

**BALANCING INNOVATION FROM EMPLOYEE MOBILITY WITH LEGAL
PROTECTION FOR HUMAN CAPITAL INVESTMENT: 50 STATES, PUBLIC
POLICY AND COVENANTS NOT TO COMPETE IN A KNOWLEDGE ECONOMY**

by

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Abstract:

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 US labor market and to the increasing importance of a knowledge-based economy? The article discusses theoretical approaches to noncompete enforcement in a knowledge economy and argues that a hybrid approach of selective enforcement which differentiates among workers as “creative” or “service” employees will enhance the positive spillovers gained from policies at the extremes of the enforcement spectrum.

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Balancing Innovation from Employee Mobility with Legal Protection for Human Capital Investment: 50 States, Public Policy and Covenants Not to Compete in a Knowledge Economy

I. Introduction and Overview: Why Covenant Not to Compete Policy Matters¹

In the abstract the American legal system is supposed to be efficient and 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 companies to meet their postal needs at the most competitive price?² 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, if Carly Fiorina, the controversial and recently ousted CEO of Silicon Valley pioneer Hewlett-Packard Company, wanted to work for one of HP’s top three competitors or hire her former HP executive assistant why shouldn’t she be able to make those choices?³

¹ I wish to thank to members of the Ross School’s Law Department, especially Cindy Schipani, George Seidel and Dana Muir for their time, support, and thoughtful comments early on in the process of researching this and other noncompete issues. Thanks also to University of Michigan faculty members Marvin Krislov and Kerwin Charles for their input on a precursor paper and to Germaine Gurr for her capable research assistance.

² See Eve Tahmincioglu, “Compete With Caution Against Past Employer”, THE NEW YORK TIMES, Small Business Section, C7, March 31, 2005 (article about two former Pitney Bowes employees who were sued by the company after they left to start a similar business and hired other former colleagues).

³ See Carleton S. Fiorina’s 1999 employment agreement with Hewlett-Packard Company, specifically Section 7 “Non-Compete; Non-Solicit”, available in SEC filings and through the FINDLAW website at: <http://contracts.corporate.findlaw.com/agreements/hp/fiorina.emp.1999.07.17.html> (accessed May 27, 2005). Fiorina’s covenant not to compete prohibits her, among other things, from working for three companies on a “prohibited list” or soliciting HP employees for a period of 24 months. *Id.* Curiously, the agreement is, by its terms, interpreted under California law, which has declared such agreements as against public policy and unenforceable. See *infra* note 19.

The answer: these individuals agreed in their employment contracts that they would not use confidential information gained from their employment, and for a 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 the employee went to work for a competitor during the prohibited period.⁴ Moreover, such agreements are believed to be increasingly common,⁵ although states have their own laws concerning covenants not to compete which can cause problems for employers and employees who have business across the country. Also the vast majority of jurisdictions do not clearly distinguish between different types of workers based on their contribution to the economy. On its face the courts in a given jurisdiction are likely to treat a fired CEO the same as a departing salesperson for purposes of noncompete enforcement.

In the United States differing employees have been, historically, categorized according to the tools of their respective trades. The threshold question was: how does that worker add value to the workplace and make his or her living? Laborers versus office professionals. Blue collar versus white collar. Manufacturing or services. Does that worker toil in the fields, on the shop floor, or behind a desk in an office? Whether workers passed the workday using their hands or more heavily depended on their mental capabilities and general education to earn a living was the difference that mattered. Therefore the legal system adapted to that paradigm and created a framework for treating those workers as distinct based upon those easily identifiable characteristics. Thus, the National Labor Relations Act addressed unions; while child labor and wage and hour laws regulated working conditions for wage earners. So-called white collar professionals were left largely unregulated, particularly from the federal level. There was, perhaps, a sense that those workers are able to fend for themselves, at least in a collective sense, within a larger labor market. Crossover concerns like workplace discrimination, sexual harassment, and the like were largely issues addressed on an individual, case-by-case basis.

For the most part American at-will sensibilities prevailed when it came to white collar professionals. For them the patchwork of state-level contract law was sufficient. Things like an individual state's approach to restrictive post-employment covenants were dictated by absolutist

⁴ See, *supra*, notes 2 and 3.

⁵ See, *supra*, note 2. See also, Stone, *infra* note 16 and accompanying text.

preferences, often inherited from long-standing common law traditions. Yet now the focus of the American economy is increasingly on this segment of the labor pool.

This is the case because the ongoing shift in the US labor market away from labor intensive goods manufacturing toward knowledge-based service industries is now clearly underway. In June 2004 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 20.8 million of the 21.6 million new wage and salary jobs generated [from 2002-2012].”⁶ This trend is at the root of what the idea of a “knowledge-based economy” or “knowledge economy” means as used in this paper. Essentially, the shift is away from manufacturing (i.e., goods producing) activities towards services that are based on information and problem-solving skills based in education and training, as opposed to interchangeable basic skills required to operate machinery. Knowledge-based industries are ones that thrive on creating new knowledge, like a high-tech, software firm or a management consulting company, as well as firms that use information and expertise to generate wealth by providing financial services like brokerage firms and investment banks. It is these sorts of industries and the highly educated and skilled workers they require that are major parts of the information economy that underscore America’s comparative advantage to the primarily low-skill, manufacturing economies in the developing world such as China.

