appreciate the noncompete formation and any subsequent enforcement process in relation to the resource-based theory, it is useful to first have a sense of the incentives, goals, and position of the parties that courts will consider when asked to adjudicate noncompete disputes. That is to say, what are the interests of the employer (the firm), the employee bound by the noncompete restrictions (the individual), and the public policy implications of enforcement (the public), which courts will consider when applying the reasonableness test discussed previously? The perspectives of employers and employees on noncompetes are for the most part two sides of the same coin, and therefore will be examined serially, with the public interest perspective to follow.

### **1. THE PERSPECTIVE OF EMPLOYERS AND EMPLOYEES**

Employers will use noncompetes as an additional mechanism to assert control over knowledge related to their business beyond the default rules provided by doctrines of duty of loyalty, trade secret law, and in addition to other contractual devices such as nondisclosure agreements. On one hand, a noncompete is useful for employers to protect their investment in human capital.<sup>108</sup> As Russell Coff has pointed out, rent-seeking by employees can neutralize a

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intellectual property-related and patent citation-based analysis of how a firm's reputation for aggressive enforcement of its patents can impact future efforts at intellectual property protection, see Rajshree Agarwal, Martin Ganco & Rosemarie H. Ziedonis, *Reputations for Toughness in Patent Enforcement: Implications for Knowledge Spillovers via Inventor Mobility*, 30 STRAT. MGMT J. 1349 (2009).

<sup>108</sup> For a discussion of the role of noncompetes in promoting investments in human capital, see Paul H. Rubin & Peter Shedd, *Human Capital and Covenants Not to Compete*, 10 J. LEG. STUD. 93 (1981). See also Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15 (arguing that noncompetes can be selectively enforced, depending on the industry involved and the knowledge spillover sought, to maximize human capital investments from employers).

firm's competitive advantage and harm a firm's performance,<sup>109</sup> therefore making a noncompete an advantageous way to address potential holdups by otherwise freely mobile employees.

On the other hand other, there are fears that employers can abuse the power of a noncompete by using them in an inappropriate overreaching way to stifle competition by restricting knowledge spillovers and as a disincentive for employee mobility and, thus, abusing their bargaining power.<sup>110</sup> In this sense, the reasonableness test of a noncompete's provisions provides a sort of *de facto* presumption that some restriction is warranted, as long as it is within the case-by-case "reasonable" bounds. Overall, noncompetes can, thus, be critiqued as giving significant power to employers in terms of bargaining and opens the door for a moral hazard of using the noncompete as a way to scare employees from going to a competitor, even when a properly challenged non-compete clause would be deemed unenforceable. The unpredictability of enforcement and the vagueness of the reasonableness test have also been cited by commentators as key reasons to reform<sup>111</sup> or eliminate noncompetes.<sup>112</sup>

Contrary to the competitive advantage perspective and incentives of employers, is a view of the empowered and protected individual employee – a version of an employee-focused workers' rights view.<sup>113</sup> This view would place the ownership of the fruits of a workers' intellectual labors and human capital with the worker, thus in opposition to the notion of a non-compete agreement.<sup>114</sup> At the root of the problem of an employee being, on balance, harmed by

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<sup>109</sup> See Coff, *supra* note 62.

<sup>110</sup> Kate O'Neill, *Should I Stay or Should I Go? – Covenants Not to Compete in a Down Economy – A Proposal for Better Advocacy and Better Judicial Opinions*, 6 HASTINGS BUS. L. J. 83, 84 (2010) (proposing that appellate courts "minimize[e] the enforcement of covenants not to compete where the assenting employee lacks significant bargaining power while preserving employers' abilities to enforce these covenants against employees who enjoy such power").

<sup>111</sup> Emily J. Kuo, *Comment, The Enforceability Gap of Covenants Not to Compete in Telecommuting Employment Relationships*, 1996 U. CHI. LEGAL F. 565 (1996) (arguing from a perspective of the changing telecommuting workplace for greater intervention by legislatures, instead of courts, because noncompetes are a policy question).

<sup>112</sup> See generally Hyde, *Should Noncompetes Be Enforced*, *supra* note 9.

<sup>113</sup> See Bishara, *Covenants not to Compete in a Knowledge Economy*, *supra* note 15, at 311-13 (discussing the employee rights approach to noncompete enforcement).

<sup>114</sup> See generally Stone, *Knowledge at Work*, *supra* note 63 (discussing the human capital ownership tension between employees and employers, and ultimately taking the perspective that noncompetes are disadvantageous to the individual worker's rights).

restrictive covenants aimed at allocating knowledge rights is a concern that the individual may not appreciate the restrictions at the time of contracting because she sees the clause as a means to an end (i.e., employment) and because she is in an inferior bargaining position. When the economic climate is poor an employee may be at an even greater disadvantage from a bargaining position and she is more likely to overvalue an employment opportunity and underestimate the longer-term restrictions of a noncompete.<sup>115</sup>

An even more sharp critique of noncompetes is that they are overtly negative from an economic perspective. A leading advocate for the wholesale banning of noncompetes is Professor Alan Hyde. In a recent article, he reviews the growing empirical economic and management research where noncompetes are a factor in studies of employee mobility and entrepreneurial activity.<sup>116</sup> Hyde focuses on these studies' conclusions about the potential negative aspects of noncompetes such as economic harm and infringing on individual freedom, thus concluding that they are an unacceptably anti-competitive anachronism.<sup>117</sup>

## 2. THE PUBLIC INTEREST

The third stakeholder group mentioned by courts when applying the reasonableness test to a noncompete is the “public.” As discussed earlier, the notion is that the restriction in the covenant must as some courts put it, “not be contrary to public policy”<sup>118</sup> or “not harmful to the general public.”<sup>119</sup> While this element essentially acts as a final, high-level inquiry as to the propriety of the terms of the agreement from a public policy standpoint, it appears to be rarely successfully invoked to void a noncompete clause. Nor is there evidence of this last element being a significant roadblock to enforcing most noncompetes.

When evaluating a request for an equitable remedy to restrict a person's post-employment mobility, a court will balance the competing interests of the parties and the

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<sup>115</sup> See, e.g., O'Neill, *supra* note 110.

<sup>116</sup> Hyde, *Should Noncompetes Be Enforced*, *supra* note 9, at 9-10.

<sup>117</sup> *Id.*

<sup>118</sup> *Star Direct*, *supra* note 86.

<sup>119</sup> *BDO Seidman*, *supra* note 55.

implications for the public, even in the absence of a non-compete clause. For instance, in *Bimbo Bakeries v. Botticella*, a trade secrets misappropriation case, the Third Circuit Court of Appeals endorsed the district court's grant of a preliminary injunction to prevent a former senior executive, with knowledge of the secret process for creating the texture of the famous Thomas' English Muffins "nooks and crannies", from working for a competitor.<sup>120</sup> The employee had signed a "Confidentiality, Non-Solicitation and Invention Assignment Agreement." He did not have a noncompete agreement, presumably because he was originally working in California where such a restriction is clearly against public policy.<sup>121</sup>

The *Bimbo* court found that "there are several public interests at play", including "a generalized public interest in "upholding the inviolability of trade secrets and enforceability of confidentiality agreements."<sup>122</sup> The court added that:

there is a public interest in employers being free to hire whom they please and in employees being free to work for whom they please. Of these latter two interests, Pennsylvania courts consider the right of the employee to be the more significant. *See Renee Beauty Salons, Inc. v. Blose-Venable*, 438 Pa. Super. 601, 652 A.2d 1345, 1347 (Pa. Super. Ct. 1995) ("[T]he right of a business person to be protected against unfair competition stemming from the usurpation of his or her trade secrets must be balanced against the right of an individual to the unhampered pursuit of the occupations and livelihoods for which he or she is best suited.") (internal citation omitted); *see also Wexler v. Greenberg*, 399 Pa. 569, 160 A.2d 430, 434-35 (Pa. 1960) (noting a societal interest in employee mobility). We are satisfied on the facts of this case that the public interest in preventing the misappropriation of Bimbo's trade secrets outweighs the temporary restriction on Botticella's choice of employment. *See SI Handling Sys.*, 753 F.2d at 1265 (finding unnecessary an "extended analysis of the public interest [because] extensive precedent supports an injunctive remedy where the elements of a trade secret claim are established").<sup>123</sup>

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<sup>120</sup> *Bimbo Bakeries USA, Inc. v. Botticella*, 613 F.3d 102, 104 (3d Cir. Pa. 2010).

<sup>121</sup> For a discussion of California's public policy against restrictions on employee mobility, *see* CAL. BUS. & PROF. CODE § 16600 (2010) and associated text, *supra* note 31.

<sup>122</sup> *Bimbo Bakeries*, *supra* note 120, at 119 (citing *Bimbo Bakeries USA, Inc. v. Botticella*, 2010 U.S. Dist. LEXIS 68990, 2010 WL 571774, at \*16).

<sup>123</sup> *Id.*

The “against public policy” assertion challenging a noncompete comes up in two instances in the modern courts. The first is in situations where choice of law provisions are implicated or where a constrained employee crosses jurisdictional lines compelling courts to decide if the noncompete policy of one state allows the enforcement of the contract which may have been permissible in the first jurisdiction.<sup>124</sup> The second line of arguments – that a noncompete is against public policy – is more aligned with the blanket statement from courts in enforcing states that the agreements are scrutinized because of their anti-competitive character and harm to the free exercise of a person’s chosen profession.<sup>125</sup> In addition, this common concern is related to the public policy concern of the free pursuit of an employee’s livelihood (their ability to earn a living) and the impact the restriction will have on competition.<sup>126</sup> These public policy-based concerns over preserving free employee mobility and employer protections

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<sup>124</sup> See, e.g., *Palmer & Cay, Inc. v. Marsh & McLennan Cos.*, 404 F. 3d 1297 (11th Cir. Ga. 2005) (finding that enforcing the agreement would violate Georgia’s more restrictive treatment of noncompetes, thus violating the state’s public policy narrow approach to noncompetes).

