

Covenants Not To Compete in a Knowledge Economy:
Balancing Innovation from Employee Mobility Against Legal
Protection for Human Capital Investment

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Covenants Not To Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment

Norman D. Bishara[†]

This Article examines a specific policy issue that goes to the heart of the larger debate surrounding the changing employment relationship: How should the law of covenants not to compete adapt to the changing landscape of the U.S. labor market and to the increasing importance of a knowledge-based economy? The author first argues that noncompete policy is of great importance to fostering economic growth and labor markets, and then discusses various theoretical approaches to noncompete enforcement in a knowledge economy. The preferred approach, the author contends, is a hybrid model of selective enforcement that differentiates among workers as “creative” or “service” employees, thereby enhancing the positive spillovers gained from policies at the extremes of the enforcement spectrum.

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I. INTRODUCTION

In the abstract, the U.S. legal system is intended to be efficient, promote economic enterprise, and protect free markets where the “little guy” can work hard and turn a good idea into financial independence, even wealth, thereby adding to the nation’s economic prosperity. If that is the case, why did two entrepreneurs in Seattle get sued when they tried to open a new business, started in a parent’s basement, to make it easier for small companies to meet their postal needs at the most competitive price?¹ If those two men provided a better, more economical service, why did they have to spend an estimated \$150,000 (plus an undisclosed settlement amount) to defend a lawsuit brought by their former employer, a large international corporation, accusing them of poaching other employees and simply taking away a tiny portion of that company’s market share? At the other end of the labor market is Carly Fiorina, the controversial and ousted former CEO of the pioneering Silicon Valley firm Hewlett-Packard Com-

1. See Eve Tahmincioglu, *Compete With Caution Against Past Employer*, N.Y. TIMES, Mar. 31, 2005, at C7 (article about two former Pitney Bowes employees who were sued by the company after they left to start a similar business and hired some of their former colleagues).

pany. In that case, what if Fiorina wanted to work immediately for one of HP's top competitors or hire away her former HP executive assistant? Why shouldn't she be able to make those choices without the risk of being sued by HP?²

In either instance, the ultimate question is, why would the U.S. legal system potentially support an employer's attempt to restrict the livelihood and control the actions of a *former* employee? The answer: these individuals agreed in their employment contracts that they would not use confidential information gained from their employment, or for a limited time, compete against their former employers. They, or the other employees they hired away from the first company, signed agreements containing covenants not to compete that triggered liquidated damages and injunctive relief if they went to work for a competitor during the prohibited period.³ While there is little empirical research on the use of noncompetes, there are indications that such agreements are increasingly common⁴ and as a result this sort of post-employment restriction will influence the decisions of employers and employees.

To further complicate the issue, each state has its own laws concerning covenants not to compete, which can cause problems for employers and employees who have business locations across the country. The majority of jurisdictions do not clearly distinguish between different types of workers

2. See Hewlett-Packard Company Employment Agreement with Carleton S. Fiorina, July 17, 1999, § 7, at 22-23 (titled "Noncompete; Non-Solicit"), available at <http://contracts.corporate.findlaw.com/agreements/hp/fiorina.emp.1999.07.17.html> (last visited Sept. 20, 2006) (hereinafter Fiorina Employment Agreement). Fiorina's covenant not to compete prohibits her from, among other things, working for three companies on a "prohibited list" or soliciting Hewlett Packard employees for a period of 24 months. *Id.* Fiorina's February 10, 2005, departure from HP also came with an estimated \$21 million payment. Paul R. LaMonica, *Fiorina Out, HP Stock Soars*, CNN/MONEY.COM, February 10, 2005, available at http://money.cnn.com/2005/02/09/technology/hp_fiorina/ (last visited Sept. 20, 2006).

Curiously, the agreement is, by its terms, interpreted under California law, which has declared such employment agreements as against public policy and unenforceable. See *infra* note 19. One suggested explanation for including the noncompete provision is that Fiorina's ownership stake in the company takes her out of the realm of a mere employee and endows her with the characteristics of an owner selling a business and agreeing not to compete, which is permissible under California law. This does not, however, make sense based on a plain reading of the contract terms or even the circumstances of her departure. To date the noncompete provisions of Fiorina's employment contract do not appear to have been triggered by her post-employment actions. Therefore, it is not clear what deterrence, if any, the employment contract has had on Fiorina's post-employment activities.

3. See Tahmincioglu, *supra* note 1; Fiorina Employment Agreement, *supra* note 2.

4. See Tahmincioglu, *supra* note 1. See also *infra* note 32 and accompanying text. The single formal attempt to quantify the volume of noncompetes and their use is now over fifteen years old. See Peter J. Whitmore, *A Statistical Analysis of Noncompetition Clauses in Employment Contracts*, 15 J. CORP. L. 483 (1990). See also Gillian Lester, *Restrictive Covenants, Employee Training, and the Limits of Transaction-Cost Analysis*, 76 IND. L.J. 49, 49 (2001) (noting "[r]estrictive covenants are an increasingly common feature of employment, used across a wide range of industries, occupations, and employees," and citing Whitmore, *supra*, while stating that she is "unaware of any empirical study directly measuring the prevalence of restrictive covenants in practice").

based on their contribution to the economy,⁵ rather courts in a given jurisdiction are likely to treat a fired CEO the same as a departing salesperson for purposes of noncompete enforcement.⁶

Outside of the covenant not to compete framework, employees traditionally have been categorized according to the tools of their respective trades. Laborers have been distinguished from professionals, blue-collar workers from white-collar workers, and people in manufacturing jobs from those in service jobs. Society has recognized differences between workers who toil in the fields, on the shop floor, or behind a desk in an office. Other distinctions are based on whether workers passed the day using their hands or depended more heavily on their mental capabilities and formal education to earn a living. Over time, the legal system adapted to those archetypes and created frameworks for treating workers as distinct based upon identifiable characteristics and job roles and labor regulation. For example, the National Labor Relations Act addressed unions and child labor restrictions and wage and hour laws regulated working conditions for wage earners, while white-collar professionals were left largely unregulated—particularly at the federal level—when it came to how those workers contracted with their employers regarding the terms of employment. In the United States, at-will sensibilities have prevailed with respect to white-collar professionals.⁷ For them the patchwork of state-level contract law has seemed sufficient and crossover concerns like workplace discrimination, sexual harassment, and the like were largely issues addressed on an individual, case-by-case basis. Individual states' approaches to restrictive post-employment covenants have been dictated by absolutist preferences about individual, unrestricted freedom of choice in employment⁸ and inherited from common law traditions.⁹

5. See generally COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY (Brian M. Malsberger ed., 2004). The exception to *prima facie* equal treatment for all types of employees is Colorado. Colorado allows employment contracts to recover training costs for less than a two year period and permits noncompetes for “executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.” COLO. REV. STAT. 8-2-113(d) (2005).

6. There are indications that, over time, courts are more likely to enforce noncompete agreements regardless of the nature of the employee’s responsibilities, level of skill, or “value” to the firm. As one federal court observed,

Until the last several decades, courts exhibited great reluctance to enforce such covenants against employees whose services were not unique in some way. This was true unless the employee had access to trade secrets or customer lists or could appropriate customer good will upon leaving his or her employment.

Borg-Warner Protective Servs., Corp., v. Guardsmark, Inc., 946 F. Supp. 495, 500 (E.D. Ky. 1996) (rejecting arguments that Gap store security guards should not be bound by noncompetes because, in part, the court acknowledged Kentucky’s recognition of an employer’s investment in employee training).

7. Regardless of occupation, historically, at-will employment is a “distinctive aspect of American labor law” not present in other developed economies. Clyde W. Summers, *Employment At Will in the United States: The Divine Right of Employers*, 3 U. PA. J. LAB. & EMP. L. 65, 65-66 (2000).

8. 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, 613-19 (1999) (discuss-

Now the focus of the U.S. economy is increasingly on the segment of the labor pool comprised of workers with some advanced education or professional training.¹⁰ This is the case because the U.S. labor market is in the midst of a momentous shift away from labor intensive goods manufacturing toward knowledge-based service industries.¹¹ The December 2005 version of a United States Bureau of Labor Statistics report summed up this trend: “The long-term shift from goods-producing to service-providing employment is expected to continue. Service-providing industries are expected to account for approximately 18.7 million of the 18.9 million new wage and salary jobs generated [from 2004-2014].”¹² This trend is at the root of the “knowledge-based economy” or “knowledge economy” that is discussed in this Article. Essentially, the shift is away from manufacturing activities, which require interchangeable basic skills, and toward service activities, which require problem-solving skills based in formal education and training.¹³ Knowledge-based industries include both those that thrive on creating new knowledge or information, like high-tech software firms, and management consulting companies that use information and expertise to generate wealth by providing financial services, such as brokerage firms and investment banks.¹⁴ These classes of industries and the highly educated and skilled workers they employ underscore the United States’ comparative advantage over the primarily low-skill, manufacturing economies in the developing world.¹⁵

ing the “serendipity” and “historical accident” of California’s adoption of an existing proposed legal code containing the strict prohibition of restraints on freedom of employment).

9. For a discussion of the long history of restrictive employment covenants beginning in England, see Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 625-46 (1960).

10. See United States Department of Labor, Bureau of Labor Statistics, Occupational Outlook Handbook, *Tomorrow’s Jobs*, available at <http://www.bls.gov/oco/oco2003.htm> (last modified Dec. 20, 2005) (last visited Sept. 20, 2006) (projecting that the greatest increase in percentage change in wage and salary employment for the categories of education and health services” and “professional and business services”). See also *id.* Chart 4.

11. *Id.*

12. *Id.*

13. *Id.*

14. See, e.g., Ann C. Hodges & Porcher L. Taylor, III, *The Business Fallout from the Rapid Obsolescence and Planned Obsolescence of High-Tech Products: Downsizing of Noncompetition Agreements*, 6 COLUM. SCI. & TECH. L. REV. 3, 3-4 (2005) (discussing the transition to an information-based economy and noting that “in the high-technology industry in particular, technical knowledge and information, along with the ability to creatively use such knowledge, forms the basis of innovation, increasing the company’s ability to compete in the marketplace”); see generally Rafael Gely & Leonard Bierman, *The Law and Economics of Employee Information Exchange in the Knowledge Economy*, 12 GEO. MASON L. REV. 651 (2004) (focusing on the impact of the knowledge economy on employment law).

15. See, e.g., Jane Morse, *U.S.-China Labor Issues Generate Strong Emotions: Employment Issues Affect Specific U.S. Sectors, Industries*, U.S. Department of State International Information Programs Article Series, available at <http://usinfo.state.gov/eap/Archive/2005/Mar/29-848102.html> (last visited Sept. 20, 2006). But see Aaron Bernstein, *Shaking Up Trade Theory*, BUSINESS WEEK, December 6, 2004, available at http://www.businessweek.com/magazine/content/04_49/b3911408.htm (dis-

As the U.S. manufacturing economy has evolved into a service economy, the internal employment practices of workplaces have also changed. In the past, internal labor markets¹⁶ within firms often promised lifetime employment for loyal workers.¹⁷ However, assumptions about lifetime employment at a single firm have changed. To the contrary, commentators now recognize that the U.S. economy and labor market are forced to adapt to the new globalized economy in which attracting educated foreign workers (sophisticated human capital) to the United States is crucial to economic growth.¹⁸ By necessity employers, employees, and the law have to deal with these roiling trends.