In the past there was a reality of internal labor markets⁷ within firms of all kinds that provided the promise of lifetime employment for loyal workers.⁸ That was then, this is now. The rules have changed. It is widely recognized that the United States economy and labor markets are straining to adapt to the new globalized economy.⁹ The next question – and an open one at the moment – is how will employees, employers, and the law deal with these roiling trends?

This paper 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

⁶ United States Bureau of Labor Statistics, “Tomorrow's Jobs”, June 2, 2004.

⁷ See, e.g., J.E. KING, *LABOUR ECONOMICS* 75 (2 ed. 1990)

⁸ See Stone, *infra* note 16 at 725-26 (Professor Stone’s arguments concerning these shift are discussed in Part II of this paper). See also PETER CAPELLI, *Market-Mediated Employment in the Historical Context*, in MARGARET M. BLAIR AND THOMAS A. KOCHAN, eds., *THE NEW RELATIONSHIP: HUMAN CAPITAL IN THE AMERICAN CORPORATION* (1999) 67-68.

⁹ See, Michael Mandel, “The Trade Deficit vs. Human Capital”, *BUSINESS WEEK*, Economic Futures Section, May 9, 2005.

compete adapt to the changing landscape of the US labor market? As it stands now there is a wide range of state-level approaches to balancing the interests of mobility, protecting goodwill, and other business and personal goals employees and their employers address with covenants not to compete (“CNCs” or “noncompetes”). On one end of the spectrum a handful of states effectively ban all covenants not to compete regarding employment relationships.¹⁰ On the other end, and through most of the middle, some states will enforce CNCs within definitions of what their individual public policy deems as reasonable restraints on trade.¹¹ Ultimately there is not a simple, “one-size-fits-all” approach to covenants not to compete and this paper seeks to outline the considerations state lawmakers should weigh in developing noncompete policy that is responsive to the burgeoning knowledge-based economy.

To begin answering these questions this Introduction continues with a fuller argument of why covenant not to compete public policy is an important component and an illustrative example of how the legal system should adapt to address the large-scale changes in the modern employment relationship. Next, Part II 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 III 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, that section explains those terms in this context. Part IV continues to explain that, within a service and creative categorization, the positive spillovers from selectively enforcing CNCs with certain types of workers allow the first two theories to be reconciled and, further, will maximize those useful knowledge transfers.

Part V provides three models and suggestions for how the interests and perspectives 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 market and within a knowledge economy context. In doing so this section argues that states should inevitably clarify

¹⁰ The most noted and studied example is California’s long traditions of banning employment covenants not to compete. The other state with a near complete ban is North Dakota.

¹¹ Two such high-profile examples are New York and Massachusetts. See Messeloff, *infra* note 57 and O’Malley, *infra* note 71.

– and codify – their CNC policy to maximize the efficient tendencies of CNCs while alleviating concerns the agreements can harm workers and hinder human capital investment, mobility, and other positive spillovers. Finally the paper concludes that greater clarity in CNC policy, particularly toward efficient enforcement, can be achieved by states clearly putting forth a policy articulated in carefully crafted state legislative guidance provided to the courts.

Why Noncompete Policy Matters

The broad, simple answer to the question of “why does a state’s covenant not to compete policy matter anyhow?” is that CNC policy has an important relationship to human capital investment and, as a result, the value of a company’s human capital and the ability for it to acquire and protect its knowledge-based property and goodwill. On an international scale, the shift away from goods-producing in developed countries continues to put greater emphasis on the US’s position as the leader in attracting highly educated workers from around the globe.¹² This positive inflow of human capital from new foreign workers entering the US has been estimated roughly at \$200 billion each year.¹³ 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 had to adjust to the new employment dynamic, the law has been slow to develop any universal rules on many aspects of the employment relationship. 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, in general, is unwieldy across the states.¹⁴ Of importance, and perhaps a testament to the disjointed nature and unpredictability of certain aspects of employment law, is the fact that the ALI chose to focus one of the initial four sections of this forthcoming Restatement solely on noncompetes.¹⁵ There are also indications

¹² See Mandel, *supra* note 9.

¹³ *Id.*

¹⁴ See generally, Matthew W. Finkin, *Second Thoughts on a Restatement of Employment Law*, 7 U. Pa. J. Lab. & Emp. L. 279 (2005).