<sup>125</sup> See Dworkin & Callahan, *supra* note 23, at 169-71. Interestingly despite the aversion to anti-competitive impacts of noncompetes, the one potential stakeholder group not considered by courts is that of the competitor to the noncompete-enforcing firm. While not explicitly considered in the public interest evaluation, the competitor’s interest may be implicitly covered by the courts desire to promote general competition. Nonetheless, there does not appear to be cases where courts have considered the knowledge transfer implications explicitly and the role of that transfer in increasing competition and innovation.

<sup>126</sup> See, e.g., *Ashland Mgt. Inc. v. Altair Invs. NA, LLC*, *supra* note 49, at 465.

The court in *Ashland* stated that:

A restrictive covenant is unenforceable if its duration is unreasonable because of the "powerful considerations of public policy which militate against sanctioning the loss of a man's livelihood", as well as the general public policy favoring robust and uninhibited competition. Protecting trade secrets and truly confidential information, however, does not have to be time limited in every instance where the covenant does not otherwise prevent a former employee from pursuing his or her livelihood or interfere with competition ["basic test for determining permissible time . . . limitations is whether the restraint as to time . . . is necessary for the protection of the promisee, but neither oppressive on the promisor, nor injurious to the interests of the general public"]. [citations omitted].

*Id.*



are exacerbated by cross-jurisdictional issues because noncompete enforcement levels vary widely.<sup>127</sup>

A third possible instance of a court's application of the "injurious to the public" standard is related to the concern that enforcing a noncompete agreement will deprive the public of the fruits of competition. Specifically, the notion is often that honoring a restrictive covenant in certain situations will result in harm to the public's access to a vital service or otherwise against public policy. The most common example is related to physicians and the provision of health care services.<sup>128</sup> For instance, concern for patient choice and physician expertise could implicate access to specialized medical services in rural communities.<sup>129</sup> These instances are related to the effects of the anti-competitive nature of noncompetes on the public's access to vital services, ideal pricing, and innovation. While the general public's interest in accessing those public goods is not generally addressed by the courts there are, however, examples of the success of these public interest arguments related to physician noncompetes may be on the rise in some jurisdictions.<sup>130</sup> Courts can disfavor noncompetes on other public policy grounds as well, including the effect they have on denying the public valuable services, but also the negative effects on the individual wishing to pursue his or her trade or profession.<sup>131</sup>

Interestingly, states ban noncompetes for lawyers on public policy grounds based on a theory of access to legal services, but, despite support from American Medical Association for a

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<sup>127</sup> For discussions of the cross-state conflict of laws and choice of law and forum in noncompetes and the related implications, see Timothy P. Glynn, *Interjurisdictional Competition in Enforcing Non-Compete Agreements: Regulatory Risk Management and the Race to the Bottom*, 65 WASH. & LEE L. REV. 1381 (2008). See also, Gillian Lester & Elizabeth Ryan, *Choice of Law and Employee Restrictive Covenants: An American Perspective*, 31 COMP. LAB. L. & POL'Y J. 389 (2010) (discussing choice of law and forum for noncompetition agreement enforcement in the U.S.).

<sup>128</sup> See generally Alina Klimkina, *Note: Are Noncompete Contracts Between Physicians Bad Medicine? Advocating in the Affirmative by Drawing a Public Policy Parallel to the Legal Profession*, 98 KY. L.J. 131 (2009).

<sup>129</sup> *Id.* But see *Karpinski v Ingrasci*, *supra* note 58 (despite discussion of the defendant former employee's restriction of practicing oral surgery in a rural county setting, the court only focused on the propriety of the restriction and did not discuss the public policy implications of restricting the public's access to specialized health care).

<sup>130</sup> See Klimkina, *supra* note 128, at 147-48.

<sup>131</sup> See, e.g., *Friddle v. Raymond*, 575 So. 2d 1038, 1040 (Ala. 1991) (stating that in Alabama noncompetes are disfavored "because they tend not only to deprive the public of efficient service, but also tend to impoverish the individual.") (citations omitted).

similar ban on noncompetes for physicians, few courts have agreed.<sup>132</sup> The other professional group that has overtly organized around noncompete policy and successfully shaped state enforcement policies through its lobbying efforts is the broadcasting industry, which has worked to prohibit noncompetes.<sup>133</sup> There are also states where other professions are exempted from noncompete enforcement. For instance in Alabama, in addition to doctors, lawyers, veterinarians, and accountants are also exempted from noncompetes.<sup>134</sup>

While a judge may invoke the public interest or public policy prong to limit the noncompete, this justification is not widely used and also provides little guidance except in a rather narrow set of cases. Also, as a matter of public policy, noncompete doctrine will play an increasingly important role as a mechanism that balances employers' investments in human capital and innovation with the broader societal goals of encouraging knowledge diffusion and dynamic competition. It is this third, yet neglected, facet of the public policy inquiry that is ripe for being reenergized by applying the resource-based theory to assess noncompete legitimacy. Accordingly, the resource-based theory discussed next will help address the lack of efficacy associated with the public interest concern.

#### **IV. NONCOMPETES AND THE RESOURCE-BASED THEORY**

At the root of our discussion of the relationship among noncompete contracts and competitive advantage is, as Professors Almeida and Kogut so eloquently state in the quote cited in Part I,<sup>135</sup> the assertion that ideas – essentially a type of burgeoning knowledge – are different from other resources which firms may seek to restrict due to the ethereal nature of knowledge and its relative ease of disbursement. In other words, the tendency of firms is to treat knowledge

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<sup>132</sup> *Id.*

<sup>133</sup> For a discussion of the broadcasting industry noncompete statutes and implications see Melissa Rassas, *Explaining the Outlier: Oregon's New Non-Compete Agreement Law & the Broadcasting Industry*, 11 U. PA. J. BUS. L. 447 (2009). Several states have such legislation, including New York's "Broadcast Employees Freedom to Work Act," N.Y. LAB. L. §202-k (2008).

<sup>134</sup> See *Martin v. Battistella*, 9 So. 3d 1235 (Ala. 2008).

<sup>135</sup> Almeida & Kogut, *supra* note 26 and accompanying text.

related to their business, in all its forms, as rivalrous (as consumable by that specific firm alone), or at least excludable (in that they can prevent others from using the knowledge). The role and limits of noncompetes as a mechanism for firms to keep and exclusively utilize knowledge for competitive advantage is the subject of this section.

Part III of this article described how neither the reasonableness test nor the public interest assessment provides a principled, comprehensive way for courts to fully balance the firm's and departing employee's competing interests. As mentioned earlier, when the courts evaluate a non-competition agreement dispute they evaluate the reasonableness of the contractual terms restricting the employees from engaging in their chosen profession. This reasonableness analysis typically focuses on the geographical, time and scope of activity limitations imposed on the departing employee.<sup>136</sup> The reasonableness approach, however, fails to address how the employer's legitimate business interest should be assessed, rendering the reasonableness analysis a *secondary* question under the framework advanced in this article.

To address the challenge of devising a useful methodology for analyzing the business value of post-employment restrictions on mobility, this section introduces the resource-based theory of competitive advantage to provide a workable solution to the problem of assessing the legitimacy of claims to knowledge in a noncompete. The resource-based theory is widely recognized in managerial literature.<sup>137</sup> As evidence of its importance as a unified theory of the firm and as the ideal of sustainable competitive advantage, the resource-based theory has been systematically explored and expanded in the last two decades.<sup>138</sup> This includes the addition of

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<sup>136</sup> The typical non-compete clause in an employment contract is drafted to specifically limit competition in terms of geography, duration and scope of business. One physician employment contract, for example, reads:

During the term of this Agreement and for twenty-four (24) months after termination for any reason, Physician shall not, for himself or herself or any behalf of any other person(s), firm(s), partnership(s), corporation(s) or entity compete with Corporation in the general practice of medicine within a twenty (20) mile radius of the Corporation...

Sample noncompete clause, on file with the authors.

<sup>137</sup> See Jay Barney, *Firm Resources and Sustained Competitive Advantage*, 17 J. MGMT. 99, 103–05 (1991) (widely cited as the seminal work on the resource-based theory).

<sup>138</sup> See, e.g., David J. Teece et al., *Dynamic Capabilities and Strategic Management*, 18 STRAT. MGMT. J. 509, 516 (1997) (building from the resource-based theory to conceptualize dynamic knowledge-based

specific typologies for understanding the use of the theory as it relates to competitive advantage.<sup>139</sup>

Accordingly, the resource-based theory offers a workable guide for courts to assess the legitimacy of competing stakeholder claims based on whether the knowledge in question is a *resource* that offers sustainable competitive advantage. The argument advanced here is that the legitimacy of any claims to knowledge will hinge on whether a party can claim that same knowledge as a resource that provides sustainable competitive advantage.<sup>140</sup>

Introducing the concept of competitive advantage into a primarily legal noncompete analysis is not foreign to the bar and bench. Throughout the remainder of this article, the argument will be advanced that the courts and litigants have already begun to apply concepts related to the resource-based theory of competitive advantage in the noncompete context, albeit in a way that does not explicitly recognize the theory outright. Courts and legislatures have discussed the requirement of a legitimate *competitive interest* in their decisions examining an employee's level of knowledge in noncompete cases.<sup>141</sup> For instance, the Oregon legislature specifically contemplated management experience as a protectable business interest.<sup>142</sup>

## A. THE RESOURCE-BASED THEORY OF THE FIRM

The resource-based theory seeks to explain one of the most fundamental aspects of business: why some firms, over time, exhibit superior performance relative to other firms. The

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capabilities as a strategic resource); and Raphael Amit & Paul J.H. Schoemaker, *Strategic Assets and Organizational Rent*, 14 STRAT. MGMT. J. 33 (1993) (advancing resource-based theory by distinguishing between capabilities and resources, with capabilities referring to the firm's capacity to deploy resources); C.f. Richard Priem & John E. Butler, *Is the Resource-Based "View" A Useful Perspective for Strategic Management Research?*, 26 ACAD. OF MGMT. REV. 22-40 (2001) (challenging the theoretical foundations of the widely adopted resource-based view).