This Article looks at a specific policy issue that goes to the heart of the larger debate surrounding the changing employment relationship: How should the law of covenants not to compete adapt to the changing landscape of the U.S. labor market? As it stands now, a wide range of state-level approaches are used to balance the interests of mobility, protecting goodwill, and other goals employees and their employers address with covenants not to compete (“CNCs” or “noncompetes”). On one end of the CNC enforcement spectrum, a handful of states effectively ban all covenants not to compete regarding employment relationships.¹⁹ On the other end, and through most of the middle, states enforce CNCs that conform to whatever their individual public policies have deemed as reasonable restraints on trade.²⁰

curring recent disputes over the traditional view of a U.S. comparative advantage over “low skill” jobs in developing countries) (last visited Sept. 20, 2006).

16. See generally J.E. KING, *LABOUR ECONOMICS* 75 (2d ed. 1990).

17. See Katherine V. W. Stone, *Knowledge at Work: Disputes Over the Ownership of Human Capital in the Changing Workplace*, 34 CONN. L. REV. 721, 725-26 (2002). Professor Stone’s arguments concerning these shifts are discussed in Part III of this paper. See also Peter Capelli, *Market-Mediated Employment: The Historical Context*, in *THE NEW RELATIONSHIP: HUMAN CAPITAL IN THE AMERICAN CORPORATION* 67-68 (MARGARET M. BLAIR & THOMAS A. KOCHAN, eds., 1999).

18. See, e.g. Michael Mandel, *The Trade Deficit vs. Human Capital*, BUSINESS WEEK, May 9, 2005, available at http://www.businessweek.com/bwdaily/dnflash/may2005/nf2005059_0127.htm (last visited Sept. 20, 2006) (discussing the positive effects of immigration on the U.S. economy and the importance that incoming human capital); *The Great Jobs Switch*, THE ECONOMIST, Oct. 1, 2005 (arguing that the loss of manufacturing jobs in the United States and Western Europe is occurring because those “economies are healthy not sick” and that “developed economies’ comparative advantage is in knowledge-intensive activities, because they have so much skilled labour”).

19. The most noted and studied example is California’s long tradition of banning employment covenants not to compete on public policy grounds. Articles focused on California’s notoriety for banning noncompetes and the implications include, for example, Gilson, *supra* note 8; Alan Hyde, *The Wealth of Shared Information: Silicon Valley’s High-Velocity Labor Market, Endogenous Economic Growth, and the Law of Trade Secrets*, Sept. 1998, <http://andromeda.rutgers.edu/~hyde/wealth>; and Tait Graves, *Nonpublic Information and California Tort Law: A Proposal for Harmonizing California’s Employee Mobility and Intellectual Property Regimes Under the Uniform Trade Secrets Act*, 2006 UCLA J. L. TECH. 1 (2006). The other state with a near complete ban is North Dakota. See John Dwight Ingram, *Covenants Not to Compete*, 36 AKRON L. REV. 49, 66 (2002). However, not all restrictive covenants in North Dakota are banned. Reasonable noncompetes with regard to the sale of the good will of a business are permissible. *Id.*

20. Brian Kingsley Krumm, *Covenants Not to Compete: Time for Legislative and Judicial Reform in Tennessee*, 35 U. MEM. L. REV. 447, 472-73 (2005) (“Although a small number of states have not

Ultimately, there is no simple, “one-size-fits-all” approach to covenants not to compete. To address the discrepancies in enforcement this Article outlines the main considerations that state lawmakers should weigh in developing noncompete policies that are responsive to and promote the burgeoning knowledge-based economy.

Part II of this Article argues that CNC public policy is an important component of the modern employment relationship and illustrates how the legal system should adapt to the challenges that relationship presents to policy makers evaluating the effects of noncompetes. Next, Part III explains three theoretical perspectives on covenants not to compete—two grounded in law and economics and one based on ethical concerns surrounding human capital ownership—and sheds light on the debate over the propriety of restrictive covenants in an employment context.

Part IV argues that, within these approaches, there are consistent, common implications for categorizing workers in an information economy as “service” or “creative” employees for CNC enforcement purposes. Accordingly, Part IV explains those terms in this context. Part V demonstrates that, within the service and creative job categories, CNCs can be selectively enforced to create positive spillovers and maximize useful knowledge transfers.²¹

Part VI provides three models for how the interests outlined in the previous sections can be balanced by utilizing a service employee and creative employee distinction when evaluating CNCs arising in the modern labor

addressed this issue or have not formally adopted a rule, the vast majority of states apply the ‘rule of reasonableness’ or some variation, when reforming the geographical and temporal restraints of a covenant not to compete”) (citing Malsberger, *supra* note 5 extensively). Two such high-profile examples of states that allow reasonable enforcement are New York and Massachusetts. See, e.g., Dan Messeloff, Note, *Giving the Green Light to Silicon Alley Employees: No-Compete Agreements Between Internet Companies and Employees Under New York Law*, 11 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 711, 711-723 (2001); Christine M. O’Malley, Note, *Covenants Not to Compete in the Massachusetts Hi-Tech Industry: Assessing the Need for a Legislative Solution*, 79 B.U. L. REV. 1215 (1999).

21. As discussed in this Part III and Part V, in particular, this Article describes knowledge transfer as a “spillover.” The concept of spillovers—the externalities or side effects of actions—is used throughout this Article to describe the unintentional consequences of employee mobility or restraints on that mobility. The knowledge transfer that is a side effect of employee mobility is a *positive* spillover when it comes to innovation in the high-tech sector. The same spillover can also have negative effects, for instance in a service sector business like the financial services industry where confidential information is important and employers have an interest in keeping client information proprietary by prohibiting former employees from using that information to gain an unfair competitive advantage.

The concept of knowledge spillovers and transfers as part of noncompete policy and enforcement has been discussed by T. Leigh Anenson, *The Role of Equity in Employment Noncompetition Cases*, 42 AM. BUS. L.J. 1, 54 (2005) (arguing that an 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”); and Barak D. Richman, *Essay: Firms, Courts, and Reputational Mechanisms: Toward a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2360 (2004) (concluding that in Silicon Valley, California the high-tech business culture provided an “emphasis on openness [that] generated positive spillovers from innovation, a more efficient labor market, and a reduced time-to-market period for many new technologies”).

market and within a knowledge economy context. In doing so, Part VI argues that states should clarify—and codify—their CNC policy to maximize the efficient tendencies of CNCs while alleviating concerns that noncompetes can harm workers and hinder human capital investment, mobility, and other positive spillovers. Finally, the Article concludes that states can achieve greater clarity in CNC policy and enforcement by crafting a carefully articulated public policy that provides guidance to the courts, as well as employers and employees.

Before continuing, it is appropriate to pause to clarify what is meant by a covenant not to compete within the context of this Article. These agreements are formal contracts between employers and employees concerning *post-employment* restrictions on employee activities. This Article will refer to such agreements as “covenants not to compete,” “noncompetes,” or simply “CNCs.”²²

Noncompete agreements are a popular contractual tool used by employers to restrict an employee’s post-employment ability to work for a competitor or start a competing enterprise. The agreements also may protect other valuable information such as trade secrets (beyond protections already offered by existing trade secret laws). Other forms of noncompetes address issues of refraining from competition after the sale of a business or non-solicitation agreements related to poaching clients or employees.²³

These covenants may be a clause in a larger employment contract or a stand-alone agreement that an at-will employee signs as a condition of employment (or continued employment). Noncompetes are distinguishable from noncompetition agreements regarding the sale of goodwill of a business and from the common law or statutory protections for an employer’s trade secrets. However, the interaction and overlap of trade secret protection with CNC concerns will be discussed in the context of CNC policy throughout the Article. For the most part, the archetypal noncompete agreement discussed herein will be the stand-alone sort that is ancillary to other employment terms and conditions.²⁴ Unless otherwise discussed, I will proceed as if these agreements are valid contracts, duly negotiated and free from defects, and that they are freely entered without unlawful duress, fraud, or mistake. The assumption is that these agreements are supported

22. They are also often called “noncompete agreements,” “restrictive covenants” or “noncompetition agreements.”

23. *See generally* Malsberger, *supra* note 5 (addressing the coverage of noncompetes across the states, including instances of additional post-employment restrictions on former employees such as the sale of a business when the seller can agree not to impair the transferred goodwill by refraining from competition within a reasonable scope).

24. Oftentimes these agreements are also concerned with expanding by contract (or simply restating) the common law of trade secrets so as to solidify the employer’s protections and put the employee on notice that the employer wants to protect specific interests. The noncompetes discussed in this paper are concerned with restricting an employee’s post-employment activity, essentially to limit unfair competition against the former employer. These agreements often will provide for liquidated damages upon breach, in because damages from impermissible competition are difficult to calculate.

by sufficient consideration for the relevant jurisdiction. In other words, the focus here will be on the public policy implications of allowing or curtailing noncompetes, not on the potential problems inherent in any type of contract.

II.

WHY NONCOMPETE POLICY MATTERS

Noncompete policy has an important relationship to human capital investment and, as a result, to the value of a company's work force and the firm's ability to acquire and protect its knowledge-based property and business goodwill (in the sense of a firm's intangible value beyond tangible assets²⁵). Noncompete policy is also relevant because, on a global scale, the shift away from goods-producing in developed countries continues to put greater emphasis on the United States's position as the leader in attracting highly educated workers from around the globe.²⁶ This positive inflow of human capital from new foreign workers entering the United States has been estimated at roughly \$200 billion each year.²⁷ Accordingly, any public policy, like that concerning covenants not to compete, that can maintain and enhance America's ability to capitalize on human capital is important to future economic growth.

While the corporate world has been forced to adjust to (or perhaps embrace) the new employment dynamic of highly skilled, mobile workers, the law has been slow to develop any overarching rules to regulate changing aspects of the employment relationship.²⁸ This lack of uniformity is particularly apparent with regard to covenants not to compete. The American Law Institute's ("ALI") recent work on creating a Restatement on Employment Law is an official recognition that employment law in this country is unwieldy, in part due to differences across states.²⁹ Interestingly, the ALI chose to focus one of the initial four sections of its forthcoming Restatement solely on noncompetes.³⁰ There are also indications that the frequen-

25. BLACK'S LAW DICTIONARY (Bryan A. Garner, ed. 1996) (defining goodwill as "[a] business's reputation, patronage, and other intangible assets that are considered when appraising the business, especially for purchase").

26. See Mandel, *supra* note 18. Mandel argues that the current large trade deficits experienced by the United States are, in fact, greatly offset by increases in U.S. human capital—particularly technology-based expertise—due to worker immigration.

27. *Id.*

28. Gely & Bierman, *supra* note 14, at 651-52.

29. See generally Matthew W. Finkin, *Second Thoughts on a Restatement of Employment Law*, 7 U. PA. J. LAB. & EMP. L. 279 (2005).