¹⁵ *Id.*

that the frequency of employment disputes has risen¹⁶ and covenants not to compete are becoming increasingly more common – at all levels of employees – in recent years.¹⁷

American employers are well aware that the quality of a business's employees is an inescapable component of a business's success that is worth fighting to protect.¹⁸ Hiring, training, and retaining productive employees is an essential driver of business efficiency and profitability. Investors too realize that the value of many corporations is not fully reflected on their balance sheet 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 not by physical assets that can be owned, sold or leveraged, but rather from employees. It is then no surprise that employers and investors want as much assurance as they can get that their investment in talented employees is secure. This is especially true when under the threat that a handful of employees could leave a firm and strike out on their own in direct competition with the exact same business that made the valuable skills possible in the first place.

So what, then, is a frustrated employer supposed to do on behalf of those frustrated investors to secure costly investments in valuable employees? Expensive and inefficient yet-to-vest stock options or other delayed compensation, or encouraging employee ownership are possible solutions. However, another more popular one is the covenant not to compete that purports to stop an employee from competing with his or her employer once that relationship ends, at least for a "reasonable" time and under "reasonable" conditions.

The uncertainty of employee contract enforcement caused by the American devotion to federalism is nothing new or surprising to employers or employees, particularly as businesses draw from an increasingly mobile workforce. Employers and employees are by now familiar with the widespread use of covenants not to compete all over the United States. Those constituencies are also increasingly aware of the uncertainty of enforcement because the public policy decision on whether or not to enforce those agreements is left to the individual states.

¹⁶ Katherine V. W. Stone, *Knowledge at Work: Disputes Over the Ownership of Human Capital in the Changing Workplace*, 34 CONN. L. REV. 721, 764 (2002).

¹⁷ See Eric Posner, Alexander Triantis, and George Triantis, "Investing in Human Capital: The Efficiency of Covenants Not to Compete" 1 (October 2004). *University of Virginia Legal Working Paper Series. University of Virginia John M. Olin Program in Law and Economics Working Paper Series*, Working Paper 11. Available at: <http://law.bepress.com/uvalwps/olin/art11>

¹⁸ See, e.g. Stone, *Knowledge at Work*, *supra* note 16 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") (footnote omitted). *Id.*

In any covenant not to compete situation there are at least two parties – the employee and the employer. As with any contract there are, ultimately, concerns about whether the agreement is valid and enforceable. However, with CNCs the varied public policy approaches among the fifty states to noncompete enforcement can lead to wildly different outcomes for the interested parties depending on the state where enforcement is desired. 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 isn't clear what public policy each state is trying to promote? While it isn't apparent that the existing CNC policy of any given state is correlated to a conscious policy goal of that state,¹⁹ it is clear that states are interested in promoting knowledge-based industries that can be impacted by CNC policy. 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.²⁰ 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, any policy impacting human capital like that concerning CNCs should be of keen interest.

The reality is that 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 and to protect other valuable information such as trade secrets beyond what protections are 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 in poaching clients or other employees from a former employer.²¹ It is also the case that most states do enforce CNCs to some extent under a reasonableness test.

Before continuing, it is appropriate to pause and make clear the scope of what is meant

¹⁹ For example, California's much-discussed ban on covenants not to compete was not enacted in response to a policy problem, *per se*, rather it is a quirk of history. 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) (noting that California's ban on noncompetes results from historical serendipity).

²⁰ Jay Rey and Stephen Watson, "Keeping the Best and Brightest", THE BUFFALO NEWS, City & Region Section, May 28, 2005 (discussing the efforts of various regions in the US to retain and attract young, educated workers).

²¹ See generally, BRIAN M. MALSBERGER ed., COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY (2004) (addressing the coverage of noncompetes across the states, including instances in addition to 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).

by a covenant not to compete within the scope of this article. We will call contracts between employers and employees concerning *post-employment* restrictions on the employee activities “covenants not to compete”, “noncompetes”, or simply “CNCs”. They are also often called “noncompete agreements”, “restrictive covenants” or “noncompetition agreements”. These contracts may be a simple clause in a larger employment contract or stand-alone agreements that an otherwise at-will employee signs as a condition of employment (or sometimes continued employment as can be the case when the employee ascends to management or partner status). These agreements are distinguishable from noncompetition agreements regarding the sale of goodwill of a business or 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 context of CNC policy throughout the paper. For the most part the archetypal noncompete agreements discussed herein will be the stand-alone sort that is ancillary to other employment terms and conditions. Unless otherwise discussed, I will proceed as if these agreements are valid contracts, duly negotiated and free from defects; and that they are freely negotiated without unlawful duress, fraud, or mistake. The assumption is that these agreements are supported by sufficient consideration for the relevant jurisdiction. In other words, the focus here will be on the policy allowing or curtailing noncompetes without getting caught up on the potential problems inherent in any type of contract.

Moreover, the noncompetes discussed in this paper are concerned with restricting post employment activity of the employee, essentially to limit unfair competition by an ex-employee at the expense of the employer which shares business techniques or client goodwill. 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. These agreements will also often provide for liquidated damages upon breach.