<sup>139</sup> Margaret A. Peteraf, *The Cornerstones of Competitive Advantage: A Resource-Based View*, 14 STRAT. MGMT. J. 179 (1993) (providing an additional resource-based model that specifies four conditions).

<sup>140</sup> See, e.g., Barney, *supra* note 137.

<sup>141</sup> See, e.g., *Kelly Servs. v. Greene*, 535 F. Supp. 2d 180, 185-86 (D. Me. 2008).

<sup>142</sup> See OR. REV. STAT. § 653.295 (7)(a) (2009), *supra* note 52.

theory ascribes sustainable competitive advantage (sustainable because the advantage is not temporary) to unique<sup>143</sup> resource positions that give a firm a strategic difference relative to other firms.<sup>144</sup> Under the resource-based theory, a resource offers sustainable competitive advantage only if it is: valuable, rare, inimitable, and non-substitutable (VRIN).<sup>145</sup> Resources that possess these attributes include knowledge-based assets such as trade secrets, processes, capabilities<sup>146</sup> and legal strategies.<sup>147</sup>

A resource is valuable if it provides a basis for the firm or individual to engage in imperfect competition. In the context at hand, knowledge asserted in a noncompete is assumed to be valuable because of its current use and the employer's desire to prevent its use by competitors through enforcement of the contract terms. Resources are rare if they are unique to the firm or the individual. In the resource-based literature, a resource is defined as rare if it is asset specific.<sup>148</sup> Asset-specific resources are those that are differentiated and include proprietary knowledge-based assets – for example trade secrets, patents, and unique methods of doing business.<sup>149</sup> Public knowledge and knowledge easily acquired through independent means stand in direct contrast to asset-specific knowledge. For example, patented knowledge may provide differentiated knowledge that is asset specific due to the legal restriction on use during the patent lifetime. After the patent expires, however, that knowledge ceases to be asset specific since it becomes part of the public domain.

Inimitable resources are those that cannot be readily observed by competitors or replicated. Resources may be inimitable because they rely on tacit knowledge, which reflects personal skills, habits, and values among individuals. Tacit knowledge, on the whole, is hard to

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<sup>143</sup> The language of the resource-based theory often uses the word heterogeneous to contrast resources that are homogenous, or widely shared among firms and, therefore, not a source of sustainable competitive advantage. See Barney, *supra* note 137, at 103–05.

<sup>144</sup> See Barney, *supra* note 137, at 105–12; *c.f.* MICHAEL E. PORTER, *COMPETITIVE STRATEGY* (Simon & Schuster 1980).

<sup>145</sup> Barney, *supra* note 137, at 106-12.

<sup>146</sup> Teece et al., *supra* note 138, at 517.

<sup>147</sup> See Bagley, *What's Law Got to Do With It?: Integrating Law and Strategy*, *supra* note 16 ; and Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 516.

articulate and therefore hard to replicate.<sup>150</sup> Knowledge-based assets may also be inimitable because the firm employs coping mechanisms to prevent knowledge spillovers. Some of these managerial coping mechanisms involve profit sharing, shared governance and investments in specific skills that tie employees to the firm.<sup>151</sup> The firm may additionally use legal mechanisms to enhance inimitability. Intellectual property rights such as patents, trade secrets, copyrights, designs, and trademarks offer legal exclusivity to knowledge resources.<sup>152</sup> As discussed previously, contracts such as non-disclosure agreements or noncompetes are also used to expand the level of inimitability.

Finally, a resource is non-substitutable if competitors may not easily find similar ways to develop or acquire acceptable alternatives to the resource. Resources are often difficult to substitute when they are embedded in socially complex systems or relationships.<sup>153</sup> An inimitable aspect of business-related knowledge is management's ability to coordinate knowledge among individuals and disparate groups through what are called higher-order organizing principles.<sup>154</sup> Higher-order organizational principles involve managerial insights and leadership to direct disparate knowledge among individuals and units. For example, a promising research and development project will require support among different business stakeholders including top management, marketing, sales, and finance personnel, among others. Such principles are required to coordinate the knowledge held by these various groups to ensure that the project moves forward successfully.<sup>155</sup> Higher-order organizational principles are also associated with coordinating knowledge-based managerial routines in a way that cannot be easily

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<sup>150</sup> Tacit knowledge is further examined in section III.B.

<sup>151</sup> See Coff, *supra* note 62, at 380-393.

<sup>152</sup> See, e.g., MERGES & DUFFY, *supra* note 33.

<sup>153</sup> See, e.g., Barney, *supra* note 137.

<sup>154</sup> Bruce Kogut & Udo Zander, *Knowledge of the Firm, Combinative Capabilities, and the Replication of Technology*, 3 ORG. SCI. 383, 389 (1992).

<sup>155</sup> See David Orozco, *Rational Design Rights Ignorance*, 46 AM. BUS. L.J. 573 (2009) (discussing legal knowledge of several intellectual property rights as a coordinating principle to unite various business activities within a firm to achieve the goal of integrated intellectual property rights). See also Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16 (discussing managerial leadership as a requirement to generate the strategic resource of legal knowledge).

unpacked to identify cause-and-effect relationships, making them difficult to replicate by would-be imitators.<sup>156</sup>

To summarize, under the resource-based theory, resources yield sustainable competitive advantage only when they are conjunctively valuable, rare, inimitable and non-substitutable (VRIN).<sup>157</sup> In today's information-based economy, knowledge-based assets are resources that firms and individuals increasingly rely on to establish a competitive market position. Knowledge is, therefore, increasingly relied upon by organizations to sustain advantage and generate differentiation vis-à-vis competitors.

Many types of knowledge can be secured under the existing laws, for example, the intellectual property laws that extend to trade secrets, patents, copyrights, designs, and trademarks. There are additional types of knowledge, however, that are not secured by the formal intellectual property regimes, and which given the practical realities faced within organizations cannot be realistically secured as a trade secret.<sup>158</sup> This category of information may include business strategies,<sup>159</sup> pricing information,<sup>160</sup> customer-related knowledge,<sup>161</sup> and confidential customer lists.<sup>162</sup> In these cases, the firm can rely on noncompetes as a realistic method to protect this unique category of knowledge against unwanted spillovers.

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<sup>156</sup> Kogut & Zander, *supra* note 154.

<sup>157</sup> Barney, *supra* note 137.

<sup>158</sup> Trade secrets, however, may be a factor to determine whether a non-compete is enforced. *See e.g.*, *The Hamilton-Ryker Group, LLC v. Keymon*, 2010 Tenn. App. LEXIS 55 (2010) (the court held the violation of a non-compete was partially attributable to the former employees unauthorized use of company trade secrets).

<sup>159</sup> *See Kelly Servs. v. Eidnes*, 530 F. Supp. 2d at 950; and *Kelly Servs., Inc. v. Noretto*, 495 F. Supp. 2d 645, 657 (E.D. Mich. 2007) (the court stated that employers have an interest in protecting such confidential information such as marketing strategies and sales strategies or techniques) .

<sup>160</sup> *See Southwest Stainless, LP v. Sappington*, 582 F.3d 1176 (10th Cir. Okla. 2009) (the court held that although pricing generally may be protectable, a court needs look at the specific pricing at issue in the case to determine whether the company protected that pricing).

<sup>161</sup> *See, e.g. Medtronic, Inc. v. Gibbons*, 684 F.2d 565, 569 (8th Cir. Minn. 1982) (the court held that a noncompete may be enforceable to protect the former employer's training related to client-specific knowledge).

<sup>162</sup> *See, e.g. St. Clair Med., P.C. v. Borgiel*, 270 Mich. App. 260, 266 (Mich. Ct. App. 2006); and *Godlan, Inc. v. Greg Whiteford & DCL, Inc.*, 2003 Mich. App. 610 (2003). The courts are also hesitant to extend trade secret protection to general managerial knowledge such as marketing plans and costing or pricing information unless this managerial knowledge is shared with upper management. *See, e.g., EarthWeb*, *supra* note 80, at 36-37.

The reason why some knowledge cannot be secured by trade secret is because of the requirement that the information be subject to reasonable efforts to preserve its secrecy.<sup>163</sup> Taking reasonable steps to preserve secrecy can be difficult to achieve in *all* cases where information is being created for two reasons. First, the value of the knowledge may not be apparent until well after its creation or dissemination.<sup>164</sup> Without a clear value of the knowledge *ex ante*, it is difficult to determine if it is worth expending resources to preserve secrecy. For this reason some of the knowledge building blocks that led to the creation of subsequent knowledge may remain unsecured after their value becomes apparent *ex post*.

Second, knowledge is often shared among parties to communicate its value and to generate additional value if external sources of knowledge must be integrated.<sup>165</sup> Businesses are collaborating with external parties with greater frequency in an era characterized by open innovation and business models.<sup>166</sup> It is often impractical for a company to guard its knowledge with legal mechanisms in an open innovation context, or when trust and other non-legal mechanisms play a strong role in mediating the risks of divulging knowledge absent formalized protection.<sup>167</sup> Yet, this valuable knowledge, which is not subject to trade secret or other formal intellectual property protection, may be a true resource nonetheless. In some cases, this

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<sup>163</sup> See Uniform Trade Secrets Act (UTSA) of 1985 § 1(4).

<sup>164</sup> This supply challenge related to knowledge transfer is often referred to as Arrow's information paradox, in reference to economist Kenneth Arrow, who first exposed the challenge. KENNETH J. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* 152 (1971).

<sup>165</sup> See *Southwest Stainless, LP v. Sappington*, *supra* note 160 (The Court, in a non-compete case, held that pricing information could a trade secret but plaintiff had failed to establish it in the case at hand since the pricing information had been shared with clients without imposing confidentiality restrictions). Also, under a leading theory of knowledge management, knowledge held by various individuals must be combined to generate new knowledge, therefore, increasing the incentive to share knowledge with others. See also NONAKA & TAKEUCHI, *supra* note 64.