30. *Id.*

cy of employment disputes, in general, has risen³¹ and covenants not to compete have become common in employment contracts.³²

Employers are aware that the quality of a business's employees is an inescapable component of a business's success and is worth fighting to protect.³³ Business efficiency and profitability are driven by effective hiring, training, and retention of productive employees. Investors, too, realize that the value of many corporations is not fully reflected on their balance sheet. This is because the value of many of today's companies, *particularly high-tech companies and other knowledge-based industries*, is tied up in the creative services provided by the human capital of their employees, not by physical assets that can be owned, sold, or leveraged.³⁴ It is then no surprise that employers and investors want assurance that their investment in talented employees is secure.³⁵ This is especially true when employees might leave the firm, strike out on their own, and compete with the firm that helped them develop valuable skills in the first place.

What, then, can frustrated employers do on behalf of concerned investors to secure costly—and indispensable—investments in valuable employees? Possible solutions include expensive yet-to-vest stock options, other delayed compensation, or encouraging employee ownership. The more popular solution, however, is the covenant not to compete: a contract that purports to stop an employee from competing with his or her employer once the relationship ends, for a “reasonable” time and under “reasonable” conditions.³⁶

In any covenant not to compete there are at least two parties—the employee and the employer—and, as with any contract, there are concerns about enforceability. With CNCs, however, the varied public policy ap-

31. Stone, *supra* note 17, at 764. See also Whitmore, *supra* note 4; Lester, *supra* note 4.

32. See Eric Posner et. al, Investing in Human Capital: The Efficiency of Covenants Not to Compete 1 (2004) (University of Virginia John M. Olin Program in Law and Economics Working Paper Series, Working Paper No. 11), available at <http://law.bepress.com/uvalwps/olin/art11> (last visited Sept. 20, 2006).

33. See, e.g., Stone, *supra* note 17, at 722 (“As firms and employees have come to recognize the enormous value of employee human capital, disputes over ownership of human capital have increased.”).

34. See Gely & Bierman, *supra* note 14, at 660 (discussing the knowledge economy, and arguing that “knowledge” has “become the key ingredient of economic activity” and “the increased importance of knowledge is twofold—knowledge becomes more important as a component of the production process, and also as a product itself”).

35. See, e.g., John Roberts & Eric Van den Steen, Shareholder Interests, Human Capital Investment and Corporate Governance (April 30, 2000) (Stanford GSB Working Paper No. 1631), available at <http://ssrn.com/abstract=230019> (discussing the importance of firm-specific human capital and the need to protect human capital through governance mechanisms) (last visited Sept. 20, 2006).

36. See Ingram, *supra* note 19, at 49 (commenting that assumptions of lifetime employment are outdated and that “increased mobility has added greatly to the opportunities of workers, but it has also created serious problems for employers who want to protect their trade secrets, confidential information, and goodwill” and that “to accomplish this protection, many employers require at least some of their employees to agree [to certain post-employment restrictions]”).

proaches among the fifty states can lead to wildly different outcomes for the interested parties depending on the state where enforcement is sought.³⁷ Employment contract law has traditionally been the province of the states. Accordingly, the vagaries of state-level enforcement have caused uncertainty regarding employee contract enforcement, particularly as businesses draw from an increasingly mobile workforce.³⁸ If there are fifty different systems of enforcement, how is an employee or an employer to know what to expect in each case, especially when it is not obvious what public policy each state is trying to promote? While it is not clear if the CNC policy of any given state is closely correlated to a conscious policy goal,³⁹ it is clear that states are interested in promoting knowledge-based industries impacted by CNC policy.⁴⁰

The practical business concerns about increasing and securing valuable human capital, such as preventing the loss of trade secrets and proprietary, confidential information have long been important. However, with the advent of a knowledge economy, how the law addresses the issue of human capital is more relevant to employers and employees than it has been in the past. Because of that increased emphasis on human capital protection and investment, a state's policy on noncompete enforcement must address the tension between knowledge-intensive industries and a mobile workforce.

III.

THE THEORETICAL PERSPECTIVES ON NONCOMPETES AND HUMAN CAPITAL

Since the first known reported covenant not to compete case in 1711, there has been a debate in the legal literature about agreements that restrict employees' post-employment activities that he or she would otherwise be free to undertake.⁴¹ This Part is about the propriety of enjoining a former

37. See, e.g., *Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881 (1998) (upholding a trial court's refusal to enforce a Maryland noncompete because of California's public policy against such agreements).

38. See, e.g., *id.*

39. For example, California's much-discussed ban on covenants not to compete with regard to employment was not enacted in response to a policy problem *per se*, rather, it is a quirk of history. See Gilson, *supra* note 8, at 613-19 (noting that California's ban on noncompetes resulted from historical serendipity due to the wholesale adoption of the "Field Code" when the state entered the United States).

40. Examples of this include Michigan's "Cool Cities" initiative, free land to new residents in some Kansas communities, and other recent college graduate retention efforts in places like Philadelphia. Jay Rey & Stephen Watson, *Keeping the Best and Brightest*, THE BUFFALO NEWS, May 28, 2005 (discussing the efforts of various regions in the United States to retain and attract young, educated workers). Any policy impacting human capital like that concerning CNCs should be of keen interest to these—often old economy—rust belt states like Michigan and Ohio that are feeling the effects of negative population growth and struggling with waning manufacturing economies.

41. See Blake, *supra* note 9, at 625-46 (discussing the history of noncompetes in the common law); see also Messeloff, *supra* note 20, at 711-723 (discussing the common law noncompete develop-

employee from competing against an employer, even when pursuant to a valid contract. The question is one of balancing, on one hand, the terms of a contract that is on its face a restraint on trade, and on the other hand, concerns about protecting an employer's goodwill and investment in an employee's human capital.⁴²

There are three cogent, general approaches to CNCs in the recent academic literature. The first derives from a classic law and economics, property rights, and contract analysis. This perspective argues that CNCs are an efficient tool to encourage and protect an employers' investment in human capital.⁴³ A second group of commentators believe that CNCs stifle innovation by favoring overreaching employers at the expense of employee mobility and attendant knowledge spillover.⁴⁴ Specifically, they argue that the absence of CNC enforcement in California has been crucial in the heightened level of labor mobility inherent in the high-tech agglomeration economy of Silicon Valley. The third critique is a consequentialist argument that CNCs are undesirable because they restrict a worker's freedom to maintain exclusive control over his or her own labor.⁴⁵

For the first and second arguments the desired outcome is to facilitate or restrict knowledge spillovers. Both employ law and economic analysis to make their assertions, but the critical policy evaluation is dependent on the stance taken toward information availability. In contrast, the third argument is, by definition, concerned with an outcome favorable to workers' freedom and self-determination, and it illuminates public policy concerns that legislatures and courts must consider. These normative theories are useful in evaluating the virtues and vices of CNCs and in addressing the human capital concerns discussed above, particularly because it is unclear what states are seeking to accomplish with CNC policy. This is, in part, because the broad landscape of U.S. noncompete policy is only covered in piecemeal, industry or jurisdiction-specific articles⁴⁶ or catalogued in a few treatises.⁴⁷

ments in Britain and the United States). With the bursting of the "dot-com" bubble around the time the article was published, in hindsight some of Messeloff's exuberance is less persuasive.

42. This general balancing of interests standard is consistent with the most used approach to evaluating a challenged covenant not to compete. *See, e.g.*, *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 388-89 (1999). Although noncompetes are disfavored restraints on trade,

[t]he 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.

Id. (citations omitted) (emphasis original).

43. *See infra* note 62 and accompanying text.

44. *See generally* Gilson, *supra* note 8; Hyde, *supra* note 19.

45. *See* Stone, *supra* note 17.

46. *E.g.*, Frank J. Cavico, "Extraordinary or Specialized Training" as a "Legitimate Business Interest" in *Restrictive Covenant Employment Law: Florida and National Perspectives*, 14 ST. THOMAS L. REV. 53 (2001); Marcus A. McDaniel, *An Alternative to California's Prohibition on Noncompete Clauses*, 27 LOS ANGELES LAWYER 25 (2004); Krumm, *supra* note 20 (surveying the law of various

In addition, in Part III.C. below, where the second argument concerning employee mobility is addressed, the mobility theory will be discussed using the Silicon Valley example in light of California's ban on noncompetes. This is because it is acknowledged that California's policy of non-enforcement, as embodied in Business and Professions Code Section 16600,⁴⁸ is a useful model for analyzing the potential impact of noncompete policy,⁴⁹ and as such it will provide a useful context for the discussion of employee mobility in a knowledge economy.

There has been relatively little analysis of the details of the policy goals of individual states, particularly in terms of a cross-state comparison. This Article analyzes public policy goals inherent in representative approaches to noncompetes, but does not categorize jurisdictions by the strength of their enforcement.⁵⁰ With that information in hand the Article then addresses the connection between the states' economic interests and their public policy of enforcement. Part VI proposes three public policy models that states should evaluate in light of individual economic concerns, concluding that each state has unique business interests in CNC enforcement that should drive a closely tailored public policy approach.

A. *A Brief Economic Analysis of the Underpinnings of Noncompetes and Human Capital*

Over the last few decades several commentators have made the connection between noncompetes and the distinction between specific and general human capital investment.⁵¹ There is also a growing literature on the possible impact of the enforcement (or abolishment) of noncompetes on labor markets.⁵² While many commentators utilize the general and specia-

states); William M. Corrigan & Michael B. Kass, *Non-Compete Agreements and Unfair Competition—An Updated Overview*, 62 J. MO. B. 81 (2006) (Missouri); Todd M. Foss, *Texas, Covenants Not to Compete and the Twenty-First Century: Can the Pieces Fit Together in a Dot.Com Business World?* 3 HOUS. BUS. & TAX L.J. 207 (2003).

47. The most cited state noncompete reference texts are: Malsberger, *supra* note 5, and KURT H. DECKER, COVENANTS NOT TO COMPETE (2d ed. 1993 & Supp. 2004).

48. At first glance California's approach to noncompetes is rather simple: it has banned them since 1872. That provision states in full: "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." CAL. BUS. & PROF. CODE § 16600 (2005). *See also*, Hyde, *supra* note 19, at Section III; Gilson, *supra* note 8.

49. *See* Gilson, *supra* note 8, at 613-19 (also noting that California's ban on noncompetes results from historical serendipity).

50. The author's research in this regard is ongoing. It is relevant to note that there is no uniform approach in the academic literature on how to gauge a state's strength of noncompete enforcement.

51. The first appears to be in an article by Paul H. Rubin & Peter Shedd, *Human Capital and Covenants Not to Compete*, 10 J. LEG. STUD. 93 (1981), applying the general and specific human capital distinctions developed by economist Gary Becker. *See* GARY S. BECKER, HUMAN CAPITAL (3d ed. 1993).