II. The Theoretical View of Noncompetes: Unlocking or Locking Up Human Capital

Seemingly since the first reported such case in 1711 there has been a debate in the legal literature about agreements which restrict an employee's post-employment activities that he or she would otherwise be free to undertake.²² This discussion is about the propriety of an employer having the coercive power, even when pursuant to a valid contract, to enjoin a former employee from competing against that employer. Essentially, the question is one of balancing the terms of a contract that is on its face a restraint on trade with concerns of protecting an employer's goodwill and investment in an employee's human capital.

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 employer's investment in human capital. A second group of commentators believe that CNCs stifle innovation by favoring overreaching employers at the expense of employee mobility and attendant knowledge spillover. 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.

A 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. For the first and second arguments the desired outcome is facilitating or restricting knowledge spillovers. Both employ law and economic analysis to make their arguments, 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 worker's freedom and self-determination, but it nonetheless illuminates public policy concerns that legislatures and courts must consider.

These normative theories are useful in evaluating the virtues and vices of CNCs and addressing the human capital concerns discussed above. This is particularly the case because

²² See Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 625-46 (1960) (for an extensive historical discussion of the history of noncompetes in the common law); see also Dan Messeloff, *Note: Giving the Green Light to Silicon Alley Employees: Non-Compete Agreements between Internet Companies and Employees under New York Law*, 11 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 711, 711-723 (Spring 2001). With the bursting of the "dot-com" bubble around the time this article was published, in hindsight some of Messeloff's exuberance is less persuasive.

often the details of what states are trying to accomplish with their CNC policy is unclear. Despite this vibrant discussion, the question of what the states and their courts are doing to promote individual states' public policy goals remains largely unanswered. This is, in part, because the broad landscape of American noncompete policy is covered only in piecemeal articles or catalogued in a few treatises.²³ Later in Part III the paper focuses on the first and second arguments, with special attention to how CNCs legal infrastructure might have both a positive and a negative impact on agglomeration economies, depending on the importance of information exchange or retention.

It is widely acknowledged that California's policy of non-enforcement embodied in Business and Professions Code §16600²⁴ is notable,²⁵ but there has also been relatively little analysis of the details of the policy goals of other states, particularly in terms of a cross-state comparison. This paper undertakes an analysis of the public policy goals inherent in representative approaches to noncompetes, but does not categorize the jurisdictions by the strength of their enforcement.²⁶ With that information in hand the paper then addresses the issue of what connections exist between the state's economic interests and the state's public policy of enforcement. In doing so the paper goes on in Part V to propose three models of public policy that states should evaluate in light of the individual economic concerns, concluding that each single state, like all the others, has unique business interests in CNC enforcement that should drive a closely tailored public policy approach.

²³ MALSBERGER, *supra* note 21 and KURT H. DECKER, COVENANTS NOT TO COMPETE (2d. ed. 1993; Cum. Supp. 2004).

²⁴ At first glance California's approach to non-competes is rather simple: it has banned them since 1872. That provision states, in full, as follows: "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." Ca. Bus & Prof. Code §16600 (2005). *See also*, Alan Hyde, *The Wealth of Shared Information: Silicon Valley's High-Velocity Labor Market, Endogenous Economic Growth, and the Law of Trade Secrets*, (Rutgers Law School, September 1998) (unpublished paper available at <http://andromeda.ritgers.edu/~hyde/wealth>) at Section III (footnotes omitted); and Gilson, *infra*, note 19.

²⁵ *See* Gilson, *supra* note 19. (noting that California's ban on noncompetes results from historical serendipity) *id.* at 613-619.

²⁶ The author's research in this regard is ongoing. However, 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.

Overview: 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.²⁷ There is also a growing literature on the possible impact of the enforcement (or abolishment) of noncompetes on labor markets. While many commentators utilize the general and specialized training framework to understand noncompetes there is, nonetheless, much disagreement on the propriety of enforcing them and the degree to which they should be enforced. In this section we begin to address different types of human capital because it lies 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.”²⁸ 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.’”²⁹

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 skills that are not of value to a third party (i.e., another employer).³⁰ Those skills are firm-specific. An example of specific skill training is when an employer invests in training an employee how to navigate the 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 notion that the employee might be developing some general filing acumen at the same time).

²⁷ The first appears to be in an article by Paul H. Rubin and Peter Shedd, “*Human Capital and Covenants Not to Compete*,” J. LEG. STUD., 93-110 (Jan. 1981), applying the general and specific human capital distinctions developed by Gary S. Becker, HUMAN CAPITAL (Columbia University Press, 1964; 3d ed. 1993).

²⁸ DAVID W. HORNBECK AND LESTER M. SALAMON, eds., HUMAN CAPITAL AND AMERICA’S FUTURE: AN ECONOMIC STRATEGY FOR THE ‘90S 3 (1991).

²⁹ *Id.*

³⁰ 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 (5th ed. 1998) at §11.4, 358-59.