<sup>166</sup> HENRY CHESBROUGH, *OPEN BUSINESS MODELS: HOW TO THRIVE IN THE NEW INNOVATION LANDSCAPE*, at xiii, (Harv. Bus. Press 2006) (discussing how open innovation "means that companies should make greater use of external ideas and technologies in their own business, while letting their unused ideas be used by other companies").

<sup>167</sup> See *Southwest Stainless, L.P. v. Sappington*, *supra* note 160. See also Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61 (1963) (this is widely recognized as a seminal work in the theory of relational contracts, a theory that places trust, norms, and other non-legal mechanisms in a contractual context). Also, general agency law may further explain this since the firm may not seek to extend trade secret protection to knowledge because it relies on the duty of loyalty of its agents-employees. RESTATEMENT (SECOND) OF AGENCY § 395 (1958).



knowledge ownership right may be legitimately enforced with a noncompete. Firms will, naturally, seek to develop several layers of knowledge asset protection and, where permitted by state law and public policy, the noncompete offers a low cost protective mechanism for employers.<sup>168</sup>

## **B. THE RESOURCE-BASED THEORY APPLIED TO FIRMS AND EMPLOYEE KNOWLEDGE**

Because the resource-based theory defines the necessary conditions for a knowledge-based resource to offer sustainable competitive advantage, this theory provides suitable grounding to assess the legitimacy of competing claims to knowledge in a noncompete. Firms and individuals can generate sustainable competitive advantage only through the creation and deployment of resources that meet the VRIN criteria specified by the resource-based theory. The assertion is that a firm's protectable knowledge interest is legitimate only if the knowledge meets these criteria as well. Knowledge that is not a resource that provides sustainable competitive advantage is knowledge that can be readily purchased or replaced in a market transaction. Restricting knowledge flows and employee mobility by granting a limited duration monopoly for a knowledge-based asset that can be readily purchased or substituted in the marketplace<sup>169</sup> offers unfair advantage akin to rent-seeking that as a matter of policy should not be allowed via judicial noncompete enforcement.

The argument that readily available or easily acquired knowledge should not be privately owned finds support in another prominent area of information regulation: the intellectual property laws. The patent laws, for example, exclude from patentability any invention that is obvious or otherwise not novel.<sup>170</sup> A trademark cannot be federally registered if the mark is not distinctive relative to other words or marks.<sup>171</sup> Product designs must also be novel to justify

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<sup>168</sup> See generally Dworkin & Callahan, *supra* note 23.

<sup>169</sup> An asset that is readily purchased in the marketplace is not a VRIN resource. See Teece et al., *supra* note 138, at 517.

<sup>170</sup> 35 U.S.C. § 101 (2010).

<sup>171</sup> 15 U.S.C. § 1052(d) (2010).

registration.<sup>172</sup> Trade secret law extends protection only to valuable information that is not readily available.<sup>173</sup> Copyright, likewise, does not extend to publicly known facts.<sup>174</sup> The public policy behind these various information-regulating laws is to prevent private ownership of what ought to rightfully remain in the public domain. Along those lines, a noncompete should not, as a matter of public policy, extend to knowledge that is widely or generally available in the market. As will be further discussed below, this contention finds ample support in the resource-based theory.

The departing employee's knowledge may be valuable and rare (VR), yet it may be easily imitated or substituted if the employee departs the firm and transfers that knowledge to a competitor or uses it to start a competing enterprise.<sup>175</sup> This reason serves as a partial justification for allowing companies to use a noncompete to restrict knowledge transfer. It also, however, places a burden on companies to extract a VRIN knowledge resource from its employees. The firm must, therefore, use the employee's knowledge and take extra steps to ensure that this individual, personal knowledge becomes a VRIN organizational resource that is inimitable and non-substitutable under the resource-based theory. This presents a challenge, however, since the employee retains the knowledge and is mobile. As described next, the firm can take steps to overcome this hurdle and ensure that the knowledge retain the "sticky" attributes of inimitable and non-substitutable organizational knowledge. When the firm takes the extra steps to transform the employee's knowledge into a VRIN organizational resource that

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<sup>172</sup> 35 U.S.C. § 171 (2010).

<sup>173</sup> See UTSA, *supra* note 163 at, § 1(4). The UTSA defines a trade secret as:

information, including a formula, pattern, compilation, program device, method, technique, or process, that: (i) derives independent economic value, actual or potential, *from not being generally known to, and not being readily ascertainable by proper means* by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy (*emphasis added*).

*Id.*

<sup>174</sup> See *Feist Publ'ns, Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340 (1991) (holding that a principle of United States copyright law is that "information" is not copyrightable, but "collections" of information can be).

<sup>175</sup> Coff, *supra* note 62, at 377.

offers sustainable competitive advantage, the firm has acquired a legitimate protectable interest that may be properly enforced with the assistance of a non-compete clause.

An analysis of the claims to employee knowledge, when assessed from the resource-based theory, requires understanding how a firm converts employee knowledge that is valuable and rare into one that has all the above-mentioned VRIN properties. Strategic organizational research offers useful insights to theoretically assess the mechanisms firms use to convert employee knowledge into a resource that offers sustainable competitive advantage. This dynamic process spans units of analysis, moving from individuals to teams and integrates different types of knowledge including public knowledge, private knowledge, tacit knowledge, explicit knowledge, and organizational routines.

The following discussion draws from knowledge management literature to explain how firms transform employees' individual intellectual capital into strategic organizational knowledge that has the VRIN resource properties. This movement involves a knowledge taxonomy involving three continuums recognized in the knowledge management literature: 1. public-private knowledge; 2. tacit-explicit knowledge; and, 3. individual-organizational knowledge.<sup>176</sup>

#### *Public-Private Knowledge*

Public knowledge, by virtue of its general availability, does not confer sustainable competitive advantage according to the resource-based theory. Public knowledge may be a factor of production, defined as undifferentiated knowledge that is not specific to the firm and that can be readily purchased in factor markets.<sup>177</sup> As a factor of production, general knowledge may be valuable, but by itself it cannot offer differentiation or long-term strategic advantage. The reason why is because under the resource-based theory, general knowledge is not rare or asset-specific. Private knowledge, on the other hand, is by definition specific to the firm and can take the form of trade secrets and idiosyncratic know-how, skills, values, and routines. Private knowledge may offer sustainable competitive advantage if it satisfies the other VRIN conditions.

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<sup>176</sup> Matusik & Hill, *supra* note 74, at 683-685.

<sup>177</sup> Teece, et al., *supra* note 138, at 516.

### *Tacit-Explicit Knowledge*

The knowledge management literature distinguishes between tacit and explicit knowledge. Tacit knowledge is personal knowledge that cannot be fully explained and relates to experience, skills, values, and learned habits.<sup>178</sup> It is often said about tacit knowledge that we know more than we can say.<sup>179</sup> For example, a pitcher would find it difficult to precisely articulate how they are able to pitch a fastball.<sup>180</sup> A good deal of tacit knowledge underlies explicit knowledge. On the other hand, explicit knowledge, such as data and information, is codified and easy to speak of, replicate, and transmit.<sup>181</sup> As stated by one well-known commentator, knowledge requires combining tacit experiential knowledge with explicit information or data:

Data, when compiled can become information. Information, when combined with experience, becomes knowledge. On their own, data and information do not represent knowledge. It is the internalization of information that turns it into knowledge.<sup>182</sup>

According to a widely held perspective, new knowledge is created when individuals learn from one another and share their tacit knowledge in a group setting to develop hypotheses using abductive reasoning.<sup>183</sup> This intuitive knowledge may then be validated and amplified within an

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<sup>178</sup> Matusik & Hill, *supra* note 74, at 683.

<sup>179</sup> MICHAEL POLANYI, *TACIT DIMENSION*, at 4 (U. Chi. Press 1966).

<sup>180</sup> See NONAKA & TAKEUCHI, *supra* note 64, at 63-64 (discussing the case of a new product development team working with a master baker to develop a home bakery device. The product development team spent time with the master baker, but gained a critical insight only after spending time watching the master baker perform a task that was never explicitly stated as a key step in the baking process).

<sup>181</sup> NONAKA & TAKEUCHI, *supra* note 64, at 59.

<sup>182</sup> JULIE L. DAVIS & SUZANNE HARRISON, *EDISON IN THE BOARDROOM – HOW LEADING COMPANIES REALIZE VALUE FROM THEIR INTELLECTUAL ASSETS* 115 (2001) (quoting Karl Eric Sveiby, Professor of Knowledge Management at the Hanken Business School in Helsinki, Finland and author of numerous books on managing tacit knowledge).

<sup>183</sup> NONAKA & TAKEUCHI, *supra* note 64 at 64.

organization when it is recorded and formalized into explicit knowledge, for example novel business heuristics or strategies, techniques, processes, or inventions.<sup>184</sup>

### *Organizational-Individual Knowledge*

Organizational knowledge is regarded as a resource that can offer a sustainable competitive advantage.<sup>185</sup> According to managerial scholars, higher-order organizing principles are a type of high-level knowledge used by top managers to coordinate resources and yield a novel strategy or business logic.<sup>186</sup> For example, the Apple Corporation uses a unique strategy to integrate research and development, industrial design, manufacturing, and marketing to obtain layers of intellectual property rights, particularly trade dress rights related to its product shapes.<sup>187</sup> This type of knowledge must be embedded in the organization among various top managers and is often comprised of strategies, values, and high-level decision-making mental models<sup>188</sup> or heuristics. At the opposite end of organizational knowledge is individual knowledge, which is the starting point for learning in any organization.<sup>189</sup> According to a prominent strategic knowledge theory, individual knowledge can be extracted, embedded, and formalized as organizational knowledge in the form of a process or routine.<sup>190</sup> This knowledge-based routine can, in turn, become a core competence. A core competence is any distinctive activity that defines a firm's fundamental business and is comprised of strategic processes and unique asset positions.<sup>191</sup>

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<sup>184</sup> These strategies can be managerial and legal strategies. For a discussion of legal knowledge as a foundation for strategic behavior, see David Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>185</sup> Kogut & Zander, *supra* note 154.