52. *See* Rubin & Shedd, *supra* note 51; *see also* Eric A. Posner & George G. Triantis, *Covenants Not to Compete from an Incomplete Contracts Perspective* (Sept. 2001) (Chicago Working Paper Series,

lized training framework to understand noncompetes, there remains much disagreement on the propriety of enforcing noncompetes and the degree to which they should be enforced. In this section the Article begins to address different types of human capital because these differences lie at the heart of a policy analysis of noncompetes.

In the broadest sense, human capital “refers to the acquired skills, knowledge, and abilities of human beings.”⁵³ Moreover,

[u]nderlying the concept is the notion that such skills and knowledge increase human productivity, and that they do so enough to justify the costs incurred in acquiring them. It is in this sense that expenditures on improving human capabilities can be thought of as ‘investments.’⁵⁴

Specific human capital is an individual employee’s earning potential and skills that are only useful in a specific work situation—essentially they are non-transferable, firm-specific skills that are not valuable to a third party (i.e., another employer).⁵⁵ An example of specific skill training is when an employer invests in training an employee on how to navigate that particular employer’s filing system. In this instance the skill of understanding *that particular* filing system is not useful to another employer (leaving aside the fact that the employee could develop some general filing acumen).

In contrast, general human capital is characterized by broadly useful skills that are transferable to other jobs.⁵⁶ General human capital is most often developed by the individual (for instance through obtaining a professional degree) and is likely paid for by that person.⁵⁷ However, when an employer trains an employee in general skills, the rational employer often asserts that it has a stake in that increased human capital now possessed by the worker.⁵⁸ That claim is partially based on assumptions that: (1) the general skills were provided at the employer’s expense; (2) the employee is now a more knowledgeable, valuable worker; and (3) the employee started the job at a lower wage than if he or she had already acquired the requisite

Law & Economics Working Papers, No. 137), available at <http://www.law.uchicago.edu/Lawecon/index.html> (last visited Sept. 20, 2006).

53. Lester M. Salamon, *Why Human Capital? Why Now?* in HUMAN CAPITAL AND AMERICA’S FUTURE: AN ECONOMIC STRATEGY FOR THE ’90S 3 (David W. Hornbeck & Lester M. Salamon eds., 1991).

54. *Id.*

55. Richard Posner succinctly states the general law and economics definition of the two kinds of human capital:

Economists distinguish between two types of human capital (earning capacity). One is general human capital; the other is firm-specific human capital...[w]orkers who develop skills that are specialized to a particular employer are more productive employees of this employer than they be of any other. They possess firm-specific human capital.

RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW §11.4, at 358-59 (5th ed. 1998). See also Lester, *supra* note 4, at 65-71 (discussing Rubin & Shedd and human capital analyses of noncompetes).

56. Lester, *supra* note 4, at 65-71.

57. *Id.*

58. See Stone, *supra* note 17, at 723.

skills. Thus, the employer has made an investment in the worker⁵⁹ and, because indentured servitude and owning another's labor are forbidden, a noncompete may be an employer's only recourse to ensure that the employee does not take her now-increased general human capital and go work for a competitor at a higher wage.⁶⁰

The last concern essentially leads to a multiple insult from the departing employee. If the employee is imbued with value transferred from the first employer and freely takes it to a second employer, then the first employer is, arguably, doubly harmed. First it loses out on some of the return on its investment in the employee and has to start training a new person (or paying more to hire an experienced one). Second, it is harmed because the employee is now aiding a competitor by capitalizing on the very human capital the first firm "paid" to develop. Moreover, that competitor reaps the reward of hiring a trained employee without investing in training. Even if the new employer pays a higher wage, that employer realizes savings by avoiding the monetary and opportunity costs of training, as well as eliminating the uncertainty of training an employee who might not remain at the firm long enough to repay the training costs. In economic terms, the marginal product of the human capital (i.e., the employee) is increased at the expense of the first employer.⁶¹ The incentive structure for this turn of events is built in: An employee will move between firms to maximize her wages and the "poaching" firm will want to maximize the quality of its human capital stock at the expense of other firms. Alternatively, the trained employee could simply leave and start a competing business on her own, thus also reaping an unfair advantage at the expense of the former employer who underwrote the general training.

Since this natural market incentive structure tends to harm the interests of employers who invest in general human capital, it is no surprise that those firms face a series of difficult decisions. First, what is the value of the general skills to the firm for carrying out its profit-maximizing goals? Can the firm live without those skills in its employees? The answers here will depend on a firm-level cost-benefit analysis that weighs the relative advantages of investing in, or acquiring access to, those generalized skills.⁶²

59. See Cavico, *supra* note 46 (arguing that courts should fully recognize generalized training as a protectable employer interest).

60. See generally, Posner & Triantis, *supra* note 52. Posner and Triantis argue from a Chicago School law and economics perspective that noncompetes can be economically efficient when the employer has financed the employee's general skills where the employee could not acquire the skills without the employer and the employee thus accepts a lower wage to, in effect, allow the employer to gain back the investment. This is because otherwise an employer cannot protect against an employee acquiring the general skills and then leaving with his or her increased human capital and going to work for a third party that is willing to pay more for the already-acquired skills.

61. See, e.g., Rubin & Shedd, *supra* note 51, at 97.

62. As a threshold matter, increasing human capital—particularly general human capital—provides both individual and aggregate societal benefits. See BECKER, *supra* note 51.

Once the firm decides to invest in accessing that human capital, a second issue arises. Should the firm, to the extent the labor market allows, invest in training existing employees with valuable general skills, given the risk of losing those employees to a competitor before the investment is recouped? Alternatively, should the employer hire employees who already possess the general skills required (assuming they are available in the labor market and the wage they demand affordable)? The answer to the first question of whether it is “efficient” to acquire that sort of human capital turns on the efficiency related to the “product” the firm produces.⁶³ The answer to the second question depends on the nature of the skills available for hire in the marketplace. From the employer’s perspective, it is a good investment to develop firm-specific skills because there is no market to hire from and there are no competitors interested in hiring away the firm’s employees for their specific skills. In sum, from a firm’s perspective, it is a risk to invest in an employee’s general skills.

For the employee it is desirable to raise the market value of her human capital through investing in her own education. The rational employee will not invest in firm-specific human capital because those skills have no value outside of that firm. Thus, employees will have the incentive to self-invest when it comes to general skills, because these are skills they will take from one job to another.⁶⁴ This is because the general human capital created at the expense of the individual is an excludible good that the worker controls and “owns” outright without concern that the employer can claim ownership rights in those skills.

However, once a firm has decided to acquire from the marketplace an employee already possessing general skills, it encounters a difficult “Catch-22”—the desired skills are particularly expensive, in a broad sense, to acquire. The question arises: Is there a way to protect, and thus encourage, investments in general human capital at the individual employee level?⁶⁵ While not a commodity or raw material like types of physical capital, human capital is indeed “purchased” by firms—although temporarily and with moral and legal restraints.⁶⁶ The terms of human capital usage can be negotiated and put into a formal written contract by the firm. The common

63. The mention of efficiency in this case refers to the general idea that firms will act rationally to maximize profits. This is to be distinguished from the efficiency of selectively enforcing covenants not to compete to maximize the specific private and overall public good, which is the focus of Part VI of this Article. In that latter sense, efficiency is a surrogate for maximizing public goods and outcomes in the form of economic prosperity through a more refined, targeted noncompete public policy.

64. See Rubin & Shedd, *supra* note 51, at 96.

65. A related issue not addressed here is differences that come with group human capital investments, particularly the complications of investing in a group (i.e., a team of workers). For a discussion of human capital investment in teams, turnover costs and related issues, see ROBERT A. HART & THOMAS MOUTOS, HUMAN CAPITAL, EMPLOYMENT AND BARGAINING 4-5, 130-156 (1995).

66. See Summers, *supra* note 7 (critiquing the traditional employer and worker relationship in the at-will employment context).

law's imperfect solution to the question posed above is to rely on the covenant not to compete.

Rubin and Shedd explain that it is inefficient for an employer to avoid providing expensive training because of a fear that the general human capital will be misappropriated.⁶⁷ They argue that noncompetes “are needed to lead to efficient levels of investment in training when the person receiving training is unable to pay for the human capital by accepting reduced wages.”⁶⁸ Rubin and Shedd conclude that such concerns lead to underinvestment that can be addressed by enforceable covenants not to compete.⁶⁹

With this initial understanding of the economics underlying human capital theory and the impact of noncompete enforcement, the next section will address how law and economics theories will impact knowledge spillovers when CNCs are enforced. The details of CNCs in employment contracts and of the policies that lawmakers should promote—through legislation and the courts—are the subject of the following Part. As a threshold matter, legal policies have long been recognized as an important part of economic growth.⁷⁰ How responsive the law is to social and market trends in economic development and whether the legal framework or the industry development comes first, are open questions.⁷¹

B. *The Law and Economics Approach to Covenants Not to Compete*

1. *Overview of the Approach*

Law and economics scholars simply ask: Are the legal rules efficient? In this analysis, as in others, perspective matters. What is efficient for an employer in this analysis might not be efficient for an individual worker. Regarding CNCs, the law and economics analysis has focused on the non-compete's ability to foster or protect human capital investment⁷² and to

67. Rubin & Shedd, *supra* note 51, at 97-99.

68. *Id.* at 99.

69. *Id.*

70. The formalization of Law and Economics as an influential discipline and worldview is a testament to this understanding. The most influential text in this discipline is arguably Richard A. Posner's *Economic Analysis of Law*. For example, Posner writes that:

Economic analysis can help clarify the controversial role of the common law in the economic growth of this country. The usual view is that the common law helped promote economic development in the nineteenth century by adopting a permissive, even facilitative, stance toward entrepreneurial activity. A variant is that it subsidized growth by failing to make industry bear all the costs that a genuine commitment to efficiency would have required it to bear.

POSNER, *ECONOMIC ANALYSIS OF LAW*, *supra* note 55, at 276.

71. A recent and controversial popular account of urban economic development is RICHARD FLORIDA, *THE RISE OF THE CREATIVE CLASS* (2002) (arguing that recent urban development success stories are attributable to knowledge-rich urban creative classes moving to blighted inner-city neighborhoods).

72. See Posner et. al, *supra* note 32, at 1.

provide a possible evaluation framework for the courts.⁷³ These assumptions are premised on a broad freedom to contract and property rights.⁷⁴ Whether by design or by intrinsic logic, these law and economics notions of economic efficiency also tend to favor employer interests.⁷⁵

How the issue is defined, of course, matters greatly. For example, Eric Posner and George Triantis argue that only generalized training is properly covered by a noncompete and that if the restriction is of serious value to the parties, a noncompete can be renegotiated at the time a breach would otherwise occur.⁷⁶ This notion of *ex post* renegotiation, they argue, allows the aggrieved employer, the departing employee, and the new employer to come to an efficient settlement whereby each is satisfied with the cost they bear.⁷⁷ In other words, they argue for the courts to resolve disputes with a costless solution based on perfect information. Moreover, they believe that agreements covering generalized training should be judicially enforced where the cost of post-employment renegotiation is too high for the parties to come to their own agreement (i.e., prohibitive transaction costs).⁷⁸ Their point is that predictable contract default rules can best fill in the gaps of agreements so that contracting parties need not spell out every contingency that they might want covered.⁷⁹

Another market-based attempt at a unified law and economics framework argues that noncompetes should always be enforced by the courts unless a “market failure” occurs.⁸⁰ These failures are categorized as: “(a) imperfect (including asymmetric) information; (b) constrained choice; and (c) externalities.”⁸¹ Essentially the first two concerns are addressed by traditional contract defenses such as overreaching, fraud, and unconscionability, while the third category is akin to the rule of reason applied in a Sherman Act antitrust analysis.⁸²

73. See generally Mark A. Glick et. al, *The Law and Economics of Post-Employment Covenants: A Unified Framework*, 11 GEO. MASON L. REV. 357, 358-359 (2002) (“The discipline of Law & Economics can contribute to a more sound analysis of post-employment restraints by state courts. By providing a uniform theory through which post-employment covenants might be analyzed, Law & Economics analysis holds promise in fostering greater predictability in this realm.”).