In contrast general human capital is characterized by broadly useful skills that are indeed transferable to other jobs. General human capital is usually developed by the individual (for instance that from a professional degree) and is likely paid for by that person.³¹ In contrast, when an employer hires an employee and then trains that employee in general skills the employer will undoubtedly assert that it has a stake in that increased human capital now possessed by the worker.³² That claim is based in part on assumptions that the general skills were provided at the employer's expense, the employee is enlightened and a more valuable worker, and that the employee took the job at a lower wage than if he or she had already acquired the requisite skills. In that way the employer has made an investment in the worker³³ 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 their now-increased general human capital and go work for a competitor at a higher wage.³⁴

The last concern leads essentially 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 getting some return on its investment in the employee and has to start over training a new person (or paying more to hire an experienced one) and, second, it is harmed because the employee is now aiding a competitor. Moreover, that competitor reaps the reward of hiring a trained employee without investing in that training. In economic terms, the marginal product of the human capital (i.e., the employee) is increased at the expense of the first employer.³⁵ The incentive structure for this turn of events is built in: an employee will move between firms to maximize her wages and the

³¹ *Id.*

³² See Stone, *supra* note 16, at 723.

³³ For an article that argues that courts should fully recognize generalized training as a protectible employer interest, see Frank J. Cavico, "Extraordinary or Specialized Training" as a "Legitimate Business Interest" in *Restrictive Covenant for Employment Law: Florida and National Perspectives*, 14 ST. THOMAS L. REV. 53 (2001).

³⁴ A Chicago School, law and economics articulation of this problem is made by Eric A. Posner and George G. Triantis in "Covenants Not to Compete from an Incomplete Contracts Perspective," *Chicago Working Paper Series, Law & Economics Working Papers*, No. 137 (September 26, 2001) (available online at <http://www.law.uchicago.edu/Lawecon/index.html>). That article argues that non-competes 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 can't 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.

³⁵ See, e.g. Rubin and Shedd, *supra* note 27, at 97.

“poaching” firm will want to maximize the quality of its human capital stock at the expense of other firms.

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 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 which weighs the relative advantages of investing in acquiring access to those generalized skills. As a threshold matter, increasing human capital – particularly general human capital – provides both individual and aggregate societal benefits.³⁶

Once the decision is made for the firm to invest in accessing that human capital a second issue arises. To the extent the market for labor allows, should firms invest in training existing employees with valuable general skills, yet risk losing those employees to a competitor before the investment is recouped? On the other hand, should the employer only hire employees already possessing the required general skills (assuming they are available and the wage they demand affordable in the labor market)?

An affirmative answer to the first question of whether it is efficient to acquire that sort of human capital is one of efficiency related to the “product” the firm produces. How the second set of questions is answered depends on the nature of the skills available for hire in the marketplace. Employees desiring to raise their marginal product (i.e., the market value of their human capital output) can invest in their own education. The rational employee will not invest in firm-specific human capital because those skills have no value outside of that firm.

For the same reason, from the employer’s perspective it is a good investment to develop firm-specific skills because there is no market to hire from, and consequently no competitors willing to hire away the first firm’s employees and reap the rewards of another’s investment. The reverse concern is that, from a firm’s perspective, investing in an employee’s general skills is risky. So the theory goes that employees will have the incentive to self-invest when it comes to general skills that are theirs alone.³⁷ In other words, general human capital created at the expense of the individual is an excludible good the worker controls and “owns” outright without encumbrance.

³⁶ See HORNBECK AND SALAMON, *supra* note 28.

³⁷ See Rubin and Shedd, *supra* note 27, at 96.

However, the second set of decisions once a firm has decided to acquire those skills in the marketplace leads to a difficult “Catch-22” when the desired skills are particularly expensive, in a broad sense, to acquire. Perhaps instinctively, the question arises: is there a way to protect, and thus encourage, investments in general human capital at the individual employee level?³⁸ 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. The terms of human capital usage by a firm can be negotiated and put formally into a written contract too. The common law’s imperfect solution is the covenant not to compete. Rubin and Shedd explained that it is inefficient for an employer to not provide the expensive training because of a fear that the general human capital will be misappropriated. They then concluded that such concerns lead to underinvestment that can be addressed by an enforceable covenant not to compete.³⁹ An example is the general human capital of commercially valuable knowledge related to the production of cutting-edge microprocessor chips. In that sort of fast-moving industry knowledge transfer is a crucial element to growth and innovation.

The details of those elements of employment contracts and the policies that lawmakers should encourage are the subject of the following section. Legal policies have long been recognized as an important part of economic growth.⁴⁰ How responsive the law is to social and market trends in economic development and whether the legal framework or the industry development comes first, is an open question.⁴¹

³⁸ 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 AND THOMAS MOUTOS, *HUMAN CAPITAL, EMPLOYMENT AND BARGAINING* (1995) at 4-5 and 130-156.