<sup>186</sup> *Id.*

<sup>187</sup> See Orozco, *Rational Design Rights Ignorance*, *supra* note 155; *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>188</sup> See C. K. Prahalad & Richard A. Bettis, *The Dominant Logic: A New Linkage between Diversity and Performance*, 7 *STRAT. MGMT. J.* 485 (1986).

<sup>189</sup> NONAKA & TAKEUCHI, *supra* note 64.

<sup>190</sup> See RICHARD R. NELSON & SYDNEY G. WINTER, *AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE* (Harv. U. Press 1982).

<sup>191</sup> Teece, et al., *supra* note 138, at 516.

The public-private and tacit-explicit knowledge continuums discussed above extend to individual and organizational knowledge. For example, an individual may obtain public knowledge when they obtain data, information, training, or skills that are commonly available.<sup>192</sup> An employee who obtains general software training or foreign language proficiency obtains public knowledge. Alternatively, the employee may develop a unique skill that is private, or idiosyncratic, for example knowledge of a novel formula or process. Likewise, individuals possess tacit knowledge such as experience, know-how, and skills such as the ability to successfully network with other professionals. Individuals also acquire explicit knowledge that can be easily communicated to others, such as the ability to prepare a report on their subject of expertise, or create financial models.

Along similar lines, organizational knowledge may be public, such as industry best practices. For example, knowledge of best practices such as total quality management (TQM), just-in-time inventory management, or six-sigma are public knowledge skills available to organizations.<sup>193</sup> Organizational knowledge may also be private, for example, if the organization engages in routines that use organizing principles to coordinate activities in an effective manner that are not easily imitated by competitors and otherwise confidential. Tacit organizational knowledge reflects the organization's values and culture, whereas explicit organizational knowledge reflects identifiable processes or systems, such as an internal, company-specific compliance training program.

### **C. FOUR GENERALIZED KNOWLEDGE SCENARIOS TO DETERMINE NONCOMPETE LEGITIMACY**

The noncompete is a contractual mechanism that, in a fairly broad and blunt manner, restricts knowledge flows and employee mobility. The objective is to constrain employee knowledge produced within a complex and dynamic environment involving employees

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<sup>192</sup> See Rubin & Shedd, *supra* note 104 (discussing the differences between general and specific human capital and the role of noncompetes in employer investments in employee training).

<sup>193</sup> Matusik & Hill, *supra* note 74, at 683.

interacting in an organizational setting.<sup>194</sup> Knowledge, however, as discussed above, flows in multiple directions and across organizational and even ontological levels.<sup>195</sup> Yet, the reasonableness test glosses over these important distinctions.

To provide a better portrait of knowledge produced within an organization, Figure 1 depicts how the competing knowledge claims between employers and employees may be analytically mapped using the resource-based theory. Figure 1 illustrates four scenarios that arise when departing employees and employers assert a protectable knowledge interest. The unit of analysis in this figure is knowledge that the former employee gained during the course of employment with the firm and that was combined, if at all, with the firm’s knowledge-based infrastructure to generate a valuable, rare, inimitable and non-substitutable (VRIN) knowledge resource. To illustrate this concept, the next sections discuss each of the four discrete scenarios using this analysis.

**Figure 1. Four Knowledge Scenarios: Firm Knowledge versus Employee Knowledge**

<b>The Individual’s Knowledge</b>	<i>VRIN</i>	C. Employee-Owned Knowledge	D. Disputed Knowledge
	<i>Not VRIN</i>	A. Public Knowledge	B. Firm-Owned Knowledge
		<i>Not VRIN</i>	<i>VRIN</i>
		<b>The Firm’s Knowledge</b>	

<sup>194</sup> See DiMatteo, *supra* note 10, at 765-66 (mentioning some reasons employer’s use noncompetes; however he continues to discuss the potential abuse of a noncompete as strategic coercion, particularly when the clause is clearly unenforceable).

<sup>195</sup> NONAKA & TAKEUCHI, *supra* note 64, at 56-57.

### *Scenario A – Public Knowledge*

In this scenario, the individual drew from publicly available knowledge to augment their human capital, for example learning a general software skill. As an employee, the individual used this general knowledge and combined it with organizational knowledge that is also easily obtained, purchased, or replicated in the factor markets. An example of easily obtained organizational knowledge available in factor markets would be the implemented knowledge of a standardized accounting system. Since public knowledge is not asset-specific or idiosyncratic, it cannot be rare, and thus cannot offer the individual or the firm sustainable competitive advantage. If a noncompete is being asserted in these cases, it would be a clear example of the firm overreaching and trying to limit competition by rent-seeking through judicial enforcement.<sup>196</sup>

There is ample precedent already in the laws of several states to uphold the idea that generally known information is not a legitimate protectable interest. In Florida, for example, the District Court of Appeals for the Second District held that an employer's investment in employee training was not a legitimate protectable interest, even though the amount of training was significant.<sup>197</sup> The reason for denying the employer relief under the asserted covenant-not-to-compete was because the employee's training, although significant, was not extraordinary since it did not involve anything beyond what was generally available to similar employees in other companies. The Court stated that:

To constitute a protectible interest, however, the providing of training or education must be extraordinary. "Extraordinary" is that which goes beyond what is usual, regular, common, or customary in the industry in which the employee is employed.<sup>198</sup>

In another case, the West Virginia Appellate Court held that an employer did not meet the burden of establishing a legitimate business interest when the company asserted an interest in the

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<sup>196</sup> See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (James M. Buchanan et al. eds., 1980) (discussing and reviewing various rent-seeking behaviors, which are defined as socially inefficient activities undertaken by individuals seeking a transfer of wealth via a state-sanctioned activity).

<sup>197</sup> Hapney v. Central Garage, Inc., 579 So. 2d 127, 129-132 (Fla. Dist. Ct. App. 2d Dist. 1991).

<sup>198</sup> *Id.* at 132.



former employee's training. In that case, the Court stated the following applicable rule:

When the skills and information acquired by a former employee are of a general managerial nature, such as supervisory, merchandising, purchasing and advertising skills and information, a restrictive covenant in an employment contract will not be enforced because such skills and information are not protectible employer interests.<sup>199</sup>

### *Scenario B – Firm-Owned Knowledge*

In this case, the firm has a legitimate interest in private organizational knowledge that is either tacit or explicit. The firm's tacit knowledge is organizational knowledge that is shared by various employees and that is personal and experiential. Tacit organizational knowledge often relates to the values held by individuals in the organization, and may generate a unique culture specific to that organization. As discussed by managerial scholars, corporate culture may be a resource that sustains competitive advantage since culture is tacit and difficult to discern and replicate.<sup>200</sup>

However, in the case of defining the legitimacy of this business resource, it would be extremely difficult if not impossible for one employee to appropriate the firm's tacit knowledge related to the firm's culture. The definition of corporate culture implies social phenomena and the inability to precisely articulate the nature or origin of that culture.<sup>201</sup> Because knowledge of corporate culture resides among various individuals and is not easily communicated, it is likely to remain a VRIN organizational resource in spite of the actions taken by one departing employee. For these reasons, even though the corporation has a legitimate interest in the corporate culture expressed as tacit knowledge that is held by various employees, it is not a legitimate protectable interest when asserted against any one departing employee through a noncompete.

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<sup>199</sup> See, e.g., *Moore Business Forms, Inc. v. Foppiano*, 382 S.E.2d 499, 501-502 (W. Va. 1989), quoting *Helms Boys, Inc. v. Brady*, 297 S.E.2d 840, 843 (W. Va. 1982).

<sup>200</sup> Peter Meso & Robert Smith, *A Resource-based View of Organizational Knowledge Management Systems*, 4 J. OF KNOWLEDGE MGMT. 224, 225 (2000).

<sup>201</sup> *Id.* at 232.

In another scenario, however, the firm does have a legitimate interest in private organizational knowledge that is explicit and held among various individuals as a routine or strategy. That interest would outweigh any employee's interest or claim if the employee simply learned about the organizational routine or knowledge-asset and did not contribute knowledge that was unique. For instance, imagine a scenario where a former employee learned of explicit organizational knowledge with VRIN attributes such as a novel marketing strategy and exercised general managerial skills and knowledge to execute this strategy without contributing any new knowledge. In this case the firm would have a legitimate protectable interest in preventing the ex-employee from disclosing or using the information post employment. In this example, the marketing department's strategy would be explicit organizational knowledge since it had been recorded in some manner and shared among various employees. In addition, confidential existing customer lists are another frequently litigated knowledge resource.<sup>202</sup> If the list is a source of private explicit knowledge that is shared within the organization to confer advantage, it would also provide the firm with a legitimate claim against the former employee who may attempt to use the list.<sup>203</sup> For example, in the case of *DoubleClick, Inc., v. Henderson*, a New York trial court enforced a noncompete against senior executives relying in part on the fact that these executives had been exposed to the long-term strategic knowledge found in DoubleClick's business plan and had used the explicit, private (confidential) and organizational knowledge contained in the business plan to develop the business plan for their competing start-up enterprise.<sup>204</sup>

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<sup>202</sup> See, e.g., *Johnson Controls*, *supra* note 47 at 532-33 (Ultimately plaintiff did not show that the defendants had taken the actual customer lists, however the court stated, "Irreparable harm to an employer may also result where an employee has misappropriated trade secrets or confidential customer information, including pricing methods, customer lists and customer preferences).

<sup>203</sup> See *House of Tools & Engineering, Inc. v. Price*, 504 S.W.2d 157, 159 (Mo. Ct. App. 1973) (A Missouri court held in favor of an employer because the former employee "became acquainted with plaintiff's customers and was given extensive information on each customer").