74. See ALAN HYDE, *WORKING IN SILICON VALLEY* 85 (2003).

75. See, e.g., Ann C. McGinley, *Rethinking Civil Rights and Employment at Will: Toward a Coherent National Discharge Policy*, 57 OHIO ST. L.J. 1443, 1486-87 (1996) (concluding that the persistence of the at-will employment doctrine and the resistance to anti-discrimination statutes is due, in part, to law and economics arguments about economically rational employer behavior).

76. Posner & Triantis, *supra* note 52, at 16.

77. *Id.*

78. *Id.*

79. See A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 27 (2nd ed. 1989).

80. Glick et. al, *supra* note 73.

81. *Id.* at 417-18.

82. *Id.* at 418 (concluding that, although the Sherman Act analysis has been infrequently applied to noncompetes, it is “increasingly attractive and relevant” because of “the rising importance of high-technology industries”).

Others simply argue that noncompetes are not anti-competitive *per se*, and should not receive even the special treatment and scrutiny they do currently under most states' reasonableness test.⁸³ This is because fears of employer overreaching are perhaps exaggerated when it comes to an examination of reported cases.⁸⁴ Similarly, noncompetes are also defended on the grounds that they help economic efficiency and growth because they protect legitimate employer interests and therefore provide the security that allows employers to invest in valuable generalized training. Essentially, the argument is that without noncompetes there would be less of an incentive for firms to invest in employees.⁸⁵

Less expansive, but consistent with part of the law and economics outcome, is an argument from some commentators that restrictive employment covenants should only be enforced to the extent that they cover trade secrets misappropriation.⁸⁶ This argument is less comprehensive, but still consistent with the law and economics view. Another view is that noncompetes, and not shirking of trade secret rights enforcement by employers or weak trade secret protection, are the best structural explanation of why there is abundant employee mobility and information.⁸⁷ Still other academics perceive a burgeoning psychological contract in the new, dynamic

83. See Maureen B. Callahan, Comment, *Post-Employment Restraint Agreements: A Reassessment*, 52 U. CHI. L. REV. 703 (1985). Ms. Callahan argues that:

The reasonableness approach to post-employment restraint agreements, which is contrary to the general rule that courts will not examine the substantive fairness of contract terms, has remained virtually unchanged since 1711, although the stated rationales for this approach no longer withstand analysis. Post-employment restraint agreements are not anticompetitive *per se*, and in fact may foster competition by affording employers needed protection for confidential business information or investments in training. The fact that such agreements are most likely to be used with high-level employees and in industries involving complex technologies suggests that employer overreaching is not pervasive enough to warrant special treatment of these contracts as a class. And, finally, because of social and economic changes, there is little likelihood that these agreements exact significant societal costs. Because contracts that are anticompetitive can be invalidated under the antitrust laws, and because the doctrine of unconscionability could adequately protect vulnerable employees, employer excesses can be restrained without incurring the economic and social costs of continuing to apply the [traditional reasonableness] analysis.

Id. at 727-28.

84. *Id.*

85. See, e.g., *id.* at 714-15 (dismissing the employee protection rationale for barring noncompetes and arguing that noncompetes are efficient in that they lower the cost of products by lowering an input cost, thus lowering the cost of production and the cost of producing information).

86. See generally Phillip J. Closius & Henry M. Schaffer, *Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not To Compete—A Proposal for Reform*, 57 S. CAL. L. REV. 531 (1984). Closius and Schaffer argue that noncompetes are restraints on trade because they restrict employee mobility and choice and that the protection of trade secrets through agency law is sufficient to prevent information misuse. *Id.* This is arguably the state of affairs in California where without any post-employment noncompete enforcement the state may have a heightened willingness to deter trade secret misappropriation.

87. See Gilson, *supra* note 8, at 610-13 (rejecting Hyde's assertion that California's trade secret protection is necessarily weaker than other states); but see Hyde, *supra* note 19, at 31 ("Silicon Valley therefore owes its existence to the reticence of employers to enforce their rights under trade secret law.").

workplace that tacitly grants employees the ability to gain new skills and have great mobility amongst firms (as opposed to a now seemingly archaic lifelong, single-firm career); this trend precludes noncompete enforcement except in the case of trade secrets.⁸⁸ Other novel approaches are also possible.⁸⁹

2. *Implications for Knowledge Transfer*

While the goal and intent of the law and economics critique is to foster the most efficient results, the outcome is that the employer is favored at the expense of employee mobility.⁹⁰ As a result, knowledge transfer from departing employees to other firms is, by design, inhibited by covenant not to compete enforcement. Knowledge spillover is thus less likely to happen in that manner because when employees are mobile and move to other firms they take tacit information with them,⁹¹ but by definition noncompetes limit mobility. The obvious alternative is that with the increased willingness of an employer to invest in general human capital there is an increased possibility of knowledge generation and value at the firm level.⁹² This in turn may be of great benefit to internal spillover among firm departments because of increased internal human capital and longer employee tenure.⁹³

A potential drawback from decreased knowledge spillovers due to decreased employee mobility is that technological innovation may suffer.⁹⁴

88. Stone, *supra* note 17; see also Katherine V.W. Stone, *The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519 (2001). For a similar argument that New York must adapt its reasonableness standards to accommodate the fast-paced world of high-tech employment, see Messeloff, *supra* note 20.

89. One such suggestion made in the defense of noncompete-like restraints is the English idea of "garden leave"—a provision that, after an employment relationship ends, the employee stops actively working for the firm, but retains all her salary and benefits for the noncompete period, during which she is prohibited from working for a competitor. See Greg T. Lembrich, Note, *Garden Leave: A Possible Solution to the Uncertain Enforceability of Restrictive Employment Covenants*, 102 COLUM. L. REV. 2291 (2002) (arguing that garden leave is increasingly used in the United States (although judicially untested), yet the idea seems only to apply to very highly valued employees and not many of the employees throughout the workforce who currently work under noncompetes); but see Callahan, *supra* note 83 and accompanying text. Callahan argues that despite some of the uncertainty of enforcement that accompanies noncompetes, garden leave might not be as effective in stopping employee unfair competition. Callahan, *supra* note 83. Essentially, the employee is free to relax at home in their garden and still collect a paycheck, but they are not allowed to compete against the former employer. It also suffers from the traditional restraint of trade and employee protection problems attributed to conventional noncompetes.

90. Posner et. al, *supra* note 32, at 1-3 (noting that encouraging employer general human capital investment is in conflict with employee mobility).

91. See Gilson, *supra* note 8, at 585-86.

92. See Rubin & Shedd, *supra* note 51, at 99.

93. It will also benefit industries where confidentiality of information not rising to the level of trade secrets is subject to other legal protection. *Id.* at 105-07.

94. See Posner et. al, *supra* note 32 (suggesting, theoretically, that one way to reconcile labor mobility and employer protection and incentives to invest in human capital is to introduce *ex post* renegotiation whereby the three parties involved in a CNC dispute can achieve an efficient outcome by agreeing on the cost of the employee's transfer from one employer to another).

Essentially, if the law and economics approach prevails, then CNCs are more likely to be enforced, leading to greater employer investment protection. However, this risks creating a chilling effect on innovation because of less employee mobility. The benefits of disallowing CNC enforcement for the sake of mobility and the attendant knowledge spillovers are discussed the next section.

C. Labor Mobility and Covenants Not to Compete

1. Overview of the Approach and the Silicon Valley Example

Enforceable employment contracts are, by design, attempts to restrict the mobility of a worker during the period of employment.⁹⁵ In addition, the common law doctrine of employee Duty of Loyalty also provides minimum standards to define what a current employee who has freely chosen to sell his or her labor at that moment can and cannot do with regard to a firm's competitor *during* the term of employment.⁹⁶ However, the contract provision specifically intended to restrict an employee's mobility to a competitor *after* employment ends is the covenant not to compete.

Ronald Gilson⁹⁷ and Alan Hyde⁹⁸ are at the forefront of advocating the model of labor mobility under a legal infrastructure that, among other things, disallows CNCs. In Hyde's nomenclature, mobility in the knowledge economy creates "high-velocity" labor markets.⁹⁹ While Gilson believes that a state's willingness to ban CNCs is a key driver of mobility, Hyde discounts the impact of a noncompete-free jurisdiction, although he does consider the lack of noncompete enforcement to be part of the legal infrastructure that allows for mobility.¹⁰⁰ For both Gilson and Hyde the touchstone benefit of mobility is the knowledge spillover that occurs when employees move between firms, taking tacit knowledge with them to the new employer and allowing for more rapid innovation, particularly in the high-tech sector.

The next step is to view these arguments for eliminating CNCs to promote employee mobility in the context of California law as an often-cited paragon of the knowledge-economy. The enormous success of Silicon Valley as the premier global high-tech region has been studied from various

95. *Id.*

96. See Benjamin Aaron & Matthew Finkin, *The Law of Employee Loyalty in the United States*, 20 COMP. LAB. L. & POL'Y 321 (1999).

97. See Gilson, *supra* note 8.

98. See Hyde, *supra* note 19; HYDE, *supra* note 74. Hyde believes that much of Silicon Valley's success can be attributed to California's law on trade secrets and the areas entrepreneurial spirit and "high-velocity" labor market, as well as California's policy against noncompetes.