³⁹ Rubin and Shedd, *supra* note 27, at 97-99.

⁴⁰ 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*, *supra*, note 19. 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.

Id. at 276.

⁴¹ 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).

1. The Law and Economics Approach to Covenants Not to Compete

Overview of the Approach

The touchstone from a law and economics viewpoint is simple: are the legal rules efficient? In this analysis, as in others, the perspective matters. What is efficient for an employer might not be advantageous for an individual worker. Regarding CNCs the law and economic analysis has focused on the noncompete's ability to foster or protect human capital investment⁴² and to provide a possible evaluation framework for the courts.⁴³ Accordingly, these assumptions are premised on ideas of a broad freedom to contract and property rights.⁴⁴

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 many noncompetes can be renegotiated at the time a breach would otherwise occur.⁴⁵ 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.⁴⁶ In other words, they argue for the courts to determine a dispute 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 (i.e., prohibitive transaction costs) for the parties to come to their own agreement.⁴⁷ Their point is that predictable contract default rules can efficiently fill in the gaps of agreements so that contracting parties need not spell out every contingency that they might want covered.⁴⁸

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.⁴⁹ These

⁴² See Posner, Triantis, and Triantis, *supra* note 17, at 1.

⁴³ See generally Mark A. Glick, Darren Bush, and Jonathan Q. Hafen, *The Law and Economics of Post-Employment Covenants: A Unified Framework*, 11 GEO. MASON L. REV. 357 (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 & Economic analysis holds promise in fostering greater predictability in this realm.”). *Id.* at 358-359.

⁴⁴ See ALAN HYDE, *WORKING IN SILICON VALLEY* 85 (2003).

⁴⁵ Posner and Triantis, *supra* note 33, at 16.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ See, e.g., A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS*, 2nd ed. (1989) at 27.

⁴⁹ Glick, Bush, and Hafen, *supra* note 43.

failures are categorized as: “(a) imperfect (including asymmetric) information; (b) constrained choice; and (c) externalities.”⁵⁰ Essentially the first two concern issues addressed by traditional contract defenses to issues such as overreaching, fraud, and unconscionability while the third category is akin to the rule of reason applied in a Sherman Act antitrust analysis.⁵¹ Others simply argue that noncompetes are not anti-competitive, *per se*, and should not receive even the special treatment and scrutiny they do now under most states’ reasonableness test.⁵² This is because fears of employer overreaching are perhaps exaggerated when it comes to an examination of reported cases.⁵³ 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 provide valuable generalized training – essentially, without noncompetes there would be less of an incentive for firms to innovate and invest in employees.⁵⁴

Less expansive, but still consistent with part of the law and economics outcome is an argument that restrictive employment covenants should only be enforced to the extent that they cover trade secrets misappropriation.⁵⁵ Rigorous enforcement of trade secret laws is particularly

⁵⁰ *Id.* at 417-18.

⁵¹ *Id.* at 418.

⁵² See Maureen B. Callahan, *Comment: Post-Employment Restraint Agreements: A Reassessment*, U. CHICAGO L. REV. 52 U. CHI. L. REV. 703 (Summer 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.

⁵³ *Id.*

⁵⁴ For example, Callahan dismisses the employee protection rationale for barring non-competes and argues that non-competes are efficient in that they lower the cost of products by lowering an input cost, thus lower the cost of production and the cost of producing information. *Id.* at 714-15.

⁵⁵ Phillip J. Closius and 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 (May 1984). The authors argue that noncompetes are restraints on trade because they restrict employee

important in the absence of noncompete enforcement because it is a mechanism to encourage what would otherwise be prohibitively expensive general human capital for an individual.⁵⁶ Still other academics perceive a burgeoning psychological contract in the new, dynamic 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) that should also preclude noncompete enforcement except for in the case of trade secrets.⁵⁷ Another recent twist pointed to in the defense of noncompetes 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 his or her salary and benefits for the noncompete period and while prohibited from working for a competitor.⁵⁸

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.⁵⁹ As a result, knowledge transfer from departing employees to other firms is, by design, inhibited by

mobility and choice and that the protection of trade secrets through agency law is sufficient to prevent information misuse. 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.

⁵⁶ See Gilson, *supra* note 19 (concluding that California’s trade secret protection is somewhat more expansive than other states’ and may fill some of the gap left by the state’s ban on covenants not to compete). *But see*, HYDE, WORKING IN SILICON VALLEY, *supra* note 44 at 31 (“Silicon Valley therefore owes its existence to the reticence of employers to enforce their rights under trade secret law.”).

⁵⁷ Stone, *supra* note 16 (some portions appearing in 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 Dan Messeloff, *Note: Giving the Green Light to Silicon Alley Employees: Non-Compete Agreements Between Internet Companies and Employees Under New York Law*, 11 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 711 (Spring, 2001).