<sup>204</sup> *DoubleClick, Inc. v. Henderson*, 1997 N.Y. Misc. LEXIS 577, 1997 WL 731413 (N.Y. Sup. Ct. Nov. 5, 1997).

### *Scenario C – Employee-Owned Knowledge*

The departing employee may have a protectable interest in private knowledge that is tacit or explicit. An individual may possess tacit knowledge such as know-how, values, experience, and skills that are difficult to articulate, for example the ability to quickly organize information. Under a widely accepted theory of organizational learning, organizations obtain new knowledge when individuals combine their tacit knowledge to yield an insight that is eventually transformed into explicit knowledge.<sup>205</sup> Organizations embed this learning and reproduce it by formalizing the explicit knowledge as a process or routine that becomes part of organizational memory, and is managed using higher-order organizing principles.<sup>206</sup> If the organization fails to manage this process of transitioning the employee's knowledge from tacit to explicit, the organization cannot formalize the learning or embed it as a routine that others in the organization can adopt, follow or learn from.<sup>207</sup> Also, an employee's individual tacit knowledge is highly personal knowledge that is difficult, if not impossible, to separate from the individual. Since tacit individual knowledge is highly personal, and is only effective as a strategic knowledge resource if it is transformed into, and combined with, explicit organizational knowledge the departing employee's claim to their tacit individual knowledge outweighs any claim to it made by the employer.

There are cases when the employee develops individual *explicit* knowledge during the term of employment and would retain a legitimate ownership interest to this knowledge. This occurs when the employee's explicit knowledge was never shared with other individuals or implemented in the organization as a routine. There are a few scenarios when this may plausibly occur. First, an employee may develop specialized explicit knowledge when operating as a type of consultant with a limited role in the organization. A consultant offers specialized expertise for discrete issues that may remain isolated to the activities solely performed by that individual.

For example, a software engineer hired as a temporary employee may develop software code that confers advantage to the engineer. In this case, however, the software engineer may

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<sup>205</sup> This process involves employees from different backgrounds sharing what are called mental models. See NONAKA & TAKEUCHI *supra* note 64, at 62-63.

<sup>206</sup> NELSON & WINTER, *supra* note 190.

<sup>207</sup> NONAKA & TAKEUCHI, *supra* note 64, at 69-70; Meso & Smith, *supra* note 200, at 232-33. It is not unjust or uncommon to require companies to take additional steps to obtain a valid property interest to knowledge assets produced within the firm. Trade secret law, for example, requires companies to take reasonable steps to insure that the information remains secret.

never be called upon to share or embed that knowledge beyond a narrowly defined software project. From a resource-based perspective, the software engineer has a knowledge resource that does not confer the *organization* with sustainable competitive advantage since the knowledge at that point lacks social complexity, that is, it was not combined with other knowledge assets and is not embedded as an explicit routine using higher-order organizing principles.<sup>208</sup>

Another example may be labeled the case of a frustrated entrepreneur. In this case, an employee, or group of employees, develops knowledge that is believed to yield VRIN attributes. There is the possibility, however, that the knowledge will never be commercialized<sup>209</sup> for a number of reasons including inertia, information asymmetries, risk aversion, or legitimacy struggles.<sup>210</sup> When this occurs the individuals contributed to the explicit knowledge that the firm never implemented. These individuals, therefore, may depart the firm and under the framework adopted here, have a legitimate claim to the knowledge that is not legitimately restricted by a noncompete. In this case, the firm's claim to the individual explicit knowledge generated by these former employees is moderated by its inability to turn the former employee's knowledge into organizational knowledge and an element of sustainable competitive advantage.

However, a counter-argument is that, under agency principles, these former employees owed a duty of loyalty to the firm during the knowledge-creation process and, therefore, whatever explicit knowledge they created is owed to the firm-principal. Although this may be appealing in a formalistic sense, in practice it offers a distorted and unbalanced treatment of knowledge creation in an information era. A pragmatic solution<sup>211</sup> is offered by the resource-

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<sup>208</sup> The firm may have required the software engineer to sign a separate contractual clause related to the assignment of inventions, or a work-made-for-hire agreement. The theoretical employment scenario described here involves the absence of such provisions. In the absence of an assignment contract, the employee and employer share the patentable rights, with the employee having full rights to the patentable invention and the employer having "shop rights", which basically provides the employer with a non-exclusive, non-transferable and royalty-free license to practice the invention.

<sup>209</sup> The commercialization of knowledge can include taking a product or service to market or licensing the knowledge to a third party, such as in the case of patent, copyright or trade secret licensing. .

<sup>210</sup> See Howard E. Aldrich & C. Marlene Fiol, *Fools Rush In? The Institutional Context of Industry Creation*, 19 ACAD. MGT. REV. 645 (1994).

<sup>211</sup> Judge-driven, pragmatic adjustments to legal doctrine in response to changing social realities have been a recognized cornerstone of the American common law ever since the Legal Realists first expounded this anti-formalistic approach. See, e.g., OLIVER WENDELL HOLMES, *THE COMMON LAW* (Dover

based theory since it defines and limits the scope of legitimate claims made by both the employee-agent and the firm-principal. As applied to the two scenarios discussed above, an analysis based on the resource-based theory would come out in favor of granting a knowledge-based property right to the former employee(s).

#### *Scenario D – Disputed Ownership*

A difficult scenario arises when both the departing employee and the firm have a legitimate protectable interest to knowledge from the perspective of the resource-based theory. These scenarios occur when the individual contributed explicit, asset-specific knowledge that was successfully combined with other sources of knowledge controlled by the firm, and was managed using higher-order organizing principles. Under these circumstances, both the former employee and the company contributed to the development of a combined knowledge asset with VRIN properties that yields sustainable competitive advantage.

The fact that the explicit individual knowledge was combined with other asset-specific knowledge controlled by the firm demonstrates that the firm took the steps necessary to promote learning throughout the organization. It may also indicate that higher-order organizing principles were used to combine the knowledge with other strategic resources to generate higher-order business logic. The value of the knowledge is confirmed if it becomes part of an organizational process or routine. All of these actions are involved with organizational learning<sup>212</sup> and indicate a knowledge resource that has the VRIN attributes.<sup>213</sup> As discussed in the following section, in cases where both parties have a legitimate claim to knowledge, the courts will have to further assess the nature of the parties' behavior and the reasonableness of the contract's restrictive terms.

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Publications 1991) (1881); and JEROME FRANK, *LAW AND THE MODERN MIND* (Brian H. Bix, ed., Transaction Publishers 2009).

<sup>212</sup> Nonaka & Takeuchi, *supra* note 64, at 62-90.

<sup>213</sup> *See* Section IV.A, *supra*.

## V. A DECISION PATH TO ASCERTAIN THE LEGITIMACY OF A NONCOMPETE

This section offers the courts a decision path<sup>214</sup> framework that synthesizes the resource-based theory approach to employee knowledge in a disputed ownership scenario. The decision path depicted in Figure 2 provides the courts with a workable and principled method to initially, as a threshold matter, assess the legitimacy of claims to employee knowledge in a noncompete. This discussion follows the levels of analysis that a court would engage in to assess the legitimacy of the claims to knowledge made by the litigants. In these circumstances, imposing the initial burden on the plaintiff-employer to factually and specifically allege that the departing employee's knowledge is private, explicit, and organizationally complex as detailed in the decision-path framework is recommended as a requirement to sustain a cause of action during the pleading stages.<sup>215</sup>

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<sup>214</sup> A decision path represents an algorithm, or process, aimed at arriving at a solution to a given problem through a series of steps and operations.

<sup>215</sup> *See, e.g.*, California's Code of Civil Procedure related to trade secrets requiring that a plaintiff identify its alleged trade secrets with "reasonable particularity" before that party can commence discovery on its claims based upon trade secret misappropriation. CAL. CODE CIV. PROC. § 2019.210 (2011). Other statutes are less rigorous in their requirement for particularity, however, they still require that the plaintiff plead the existence of a protectable interest. For example, Florida's non-compete statute states:

The person seeking enforcement of a restrictive covenant shall plead and prove the existence of one or more legitimate business interests justifying the restrictive covenant. The term "legitimate business interest" includes, but is not limited to:

1. Trade secrets, as defined in s. 688.002(4).
2. Valuable confidential business or professional information that otherwise does not qualify as trade secrets.
3. Substantial relationships with specific prospective or existing customers, patients, or clients.
4. Customer, patient, or client goodwill associated with:
  - a. An ongoing business or professional practice, by way of trade name, trademark, service mark, or "trade dress";
  - b. A specific geographic location; or
  - c. A specific marketing or trade area.
5. Extraordinary or specialized training.