99. HYDE, *supra* note 74.

100. *Id.* at 32-33.

perspectives, including from urban planning and sociological viewpoints.¹⁰¹ Gilson¹⁰² and Hyde¹⁰³ have compared the legal framework of California's Silicon Valley with the high-tech labor markets in states that allow non-competes. Hyde argues that noncompetes should be banned as in the California model, because inhibiting employee mobility has deleterious effects.¹⁰⁴ He argues that California's laws, including its ban on noncompetes, have facilitated a "high-velocity" labor market where employees move quickly between jobs or simply remain independent contractors; thus, technical information and innovation are shared quickly, without restrictions¹⁰⁵ and are "porous to outside influence."¹⁰⁶ Hyde concludes that these factors are the key to Silicon Valley's success and that noncompetes are part of the reason why high-tech industries have not flourished to the same extent in a state like Massachusetts where CNCs are enforced.¹⁰⁷

Gilson's analysis explores the difference between Route 128 outside of Boston and California's Silicon Valley in applying CNC policy to practice.¹⁰⁸ He concludes that, in addition to the factors Hyde points out, there is an important industry agglomeration effect at play because Silicon Valley is a high-technology industrial district.¹⁰⁹ He points out that there has been a resurgence in scholarly interest in studying agglomeration economies, which are essentially spatially connected industries.¹¹⁰ The particular high-

101. See ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994) (providing a well-regarded urban planning and sociological perspective explaining Silicon Valley's growth as the world's premier high-tech regional economy). Other recent social science books exploring the intricacies of the Silicon Valley agglomeration economy include: THE SILICON VALLEY EDGE (Chong-Moon Lee et. al eds., 2000) (an overview of Silicon Valley's entrepreneurial atmosphere for economic growth); UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION (Martin Kenney, ed. 2000) (evaluating Silicon Valley from an industry agglomeration perspective); DAVID ROSENBERG, CLONING SILICON VALLEY: THE NEXT GENERATION HIGH-TECH HOTSPOTS (2002) (a business reporter's evaluation of high-tech regions in light of the Silicon Valley experience); DAVID NAGUIB PELLOW & LISA SUN-HEE PARK, THE SILICON VALLEY OF DREAMS (2002) (a critique of the negative externalities of high-tech economic growth in relation to the environment and immigrant workers).

102. See Gilson, *supra* note 8.

103. See HYDE, *supra* note 74 (contending that much of Silicon Valley's success can be attributed to California's law on trade secrets and the areas entrepreneurial spirit and "high-velocity" labor market, as well as California's policy against noncompetes).

104. *Id.*

105. See FRBSF ECONOMIC LETTER, No. 2002-24, ON THE MOVE: CALIFORNIA EMPLOYMENT LAW AND HIGH-TECH DEVELOPMENT 1, 3 (2002) (a Federal Reserve economist finding quantitative evidence that "suggests that Silicon Valley's success may derive in part from some unique features of California employment law").

106. Gilson, *supra* note 8, at 591.

107. HYDE, *supra* note 74, at 33; see also Saxenian, *supra* note 101 (supporting Gilson and Hyde by taking an urban planning approach to the issue and concluding that much of Silicon Valley's success (as compared to the Boston area's Route 128 stagnation) is attributable to the small and dynamic entrepreneurial firms of the former and the large, unwieldy traditional firms ingrained in the later).

108. See Gilson, *supra* note 8.

109. *Id.* at 586-592.

110. *Id.* at 575.

tech “culture” with the easy access to jobs and the ease of mobility between firms located in the same regions are connected to the rise and continued success of Silicon Valley. Gilson concludes that other areas should not view Silicon Valley as providing a legal framework that is an easy road map for economic success, but rather that caution is in order because each regional business area is unique.¹¹¹

It is worth noting that risk of employer backlash from a CNC-free jurisdiction (one without CNCs as a form of human capital investment protection) has not materialized within Silicon Valley, despite California’s ban on noncompetes.¹¹² If California’s ban increases mobility at the expense of human capital investment, why would the much-admired knowledge-based high-tech world of Silicon Valley be so vibrant and profitable when firms are less able to protect their investment? One possible answer is that, on the scale of an agglomeration economy the size of Silicon Valley, the regional advantages that formed that particular agglomeration economy are unique and simply cannot be replicated.¹¹³ This is because, in contrast to the Route 128 high-tech economy around Boston, Massachusetts (a state that enforces CNCs under a reasonableness analysis¹¹⁴), Silicon Valley’s growth was enabled by many systematic factors, such as post-WWII government investment in research and vibrant university partners, and intangibles, such as a culture in which business failures were viewed as a positive step in the evolution of high-tech entrepreneurs.¹¹⁵

Silicon Valley’s impressive success as a region is, thus, in many crucial ways attributable to factors beyond the legal framework of covenants not to compete.¹¹⁶ The most thorough CNC discussion of the Silicon Valley and Route 128 comparison is Gilson’s.¹¹⁷ He concludes that Silicon

111. *Id.* at 627-29. As Professor Gilson advises:

Thus, it may well be that a state concerned with regional development today should not blindly seek to replicate the historical source of Silicon Valley’s success. Given the opportunity to act by design rather than by historical accident, the better approach may be to craft a legal infrastructure that has the flexibility to accommodate the different balance between external economies and intellectual property rights protection that may be optimal in different industries. In contrast, for California, where the industrial distribution already reflects the long-term presence of Business and Professions Code Section 16600, the best course may simply be staying the course.

Id. at 629.

112. See HYDE, *supra* note 74, at 43 (concluding that there is no ascertainable social harm to the state—including no evidence of a lack of employer investment in information production—because of what he sees as weak trade secret protection and a ban on noncompetes).

113. Saxenian, *supra* note 101. Saxenian is also compelled to point out the uniqueness of Silicon Valley, noting that “while the institutions in other regional network-based systems may offer broad templates for policymakers, a regional industrial strategy will work only if it is tailored to the specific problems and conditions of the particular locality and its industrial community.” *Id.* at 167.

114. See O’Malley, *supra* note 20.

115. Saxenian, *supra* note 101.

116. *Id.* (identifying cultural aspects of Silicon Valley high-tech employees that made information exchange and innovation more possible than near Boston’s Route 128 region).

117. See Gilson, *supra* note 8.

Valley's legal infrastructure provided the initial conditions for the region's continuously evolving second-stage agglomeration economy.¹¹⁸ Gilson also demonstrates that California's ban is based on a historical quirk of lawmaking, and not a recent or intentional human capital-based policy.¹¹⁹

2. *Implications for Knowledge Transfer*

Covenants not to compete are in tension with fostering employee mobility and knowledge spillovers that encourage innovation in the high-tech arena.¹²⁰ It is particularly attractive to ban, or severely limit, noncompetes in the high-tech sector, where the uninhibited exchange of ideas can lead to innovation from information spillovers. Departing employees are likely to take knowledge to firms in the same industry where they, and their new firms, will benefit from the general human capital the employee honed elsewhere.¹²¹ Without the specter of a noncompete, employers are more likely to hire away employees from other firms, precisely for the expertise they will bring. One of Hyde's main arguments is that increased mobility will create smaller, more agile firms, including start-ups, which have a greater tendency to innovate and grow at a "higher velocity" than larger, established firms.¹²²

It is also possible, however, that knowledge sharing could be harmed by high-velocity labor markets characterized by rapid turnover. A truly mobile knowledge-based workforce can harm the interests of the firms investing in creating knowledge.¹²³ Such a system can produce a backlash from firms that are unwilling to lose a knowledge advantage. That backlash could come in several forms, such as revoking of employer retirement contributions to ERISA plans¹²⁴ or lobbying for more expansive trade secret protection. As mentioned above in the discussion of the law and economics approach, CNCs can be efficient in fostering general human capital investments from firms because the existence of a noncompete can raise the opportunity cost for a worker contemplating leaving for a competitor. In a jurisdiction without CNC enforcement there is a greater risk that higher mobility could result in less overall general human capital investment and thus less "public good" from a highly skilled workforce. This ease of mo-

118. *Id.* at 619-620.

119. *Id.*

120. Posner et. al, *supra* note 32, at 1.

121. *See* HYDE, *supra* note 74, at 29.

122. *Id.* at 15-19 (discussing Silicon Valley high-tech start-up companies).

123. *See* Yuval Feldman, *Experimental Approach to the Study of Normative Failures: Divulging of Trade Secrets by Silicon Valley Employees*, 2003 U. ILL. J.L. TECH. & POL'Y 105 (2003) (concluding that California trade secrets protection is an insufficient deterrent to trade secret sharing by Silicon Valley employees).

124. *See, e.g.*, Robert W. Hillman, *Ties that Bind and Restraints on Lawyer Competition: Restrictive Covenants as Conditions to the Payment of Retirement Benefits*, 39 IND. L. REV. 1 (2005).

bility will intuitively reduce an employee's feelings of loyalty to any single employer.

D. *The Employee Rights Approach to Covenants Not to Compete*

1. *Overview of the Approach*

Some commentators who criticize noncompetes outright on grounds other than inefficiency argue that CNCs limit the rights of workers to exclusively control how their labor is directed.¹²⁵ These arguments emphasize the unfair competition aspects that underlie the judicial public policy dilemma of whether noncompetes are legitimate contracts not unduly restricting trade. Abolishment proponents argue that noncompetes should not be enforced because: (1) they restrain trade and keep important information from the public, (2) they can cause an overall loss to society by depriving it of valuable services, and (3) employees have unequal bargaining power and need protection to ensure their ability to pursue a chosen livelihood and mobility.¹²⁶

Professor Katherine Stone argues that there is a "new psychological contract" between employers and workers, in contrast to the traditional implicit contract for lifetime employment and human capital investment from a single firm.¹²⁷ The new contract is characterized by an understanding that lifetime employment and internal firm labor markets for promotion are no longer possible, and so in exchange for continued employee loyalty employers will invest in the general human capital of workers.¹²⁸ Workers will, thus, still gain valuable, marketable skills and networks from the arrangement and be free to take those attributes with them when they move on to other firms. Covenants not to compete are, therefore, a violation of this new psychological contract in that the employer seeks to protect its investment by cutting back on employees' mobility and free use of know-

125. See, e.g., Stone, *supra* note 17.

126. See Callahan, *supra* note 83, at 711-24.

127. Stone, *supra* note 17, at 739-46. However, the traditional American rule of at-will employment represents a deviation from this model and even a safety valve of sorts for an employer needing to cut labor costs. As one author has vividly described at-will employment:

The assumption is that the employee is only a supplier of labor who has no legal interest or stake in the enterprise other than the right to be paid for labor performed. The employer, as owner of the enterprise, is legally endowed with the sole right to determine all matters concerning the operation of the enterprise. This includes the work performed and the continued employment of its employees. The law, by giving total dominance to the employer, endows the employer with the divine right to rule the working lives of its subject employees.

Summers, *supra* note 7, at 65.

128. In reality there may be little awareness of many workers about their rights under employment law and the nature of their at-will employment. See, e.g., Pauline T. Kim, *Bargaining with Imperfect Information: A Study of Worker Perceptions of Legal Protection in an At-Will World*, 83 CORNELL L. REV. 105 (1997) (concluding that, in fact, many workers are unaware of the at-will nature of their employment and the lack of default job protection available).

ledge (i.e., general human capital).¹²⁹ This approach emphasizes the sovereignty of the employee and challenges the firm's ability to control the individual's labor post-employment.

2. *Implications for Knowledge Transfer*

Under the employee rights model, the outcomes for human capital investment and employee mobility are similar to the outcomes of the pure employee mobility approach. This theory, however, is applied to all workers, unlike the high-velocity labor market model that addresses mobility only in the high-tech, knowledge economy. While highly educated employees with a great deal of employer-provided human capital will bring positive knowledge spillovers to a subsequent employer in the same industry, the valuable spillover is less likely to occur with workers having less aggregate human capital.