⁵⁸ See Greg T. Lembrich, *Note: Garden Leave: A Possible Solution to the Uncertain Enforceability of Restrictive Employment Covenants*, 102 COLUM. L. REV. 2291 (2002). While the author argues that garden leave is increasingly used in the United States (although judicially untested), the idea seems only to apply to very highly valued employees and not many of the employees throughout the workforce who currently work under non-competes. Despite some of the uncertainty of enforcement that accompanies noncompetes, garden leave might not be as effective in stopping employee unfair competition. 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. See Callahan, *supra* note 52 and accompanying text.

⁵⁹ Posner, Triantis, and Triantis, *supra*, note 17, at 1-3 (noting that encouraging employer general human capital investment is in conflict with employee mobility).

allowing any level of covenant not to compete enforcement. Knowledge spillover is thus less likely to happen in that manner. However, the obvious benefit 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. This in turn may be of great benefit to internal spillover among firm departments because of increased internal human capital and longer employee tenure. Enforcing CNCs on the law and economics efficient human capital investment grounds, moreover, may lead to larger firms. It will also benefit industries where confidentiality of information not rising to the level of trade secrets is subject to other legal protection.⁶⁰

The largest potential drawback from decreased knowledge spillovers due to decreased employee mobility is that technological innovation may suffer.⁶¹ Next, we turn to this aspect of the argument against noncompete enforcement and in favor of employee mobility.

2. Labor Mobility and Covenants Not to Compete

Overview of the Approach

Enforceable employment contracts are, by definition, attempts to restrict the mobility of a worker during the period of employment.⁶² As a backstop the common law doctrine of employee Duty of Loyalty also serves 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.⁶³ However, the evolved (and custom tailored) contract provision specifically intended to restrict an employee's mobility to a competitor *after* the first employment ends is the covenant not to compete.

The enormous success of California's Silicon Valley as the premier global high-tech region has been studied from various perspectives, including from urban planning and

⁶⁰ See Rubin and Shedd, *supra* note 27.

⁶¹ One theoretical suggestion 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. See Posner, Triantis, and Triantis, *supra* note 17.

⁶² *Id.*

⁶³ See Benjamin Aaron and Matthew Finkin, *The Duty of Loyalty: The Law of Employee Loyalty in the United States*, 20 COMP. LAB. L. & POL'Y 3321 (Winter 1999).

sociological viewpoints.⁶⁴ In addition, both Ronald Gilson⁶⁵ and Alan Hyde⁶⁶ have compared the legal framework of California's Silicon Valley and the high-tech industry and labor markets in other states that allow noncompetes. Hyde argues the virtues of banning noncompetes altogether along the California model because of the deleterious effects of inhibiting employee mobility. 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 and thus technical information and innovation is shared quickly, without restrictions.⁶⁷ As a result, 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.⁶⁸

Gilson's analysis searches for the root of the difference between Route 128 outside Boston and Silicon Valley when it comes to applying CNC policy to practice. He concludes that, in addition to the factors Hyde points out, there is an important industry agglomeration effect at play. Moreover, Gilson concludes that other areas should not view the Silicon Valley experience

⁶⁴ 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 Chong-Moon Lee, William F. Miller, Marguerite Gong Hancock, and Henry S. Rowen, eds. THE SILICON VALLEY EDGE (2000) (an overview of Silicon Valley's entrepreneurial atmosphere for economic growth); Martin Kenney, ed., UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION (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); and David Naguib Pellow and 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).

⁶⁵ See Gilson, *supra* note 19.

⁶⁶ Hyde, *The Wealth of Shared Information*, *supra* note 24. 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. *Id.*

⁶⁷ See also, Rob Valletta, "On the Move: California Employment Law and High-Tech Development", *FRBSF Economic Letter*, No. 2002-24, August 16, 2003 (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"). *Id.* at 3.

⁶⁸ One main and often cited source of support for Gilson, Hyde and others is Saxenian, *supra* note 64. Saxenian takes an urban planning approach to the issue and concludes 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.

as a pre-packaged 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.⁶⁹

It is worth taking a moment to note that risk of an employer backlash from a CNC-free jurisdiction (one without CNCs as a form of human capital investment protection) has not materialized within the realm of Silicon Valley, despite California's complete ban on noncompetes. 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 simple answer is, on the scale of Silicon Valley, the regional advantages that formed that particular agglomeration economy are unique and simply cannot be replicated.⁷⁰ This is because, in contrast to the Route 128 high-tech economy around Boston, Massachusetts (a state that enforces CNCs to a great degree⁷¹), Silicon Valley's growth was enabled by a host of factors, including intangibles such as a "culture" where business failures were viewed as a positive step in the evolution of high-tech entrepreneurs.⁷² 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, a single legal policy. The most thorough CNC discussion of the Silicon Valley and Route 128 comparison is from Gilson.⁷³ He concludes that Silicon Valley's legal infrastructure provided the initial conditions for the region's continuously evolving second-stage agglomeration economy.⁷⁴

⁶⁹ Gilson, *supra* note 19 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.