The precise pleading requirements advocated under the resource-based approach may ameliorate the problem of vague pleading by defendants in cases involving employee-held knowledge. It is commonly stated by practitioners that plaintiffs strategically engage in vague pleading in the related area of trade secret litigation<sup>216</sup> and that the courts have widely varying specificity standards with regards to trade secret pleading. According to some commentators, this variation results in unpredictable outcomes, subjectivity, and overreaching, as is often the case in noncompete cases.<sup>217</sup>

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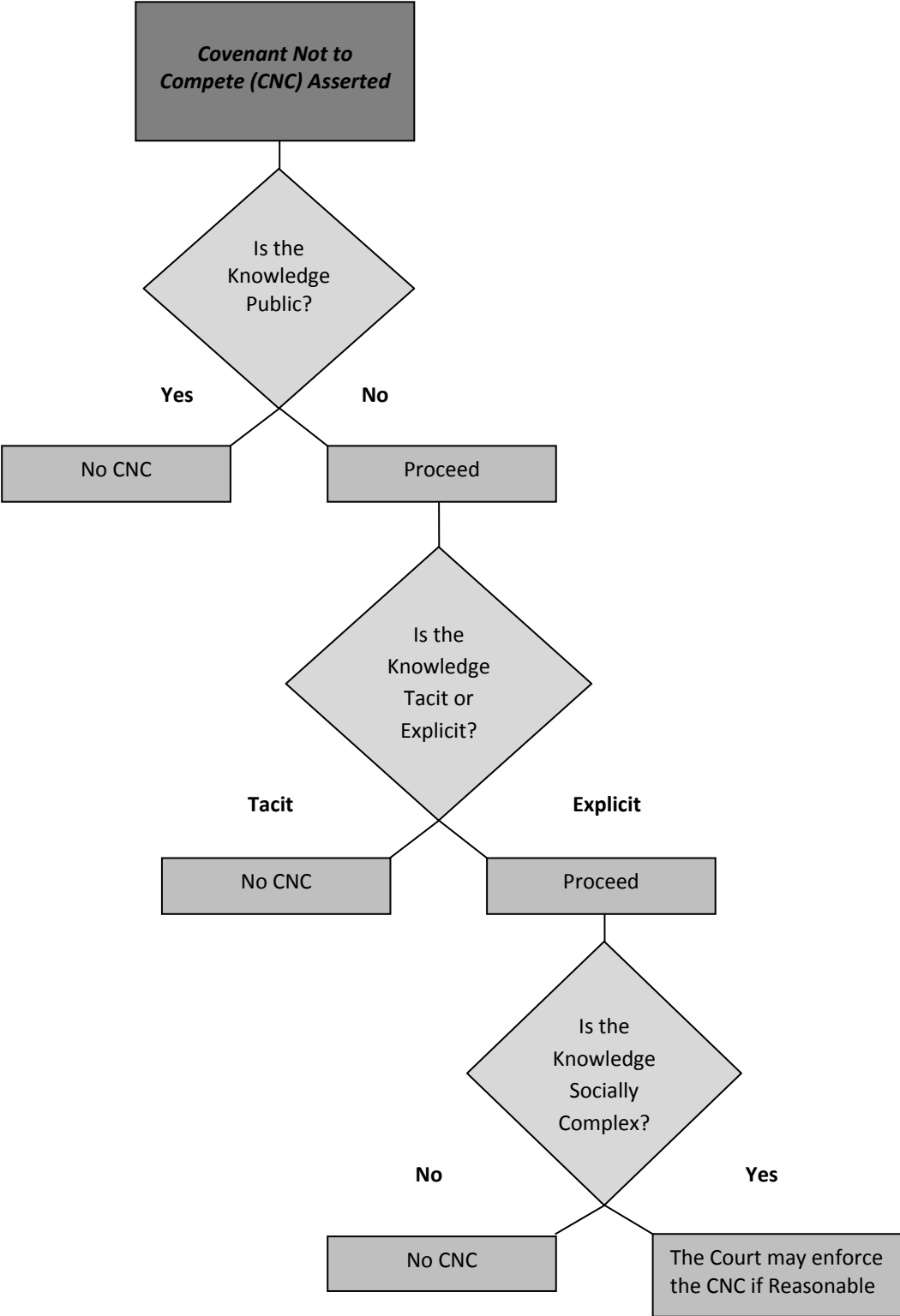
Any restrictive covenant not supported by a legitimate business interest is unlawful and is void and unenforceable.

FLA. STAT. § 542.335(1)(b) *et seq.* (2010) (emphasis added). States vary in their application of the initial burden of proof to establish the reasonableness of a noncompete. Some states like Arizona, Illinois, Ohio and Mississippi impose the initial burden on the employer whereas other states like Connecticut impose the initial burden of proof on the employee.

<sup>216</sup> Charles T. Graves & Brian D. Range, *Identification of Trade Secret Claims in Litigation: Solutions for a Ubiquitous Dispute*, 5 NW. J. TECH INTELL. & PROP. 68, 68 (2006).

<sup>217</sup> *Id.* at 69.

**Figure 2. Decision Tree Framework to Assess the Legitimacy of Noncompetes**





## A. FRAMEWORK APPLICATION

### 1. *Public vs. Private Knowledge*

The analysis begins when a firm asks the court to uphold their exclusive claim to knowledge in the noncompete, usually by requesting a preliminary injunction or, if the employee has begun working for the competitor, a temporary restraining order forbidding the former employee from continuing to work for that competitor. Following this, the court can initially determine from the pleadings whether the knowledge in question is public or private. If it is apparent that the knowledge is public, the court may determine that it is not a VRIN resource and grant the defendant's motion to dismiss the complaint, thus refusing to enforce the contract.<sup>218</sup> If this were the case, the court would uphold the public interest and prevent any private party from restricting competition via rent-seeking. This policy would also protect the public interest in furthering intellectual capital mobility and the freedom of individuals to engage in their chosen trade or profession without hindrance by firms exploiting a financial advantage.

### 2. *Tacit vs. Explicit Knowledge*

If the court finds the knowledge is private, it will continue its analysis and determine next whether the knowledge is tacit or explicit. Explicit knowledge may take many forms, for example, written materials, memos, presentations, reports, lists, and statistical compilations. The court should, therefore, place the burden on the employer to specifically identify in the pleadings the precise nature of the knowledge being claimed.<sup>219</sup> If the knowledge is tacit, and therefore vaguely identified,<sup>220</sup> the judge may infer using the resource-based theory as justification that the knowledge cannot be used by the departing employee to disadvantage the firm for the reasons described earlier. If the departing employee's knowledge is tacit and vaguely described, the

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<sup>218</sup> See section IV.C., *supra*, discussing cases where state courts have held that generally available information is not a legitimate protectable business interest.

<sup>219</sup> See Graves & Range, *supra* note 216.

<sup>220</sup> For example, unacceptably vague trade secret claims make reference to general categories such as "pricing strategy and policies, ratio of ingredients, confidential materials, confidential suppliers and customer lists among other things." Graves & Range, *supra* note 216, at 85-86. Any of these categories may include protectable knowledge and enforced with a noncompete, however, as long as they are clearly identified as a resource under the framework advanced here.

court may, likewise grant the defendant's motion to dismiss the complaint on the grounds that the employer failed to meet the burden of establishing a legitimate protectable interest.

### 3. *Organizational vs. Individual Knowledge*

Assuming that the former employee's knowledge is private, identifiable, and explicit the Court will lastly determine whether the knowledge has social (organizational) complexity. Social, i.e. organizational, complexity can be assessed by two evidentiary queries: 1. whether the former employee's knowledge was combined with other sources of the firm's explicit knowledge to promote learning and 2. whether the former employee's knowledge was coordinated within the firm using higher-order organizing principles. Examples involving these factors are offered next.

Courts can infer organizational learning when an employee interacts with other employees and shares knowledge in a team setting.<sup>221</sup> If the team is cross-disciplinary, there is an added presumption of learning since this type of learning requires extra effort and planning.<sup>222</sup> In the case of *Lumex, Inc. v. Highsmith*,<sup>223</sup> a former employee (Highsmith) was prevented from joining a competitor because he possessed knowledge that that was transferred across departments within the Lumex organization. As stated by the judge in that case:

The Court finds that Highsmith, as the Lumex Worldwide Marketing Manager and an engineer by training, had a wide range of duties, including marketing and product management. He interacted with virtually every part of the company, including sales, engineering, marketing, manufacturing and research and development.<sup>224</sup>

The Court also found that it was relevant that Mr. Highsmith had gained knowledge from customers and also had attended high-level strategic policy meetings with other top executives in the organization. On this point, the Court said the following about Mr. Highsmith:

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<sup>221</sup> Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, *supra* note 16.

<sup>222</sup> *Id.*

<sup>223</sup> 919 F. Supp 624 (E.D.N.Y. 1996)

<sup>224</sup> *Id.* at 16.

He attended high level policy designing, marketing and financial meetings. Highsmith was not a salesman, or a sales representative, or a sales manager and did not service or solicit Cybex customers. However, he occasionally interacted with some customers to obtain "feedback" and in connection with his other duties. His job was to interpret the market and the market needs and relate it to the Cybex products. Highsmith attended all the trade shows, that are so important in this industry. He interacted and worked closely with Roy Simonson, the Lumex Chief Designer, who the Court finds to be a credible witness, and Highsmith was a sounding board for Simonson with regard to the 25 to 40 Cybex products... Highsmith was privy to discussions involving future Cybex markets, products on the drawing board and new prototypes, was a member of the elite strategic planning committee together with the top personnel of Cybex and attended high level meetings in which future restructuring of Cybex was discussed, together with detailed financial information, including costs and Lumex profit margins.<sup>225</sup>

The courts may, as in this instance, find that credible evidence that the former employee shared knowledge with other employees and even customers and attended strategic or planning meetings to disseminate identifiable knowledge is persuasive evidence that the departing employee's knowledge is organizational in nature.<sup>226</sup> Thus, in this instance, there is a legitimate reason to enforce an otherwise properly executed noncompete on the grounds that it covers a protectable interest of the employer.

Organizational principles include high level managerial techniques used to transform knowledge into strategic advantage.<sup>227</sup> These techniques include designing incentives and organizational structures to maximize employee performance and knowledge transfers within an organization. One such technique may involve transferring an employee to another division to complement or expand the employee's skill set and the organization's knowledge base. Another technique is to include the employee in a high level group that develops strategies through knowledge sharing. This is done to augment the employee's managerial and leadership skills, which complement pre-existing operational knowledge.

In another recent case, the Southern District of New York enforced a noncompete against a former IBM employee in part because the employee was exposed to highly confidential

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<sup>225</sup> *Id.* at 16-17.

<sup>226</sup> *Id.*

<sup>227</sup> Kogut & Zander, *supra* note 154.

information obtained by virtue of the employee's membership in an elite management team.<sup>228</sup>

According to one of the IBM managers, the members of this highly select team were:

[E]xposed to highly confidential information regarding IBM's entire business. The purpose behind such exposure is to (1) develop corporate strategy, (2) drive innovation and growth, (3) address firm-wide issues through collaboration across departments, and (4) allow up-and-coming leaders to gain exposure to all areas of IBM's business.<sup>229</sup>

The court continued and pointed out that the relevant team members "are not merely given access to highly confidential information, but participate extensively in programs that are designed to expose them to highly confidential aspects of IBM's business with which they would otherwise not be familiar based on their primary job responsibilities."<sup>230</sup> It added that this access was provided "with a view to broadening their understanding of the company and the most important issues, strategic choices, and competitive challenges it faces."<sup>231</sup> The logical conclusion is that, if the employee's knowledge was managed to combine with others within the organization, this might be yet another factor upon which the courts can rely to infer organizational learning.