This theory, nonetheless, explains part of the rationale for why the influential state of California continues to ban noncompetes. California policy embodied in the anti-noncompete statute is not rooted in a desire to promote worker mobility in Silicon Valley's high-tech sector; rather, it is rooted in a concern for employee autonomy.¹³⁰ The state's courts, in fact, express the public policy of Section 16600 in terms that echo the sentiments of the employee rights approach, stating that California has a "strong public policy against noncompetition agreements under section 16600"¹³¹ because that policy "protects Californians, and ensures 'that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice' [and it] protects 'the important legal right of persons to engage in businesses and occupations of their choosing.'"¹³² Similarly, the statute "is an expression of [California's] strong public policy in favor of open competition and the right of its citizens to pursue the enterprise of their choice."¹³³

An employee rights model of addressing noncompetes tends toward banning noncompetes under an equity rationale, in line with the autonomy public policy justification articulated by the California courts. Accordingly, the practical result would be similar to the employee mobility model and knowledge spillovers developed by Gilson and Hyde and discussed above. However, the employee rights approach does not come to the same analytical conclusion that innovation is the goal of weakening noncompete en-

129. Stone, *supra* note 17, at 739-46.

130. See Gilson, *supra* note 8, at 613-19.

131. *Advanced Bionics Corp. v. Medtronic, Inc.*, 29 Cal. 4th 697, 705-706 (2002).

132. *Id.* at 236-37 (quoting *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 33 Cal. App. 4th 853, 859 (1994) and *Morlife, Inc. v. Perry*, 56 Cal. App. 4th 1514, 1520 (1997)).

133. *Beer & Wine Servs., Inc. v. Dumas*, No. B151792, 2003 LEXIS 2556, at *7 (Cal. Ct. App., March 17, 2003) (citing *Hill Medical Corp. v. Wycoff*, 86 Cal. App. 4th 895, 900-01 (2001) and *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 859 (1994)).

forcement, rather the ideal promoted by this approach is solely employee rights-based.

IV.

CREATIVE VERSUS SERVICE EMPLOYEES: A DISTINCTION WITHIN THE KNOWLEDGE ECONOMY

In the debate over human capital and noncompetes, commentators have divided general human capital into industry-specific and then firm-specific human capital and training.¹³⁴ This section describes the distinctions between the types of workers contributing to the knowledge-based economy and asserts that their human capital must be treated differently with regard to the CNC analysis based on the type of contribution they make. The division will be drawn between “creative” and “service” workers within the knowledge economy.¹³⁵

Within the context of a knowledge-based economy, “creative” workers use their employer-provided human capital to create products used in that economy. Essentially, these workers are valued by firms for their contribution to marketable innovation. For example, a creative worker is one who works in an engineering capacity, designing computer software, or as a chemist, researching new drugs for a pharmaceutical company. These employees are characterized by a high level of education, and thus a high level of general human capital. This category includes the high-tech industry employees that are appropriately part of the “high-velocity” labor market described by Alan Hyde.¹³⁶

A second type of worker in the knowledge economy is the “service” worker. Like creative workers, service workers are characterized by a high level of education, but they are likely to have a larger amount of firm-specific human capital. These workers are engaged primarily in servicing other elements of the knowledge economy with their expertise. Examples include investment bankers, stock analysts, journalists, management consultants, trained salespeople at a pharmaceutical company, and service-providing professionals like physicians.¹³⁷ These individuals are not engaged in goods manufacturing, rather they use specialized knowledge and a

134. See, e.g., Rubin & Shedd, *supra* note 51.

135. If they are in the knowledge economy then, by definition, they are not producing goods in the traditional sense, such as making steel or engaging in traditional agricultural activities.

136. See HYDE, *supra* note 74, at 86-87 (describing how Silicon Valley programmers are expected to develop their own skills without employer-provided training).

137. Technically lawyers would fall into this theoretical category, however attorneys are exempted from restrictions on freedom of employment for ethical and public policy reasons, and sometimes specifically by state statute, from falling under CNC restrictions. See Hillman, *supra* note 124, at 1 (focusing on the prospect of tying post-employment noncompetition to the payment of retirement benefits, the “one important, but largely undeveloped, exception to the ethics codes’ ban on restrictive covenants” for lawyers).

large degree of human capital to problem-solve and promote elements of the knowledge economy. Their jobs are fuelled by a high level of human capital—both specific and general—and their value is in how they use that knowledge to engage in important activities like writing reports, selling products, and evaluating corporate stocks. In other words, they are not *creating* that knowledge *per se*, rather they are *using* it to provide valuable services. This category encompasses the sorts of workers contemplated by the law and economics approach to human capital investment and noncompetes discussed in Part III.

V.

TAKE THE BEST, AVOID THE REST:

RECONCILING CNC THEORIES TO MAXIMIZE MARGINAL BENEFITS

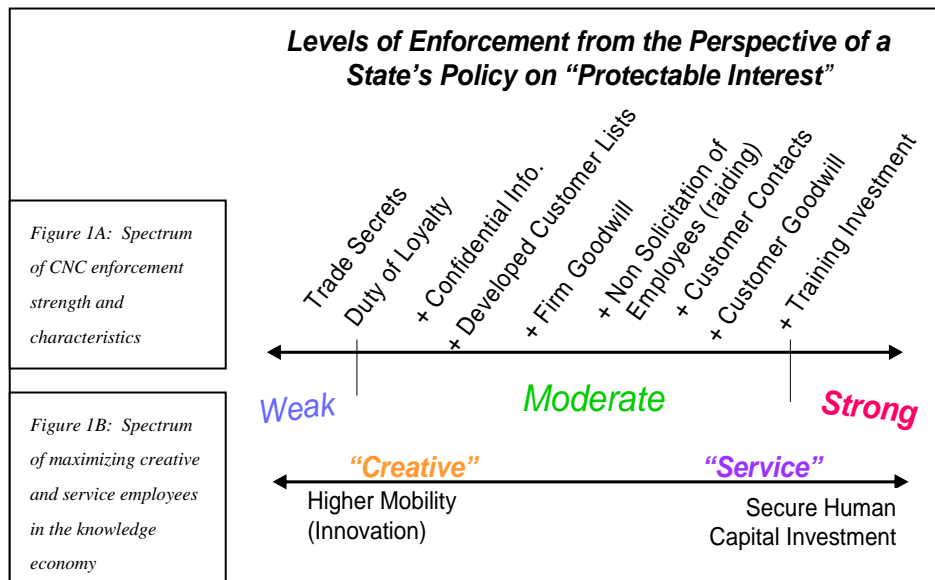
The theories outlined in Part III all argue from valid points of view. They are not, however, inconsistent with each other on their face. The next step is to draw on theories of how covenants not to compete should ideally function, minimizing their drawbacks while accentuating their benefits. This portion of the Article argues that the purported benefits and efficiencies extolled by both ends of the spectrum can lead to a unitary, hybrid model.

As seen in Part III, there are benefits that result from each of the models. For the law and economics model, investment in otherwise hard to acquire human capital is encouraged when employers have CNC protection. However, the mobility model and the employee rights model would ban noncompetes, albeit on different grounds. The justification for that policy is that it increases innovations and knowledge transfer as side effects of greater employee mobility and independence from employers.

The implication is that *on the margins* of the enforcement spectrum the opposing—yet mutually desirable—externalities are maximized. Specifically, the beneficial knowledge spillovers that come from the mobility and attendant information sharing of not enforcing noncompetes in certain employment situations are compatible with the benefits of selective enforcement under other circumstances. If the positive elements of the law and economics approach *and* the employee mobility approaches are accepted as persuasive in their own regard, then the best public policy is one that allows for the maximization of those positive spillovers.

The differences can be reconciled in a manner that maximizes the positive outcomes of both policies with respect to service and creative workers in a knowledge-based economy. By maximizing those positive spillovers on the margins, the conflict of the two theories can be reduced and the positives enhanced. The key is to treat different types of workers differently with respect to CNC enforcement policy. Simply put, this model challenges the assumption that all workers with CNCs should be treated equally under a state's policy framework.

To demonstrate how the two theories can be reconciled for overall benefit, it is useful to conceive of the opposing models graphically. The following diagrams shows how the theories are, at least in part, in conflict in terms of how they relate to varying levels of enforcement. Specifically, Figure 1A illustrates a spectrum showing the levels of possible state enforcement (weak, moderate, or strong) of covenants not to compete. To show what elements of a state's public policy constitute a certain level of enforcement, the various protectable interests recognized by jurisdictions' reasonableness tests are placed along the spectrum in order of their extraordinary nature. For example, all states, even California with its policy of non-enforcement, recognize trade secret protection and the employee's duty of loyalty, but only states that vigorously enforce CNCs will extend an employer's portfolio of rights to the level of recognizing training and customer goodwill as protectable interests.¹³⁸ Figure 1B introduces the distinction between creative and service employees and illustrates how those types of workers (and the implications for positive spillovers) are relate to different levels of enforcement.



While the benefits of the opposing mobility and law and economics justifications for noncompete policy seem irreconcilable, they are not. In fact, when the creative and service worker categories developed in Part III are applied to the benefits sought under each model, it becomes apparent that there is actually theoretical convergence regarding the positive out-

138. See generally Malsberger, *supra* note 5.

comes (spillovers) a CNC policy could promote. The next diagram (Figure 2) is a matrix representing the overlap of the two theories and the positive spillovers associated with each. Enforcing a covenant not to compete against a creative employee produces a negative result while, to the contrary, allowing enforcement of a noncompete against a service worker allows for the positive spillover of increased general human capital investment.

The theory shows that, on one hand, if noncompetes are not enforced in a given jurisdiction, the model results in a positive spillover of knowledge sharing and innovation for *creative* employees. On the other hand, if noncompetes are not enforced in a jurisdiction there is a negative effect (inefficiency) with respect to general human capital investment in *service* workers.

A Model for Maximizing Outcomes

	CNC Enforcement	CNC Non-Enforcement
“Service” Employee	Efficient Human Capital Investment	Negative Spillover (Disincentive to invest in General Human Capital)
“Creative” Employee	Negative Spillover (Hinders Innovation)	Positive Information Spillover Across Firms

Figure 2

By using these models as an analytical starting point it is possible to envision a CNC public policy that maximizes the spillovers possible from creative workers or service workers by taking an extreme stance on CNC enforcement. The other alternative—the one that is argued for in this Article—is to attempt to balance the results and maximize the marginal gains for both classes of workers. The next Part discusses these options in detail and makes recommendations in light of the preferred policy outcome and the economic goals of hypothetical states with differing goals.

VI.
FIFTY WAYS TO LEAVE YOUR EMPLOYER:
WHAT ARE THE PUBLIC POLICY IMPLICATIONS FOR STATES?

There is no uniformity in the enforcement of post-employment non-competition agreements among states.¹³⁹ There are numerous standards for enforcing these agreements, in part or in whole, and there are reasonable and numerous standards for voiding them as against public policy, often because the terms are overbroad. This section will present recommendations for how states should evaluate their policies toward noncompetes in light of the models discussed above as they relate to a knowledge economy.

Each state should clearly lay out its chosen noncompete policy goals and formalize them in a piece of legislation that can serve as guidance for the parties to an employment agreement, prospective employers, and the courts. Ideally, a CNC statute would provide a set of clear rules about the state's policy and enforcement guidelines. To ensure an overall fair and reasonable application of a CNC policy—whatever model it is based on—the discretion to apply the policy should be left up to the courts, in part because the CNC cases are intensely fact specific and must be evaluated on a case-by-case basis. A significant number of states already have CNC enforcement statutes of general applicability to all employees,¹⁴⁰ and some others have specialized ones concerning certain professions.¹⁴¹

If one accepts that noncompete policy and enforcement guidelines should be formalized in a piece of legislation, the next step is to determine what policy is most appropriate for a jurisdiction. To do this one must consider the nature of a particular state's economic interests. This paper is concerned with how states might adapt their noncompete policies to the changing employee-employer relationship and the rising importance of a knowledge-based economy as the role of producing goods becomes less important.¹⁴² Thus, the remainder of this Part's focus is on what factors a state should consider when crafting its noncompete policy, based on its current needs and future goals.

139. Nor does this issue seem ripe, even remotely, for generalized federal preemption. For a discussion of the federal court's approach to covenants not to compete, particularly in the antitrust context, see Glick et. al, *supra* note 73, at 408-17.

140. Specifically, fifteen states (30%) have enacted some sort of statute of general applicability to CNCs. See *infra*, Appendix, Figure 3.

141. See generally Malsberger, *supra* note 5. For a discussion of the states that have enacted anti-CNC legislation regarding broadcaster employee contracts at the insistence of interests representing broadcast professionals, see Nancy Morrison O'Connor, *Promises and Pye Crusts: State Statutes Threaten Broadcast Noncompetes*, COMMUNICATIONS LAWYER 21:3 (2003) (discussing the successful state-level lobbying efforts of the American Federation of Television and Radio Artists to ban noncompetes for broadcasters).

142. See Mandel, *supra* note 18.

A. *Mobility Maximizing Public Policy*

A mobility maximizing approach would entail little or no noncompete enforcement and is most appropriate for states primarily to create a legal infrastructure conducive to knowledge spillovers from a high rate of employee turnover. Such a policy would encourage the formation of start-up companies in a knowledge economy because it would greatly lower the legal barriers to obtaining general human capital from an established firm and then using those skills to start a competing firm. It would also be, on the whole, more employee-friendly than other policies. As discussed above, this policy would most favor multi-firm industries, such as the high-tech industry, that benefit from high-velocity labor markets.¹⁴³ However, there is also the risk that free-flowing information will lead to the circumvention of trade secret laws in an environment like the Silicon Valley high-tech community.¹⁴⁴

The downside is that this approach is not favored by employers and, as a result, would also discourage employer investment in general human capital. The interests of traditional financial services industries such as the securities, banking, and insurance sectors would be disfavored by such a policy. This is because those businesses require protection of confidential information, even when that information does not have trade secret protection. For example, service-based enterprises for which it is key to hold confidential client relationships, sales information, and research will be harmed by an inability to secure human capital investments and employee loyalty. Without noncompete enforcement there is a greater likelihood that a worker will leave to work for a competitor or to start a competing enterprise before the investment in human capital is recouped by the employer.¹⁴⁵ Accordingly, a state wishing to encourage financial services or other knowledge service industries would not want a policy that only encouraged employee mobility.

In effect this mobility maximizing approach is the policy of California's Business and Professions Code Section 16600, which is credited with creating the proper legal framework for Silicon Valley's so-called high-velocity labor market and the resulting technological innovation.¹⁴⁶ Unfortunately for other states that want to create a similar high-tech knowledge economy, the risk is that Silicon Valley is not so easily replicated,¹⁴⁷ in part

143. See Hyde, *supra* note 19; HYDE, *supra* note 74.

144. See Feldman, *supra* note 123.

145. Rubin & Shedd, *supra* note 51, at 96.

146. See HYDE, *supra* note 74.

147. See Gilson, *supra* note 8, at 629 (concluding that a state concerned with regional development "should not blindly seek to replicate[] the historical source of silicon Valley's success," and that "the better approach may be to craft a legal infrastructure that has the flexibility to accommodate the different balance between external economies and intellectual property rights protection that may be optimal in different industries").

because so many extralegal factors are involved. The drawbacks of disallowing CNCs might outweigh the benefits of a policy that encourages a potentially small economic driver, especially when the economy is in the initial stages of industry agglomeration.¹⁴⁸

B. *Knowledge Services Maximizing Public Policy*

In contrast to the previous recommendations, a knowledge services maximizing jurisdiction would allow strong noncompete enforcement to promote firms—like financial services companies—that require confidentiality and prefer a minimum of knowledge spillover to competitors. Strong enforcement would perhaps include extending protection specifically to training, client goodwill, and client contacts. In this way, such a jurisdiction would enact a statute that, in effect, favors employers desiring to withhold information from competitors and the marketplace. The positive outcome would be seen in increased general human capital investment because that investment would receive legal protection and employers would have the comfort of securing their investment.¹⁴⁹

This approach, however, creates obstacles to employee mobility and discourages innovation through knowledge exchange among firms. It is also thus subject to the employee rights critique.¹⁵⁰ For both reasons, this type of noncompete policy risks alienating employees and pushing away valuable creative workers in desirable high-tech firms because those workers will be unable to move between firms and acquire transferable human capital in the process. A jurisdiction choosing this path will have to make a policy decision to favor larger, more knowledge service-based firms. Such a policy is appropriate for a state like New York that has a stated interest in protecting the existing agglomeration economy of Wall Street investment banks and other financial service industries located in the New York City area. While certainly any state, New York included, cannot risk concentrating on only one type of industry to the exclusion of others, the importance of confidential knowledge, or alternatively the sharing of knowledge through the mechanism of employee mobility, should be a factor that policy makers seriously consider when shaping noncompete policies.

C. *A Model Hybrid Jurisdiction*

A state adopting the model hybrid approach would maximize the marginal positive spillovers presented in Part V. Specifically, it would treat CNCs for workers in the knowledge-based economy differently depending

148. See Gilson, *supra* note 8, at 592 (discussing the unique factors Saxenian cites for Silicon Valley's prosperity and how those factors gave rise to a second-stage agglomeration economy not present with Route 128).

149. See, e.g., Posner and Triantis, *supra* note 52.

150. Stone, *supra* note 17.

on whether the worker is a service or a creative employee. This model policy for CNCs does not presently exist in any state.

Of the three models discussed in this part, this is the most complicated to implement because, by design, it requires another layer of analysis and the risks that come with giving more discretion in decision-making to the courts. With this model, a court evaluating a CNC dispute would have to first determine if the employee at issue is properly categorized as a covered “service” worker, or instead a “creative” worker not subject to CNC enforcement. One can imagine that this inquiry might be rather complicated because some job descriptions might cover both creative and service aspects. However, that uncertainty will also encourage employers and employees to categorize the employee’s duties *ex ante* and make that determination part of the covenant.

The hybrid option attempts to maximize the benefits of each policy at the extremes by drawing distinctions within the labor market in a knowledge economy. In turn, this requires a delicate balance in the way knowledge service workers and creative workers are defined. One way to get that balance is to create a metric, such as gross salary or rank in the corporate structure, as a means to establish a sliding scale of accepted noncompete boundaries. While such line drawing may be difficult, such an approach is not without precedent. One state, Colorado, chose to enact a detailed statute that makes covenants not to compete illegal—complete with criminal sanctions—except for certain specific permissible situations that provide guidance to the courts.¹⁵¹

The Colorado exceptions are for “contractual provision[s] providing for recovery of the expense of educating and training an employee who has served an employer for a period of less than two years” and “[e]xecutive and management personnel and officers and employees who constitute professional staff to executive and management personnel.”¹⁵² The latter provision is essentially an attempt to allow selective noncompete enforcement for a segment of the labor force. While the legislative intent is unclear, the implicit justification for allowing noncompetes for management workers is presumably that those employees are already relatively well compensated. By definition, those employees have a management role in the firm that would give them access to confidential information, thus making post-employment competition by those managers potentially unfair to the former employer.

A state following this hybrid model would draft a statute that, similar to Colorado’s detailed approach, provides for noncompete enforcement for knowledge service workers as a means of encouraging human capital development in industries that require employers to invest large amounts in

151. COLO. REV. STAT. § 8-2-113 (2005); *see supra* note 5.

152. *Id.* § 8-2-113(c)-(d).

confidential information and client relationships. The reverse would be true for creative knowledge employees. There the statute would ban noncompete enforcement to promote innovative, mobile creative service workers. Under this hybrid model, confidential information-dependant firms (Wall Street) could be protected without disfavoring firms that depend on innovation and mobility (Silicon Valley).

This model focuses *on the nature* of the employee's work, not simply the industry in which he or she is employed, and it obviously allows for a single firm to employ both knowledge-based creative and service workers and to treat them differently when deciding if a noncompete is advantageous or appropriate. Rather than seeming to treat different categories of employees unfairly by treating them differently, the firm would have the ability, as it does under any CNC system, to limit access to information to certain employees.

This policy would also force employers to choose which employees fall into which category. This may allow for employer overreaching; however, the ability to discriminate amongst different work functions in order to selectively apply noncompete enforcement would be useful for many states that do not have, for example, California's already developed high-tech economy. In that sense this model allows a jurisdiction to hedge its economic development bets. Ideally a state can encourage new creative knowledge workers to come to its cities or stem the tide of a so-called "brain drain" by allowing creative employees to have the ability to move easily between firms, taking general human capital with them, and innovate. Simultaneously, knowledge economy service workers and their employers will benefit from the human capital investment provided by a legal framework that allows limited covenant not to compete enforcement. The result is that both the positive spillovers from mobility and from encouraging human capital investment are facilitated to the aggregate benefit of a state's economic development goals.

VII.

CONCLUSION

There is no one-size-fits-all framework for how a state should develop its public policy concerning the enforcement of covenants not to compete. It should also be clear that there are challenges to producing a noncompete policy embodied in a statute and intended to differentiate between service workers and creative workers in a knowledge economy. However, the existing approaches of complete non-enforcement of CNCs on one hand, and complicated enforcement under a reasonableness test on the other, generate negative effects whereby only one positive spillover is encouraged at a given time, at the expense of other beneficial outcomes.

This leads to the conclusion that the approach represented by the hybrid model is superior to either the pure mobility or pure knowledge services

models. This is because those two models are “all or nothing” approaches where only one element of positive spillover is encouraged. The hybrid approach, in contrast, seeks to maximize both positive elements by selectively applying noncompete enforcement in the hopes of pleasing both Wall Street and Silicon Valley. This is not merely an argument that states can have it both ways. Rather it is a means to, at a minimum, encourage states to think about the spillovers their policies create as they develop long-term plans for how to utilize covenants not to compete as a tool to help secure a leading role in a knowledge-based economy.

APPENDIX

(The raw research used to compile this map is derived from COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY (Brian M. Malsberger ed., 2004); KURT H. DECKER, COVENANTS NOT TO COMPETE (2d. ed. 1993; Cum. Supp. 2004); and independent case and statute research.)

Figure 3