Oftentimes, employee knowledge that has been coordinated with organizational knowledge is held at a higher standard in noncompete cases. For example, courts have held managers and senior executives to a somewhat higher standard in noncompete disputes, often coming out in favor of the former employer.<sup>232</sup> This may be in part because the court believes that senior managers are often exposed to sensitive company information. However, another justification for this exists from the perspective of the resource-based theory. That justification exists because senior business people are often involved in managing knowledge among various

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<sup>228</sup> IBM v. Papermaster, 2008 U.S. Dist. LEXIS 95516 (S.D.N.Y. Nov. 21, 2008).

<sup>229</sup> Declaration of J. Randall MacDonald 2-3, Oct. 22, 2008 (on file with authors).

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> The skepticism with which courts traditionally viewed noncompetes and the transition to a more enforcement friendly reasonableness approach is discussed by Stone, *Knowledge at Work*, *supra* note 63, at 741.

individuals and often derive confidential knowledge that is socially complex, as illustrated in the prior examples.

If social complexity exists, the judge may then determine as a matter of law that the firm has established a legitimate claim to the former employee's knowledge. In other words, there is a protectable interest at issue. In that case, the judge would be amenable to enforcing the non-compete as a threshold matter, subject to the additional inquiry concerning whether or not the asserted provision is contrary to the jurisdiction's public policy, or is unreasonable in light of precedent or evolving industry conditions.

At this point, a noncompete analysis based on the resource-based theory provides a more principled and analytically rigorous method to determine, at the threshold level, the legitimacy of a firm's claim to the departing employee's knowledge. The analytical approach provided here can help the courts efficiently separate, at the earliest stages of litigation, those claims that are legitimate from those that are not. The noncompete, however, may still reach too far, even if the firm persuades the court that it has a legitimate business claim to the former employee's knowledge. The analysis using the resource-based theory, however, helps to reduce the blunt impact of the noncompete as an overly broad, unprincipled mechanism that may harmfully restrict knowledge flows by restricting employee mobility, especially in the hands of an employer who wields disproportionate bargaining power or resources.

Nonetheless, the courts would still be able to assess whether the noncompete is reasonably limited in time and space, and consonant with the public interest. This determination is straightforward if the employer has a legitimate claim to knowledge as assessed by the framework offered here, and if the departing employee made no substantial contribution to developing that knowledge.<sup>233</sup> In that case, the judge would find that the employer's interest to the knowledge is sound, and award the employer's request for an equitable remedy consisting of a preliminary injunction, temporary restraining order or permanent injunction if appropriate.

The resource-based theory approach to noncompetes is consonant with the law of equitable remedies. One of the factors that courts use to evaluate whether to grant the injunction

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<sup>233</sup> This case would fall under scenario B in Figure 1, *supra*.

is the irreparable harm that the plaintiff would suffer absent the remedy.<sup>234</sup> An irreparable harm is usually used to define an asset that cannot be easily replaced or substituted in the marketplace, for example, goodwill, customer relationships, and trade secrets. Likewise, employee knowledge that is a resource is knowledge that cannot be easily substituted or that would cause irreparable injury if replicated by a competitor.

## B. ASSESSING REASONABLENESS IN CASES OF DISPUTED KNOWLEDGE

Admittedly, the more difficult cases arise when both the employer and former employee have legitimate competing claims to knowledge.<sup>235</sup> In these cases, the court would still assess the reasonableness of the covenant's specific language. The courts are empowered in cases involving public policy<sup>236</sup> to determine the reasonableness of noncompete terms. This reasonableness determination, in most states, is a question of law and it is squarely within the courts' adjudicatory power in these jurisdictions to re-write unreasonable terms in employment contracts that are held to violate public policy.<sup>237</sup>

Some factors that the courts often use to consider weighing the reasonableness of terms, and to balance the interests of both parties include whether the covenant is a blanket restriction against employment by *any* competitor<sup>238</sup> whether the former employee will inevitably use or

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<sup>234</sup> See Richard R.W. Brooks & Warren F. Schwartz, *Legal Uncertainty, Economic Efficiency, and the Preliminary Injunction Doctrine*, 58 STAN. L. REV. 381, 389-90 (2005).

<sup>235</sup> As illustrated by Scenario D in Figure 1, *supra*.

<sup>236</sup> Courts are empowered to limit or re-write private contracts for various public policy reasons. For example, one equity-based public policy justification involves the doctrine of unconscionability. See DiMatteo, *supra* note 10 at 766-67.

<sup>237</sup> For a list of the states that allow for the "blue pencil" rewriting of a noncompete, see Bishara, *Fifty Ways to Leave Your Employer*, *supra* note 25.

<sup>238</sup> For example a broadly drafted covenant might read: "I agree that for a period of one (1) year following termination of my employment, I will not become an employee, or in any way engage in or contribute my knowledge to a competitor." A covenant such as this one may be unduly broad since the former employee may never use the knowledge gained in their prior employment to the disadvantage of the former employer. For example, the employee may join the ranks of a competitor, yet work in a different business area or division. See *ANSYS, Inc. v. Computational Dynamics N. Am., Ltd.*, 595 F.3d 75, 78 (1st Cir. N.H. 2010)

disclose the knowledge in their new employment,<sup>239</sup> whether there are any unique industry conditions,<sup>240</sup> whether intellectual property was used to help secure the knowledge,<sup>241</sup> and whether the employee engaged in any unethical behavior.<sup>242</sup>

The approach advanced up to this point may be criticized by some as an example of undue interference with the important principle of freedom of contract.<sup>243</sup> From this perspective, the argument often made is that the employee and employer willfully bargained for the non-competition agreement terms, suggesting that this agreement should not be set aside as a general matter. The approach advocated here does, to some extent, limit the freedom of contract principle. Freedom of contract, however, is not unlimited.<sup>244</sup> In the noncompete context, the courts and legislatures have already limited the freedom of contract principle as a policy matter with their explicit adoption of the reasonableness and balancing tests. The resource-based approach described in this article simply provides a more principled and rigorous application of the existing policies that are meant to restrict overreaching contract terms.

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<sup>239</sup> Some jurisdictions, for example, uphold the doctrine of inevitable disclosure. *See Hyde, Should Noncompetes Be Enforced*, *supra* note 9, at 9 (criticizing New Jersey for a lack of venture capital or a culture or infrastructure of start-ups and point out that the state “vigorously enforces noncompetes and is one of perhaps three states in which employers may enjoin a departing employee from taking a job on the grounds that he or she will ‘inevitably disclose’ some unspecified trade secret”).

Under this doctrine, an employer may restrict a former employee from joining a competitor if disclosure of confidential information would be inevitable in that new employment setting.

<sup>240</sup> *See EarthWeb, Inc. v. Schlack*, *supra* note 80.

<sup>241</sup> Frequently, noncompete cases are litigated along with claims of trade secret infringement. *See Dworkin & Callahan*, *supra* note 23.

<sup>242</sup> There are cases when an employee “poaches” or “raids” other employees, encouraging them to depart the firm as a group. If these additional employees contributed explicit, private, asset-specific knowledge they individually have a claim to the knowledge. However, the firm has a competing legitimate interest since the knowledge shared by these individuals is likely to be organizational and socially complex knowledge, since it was shared amongst several employees. This action may be prevented with a separate non-solicitation clause. From the perspective of the resource-based theory of knowledge, however, a raid on employee talent may unfairly deprive the firm of organizational knowledge that has all the VRIN properties.

<sup>243</sup> *See Richard A. Epstein, Unconscionability: A Critical Reappraisal*, 18 J. LAW & ECON. 293 (1975).

<sup>244</sup> For example, the unconscionability doctrine appears in U.C.C. § 2-302 and RESTATEMENT (SECOND) OF CONTRACTS § 208.

## VI. CONCLUSION

Surprisingly, the resource-based theory has yet to be fully appreciated in legal scholarship.<sup>245</sup> There are, however, clear strategic benefits to applying this theory to noncompete enforcement policy. First, the resource-based theory helps explain and justify the courts' decision-making process related to noncompete enforcement in terms of legitimately protectable interests and balancing stakeholder rights.

Second, as presented in this article, the resource-based theory offers a modern and principled analysis of noncompetes that recognizes the importance of both knowledge ownership and spillovers in an increasingly complex and fluid business environment. As the decision-making model presented above demonstrates, the resource-based theory gives the courts a new analytical tool and a robust theoretical justification for critically interpreting noncompetes in a world where human capital and knowledge are crucial elements necessary to achieve growth and sustainable competitive advantage.

Third, the resource-based theory provides support for analyzing noncompetes from a public interest perspective that has not been fully explored by the courts or scholars. The model presented in this article provides a tool that empowers courts and state policymakers to reconcile the ideals of knowledge ownership, transfer, and development while encouraging human capital investments. The model provides a dependable rationale for allocating knowledge ownership rights and furthers business and knowledge development, while recognizing the rights of employees and the benefits of permissible knowledge spillovers due to increasing employee mobility.

If the framework advanced here takes root and is used by policy makers and courts to regulate the use of noncompetes, then the greater predictability offered by the model's analytical clarity will likely reduce the high level of uncertainty currently plaguing this important area of the law. Ultimately, if more predictability and consistent enforcement levels can be achieved, then this updated approach towards the role of noncompetes will have a positive influence on contract formation, negotiations, and knowledge-management practices. This will ultimately

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<sup>245</sup> See note 16 *supra*, and accompanying text.



lead to a decrease in employer overreaching and an overall improved climate for investment in human capital and knowledge-based assets.