⁷⁰ Saxenian, *supra* note 64. Saxenian is also compelled to point out that 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.

⁷¹ See 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 (Dec. 1999).

⁷² *Id.*

⁷³ Gilson, *supra* note 19.

⁷⁴ *Id.* at 619-620.

Gilson also demonstrates that California’s ban, like North Dakota’s, is based on a historical quirk of lawmaking, and not a recent or intentional human capital-based policy.⁷⁵

Implications for Knowledge Transfer

Fostering employee mobility and attendant knowledge spillovers tending toward innovation in the high-tech arena is anathema to – or at least in tension with – the purpose of covenants not to compete.⁷⁶ Banning or at least severely limiting noncompetes is particularly attractive in the high-tech sector where the rapid, uninhibited exchange of ideas can lead to innovation from the resulting information spillovers of valuable information not rising to the level of protectible trade secrets. Departing employees are likely to take that knowledge with them to firms in the same industry where they, and their new firms, will be able to benefit from the general human capital the employee honed elsewhere. 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.

However, it is also perhaps the case that, because so called high-velocity labor markets are characterized by rapid turnover, that knowledge sharing could be harmed in some instances. This risk of a truly mobile knowledge-based workforce is that a system enabling knowledge spillovers can harm the interests of the firms investing in creating knowledge. That is to say such a system can produce a backlash from firms which are unwilling to lose a knowledge – comparative or competitive – advantage. That backlash could come in several forms. 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 and the threat of enforcement 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 of an aggregate “public good” of a highly skilled workforce. This ease of mobility will intuitively reduce an employee’s feelings of loyalty to any single employer.

⁷⁵ *Id.*

⁷⁶ Posner, Triantis, and Triantis, *supra* note 17, at 1.

3. The Employee Rights Approach to Covenants Not to Compete

Overview of the Approach

In addition, there are commentators who criticize noncompetes outright on grounds other than inefficiency because CNCs are contrary to the rights of workers to exclusively control how their labor is directed. For the most part 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) employees have unequal bargaining power and need protection to ensure their ability to pursue a chosen livelihood and mobility; and (3) they can cause an overall loss to society by depriving it of valuable services.⁷⁷

Katherine Stone argues that there is a “new psychological contract” between employers and workers, in contrast to a traditional implicit contract for lifetime employment and human capital investment from a single firm.⁷⁸ The new contract is characterized by an understanding that lifetime employment and internal firm labor markets for promotion are no longer possible, but that in exchange for continued employee loyalty employers will invest in the general human capital of workers.⁷⁹ 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. However, covenants not to compete are a violation of this new psychological contract in that the employer seeks to protect its investment by cutting back on mobility and the employee’s free use of knowledge (i.e., general human capital).⁸⁰ Moreover, this approach emphasizes the sovereignty of the employee and challenges the firm’s ability to control the individual’s labor post-employment.

⁷⁷ See Callahan, *supra* note 52, at 711-24.

⁷⁸ Stone, *supra* note 16.

⁷⁹ In reality the 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. REVIEW 105 (concluding that, in fact, many workers are unaware of the at-will nature of their employment and the lack of default job protection available).

⁸⁰ Stone, *supra* note 16, at 739-46.

Implications for Knowledge Transfer

The outcome regarding human capital investment and employee mobility, and thus knowledge spillovers, are similar to the outcome (and drawbacks) of the pure employee mobility approach. However, this theory attempts broad applicability to all workers, unlike the high-velocity labor market model that addresses mobility only in the high-tech, knowledge economy. Accordingly, the drawbacks of this approach are that, in terms of disincentives, for firms to invest in general human capital that can't be protected by insisting on a CNC are heightened. 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 same valuable spillover is less likely to occur with workers having less aggregate human capital.

Nonetheless, this theory is a useful foil to the others, in part because it explains part of the rationale for why the influential state of California chooses 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 an historical anomaly.⁸¹ The state's courts, in fact, express the public policy of §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."⁸² 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'."⁸³ 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."⁸⁴

⁸¹ See, Gilson, *supra* note 19.

⁸² *Advanced Bionics Corporation v. Medtronic, Inc.*, 59 P.3d 231, 236 (2002)

⁸³ *Id.* at 236-37 (citations omitted).

⁸⁴ *Beer & Wine Services, Inc. v. Dumas*, 2003 Cal. App. Unpub. LEXIS 2556, (Cal. App. 2nd, March 17, 2003) (citations omitted).

III. Creative v. Service Employees: A Distinction Within the Knowledge Economy

In the debate over human capital and noncompetes commentators have asserted divisions of general human capital, subdividing it into industry-specific and then firm-specific human capital and training. This section describes a distinction of the type of workers contributing to the knowledge-based economy and does so by asserting that, based on that type of contribution, the nature of the human capital involved is very different in each of two situations. This division will be between “creative” and “service” workers within the knowledge economy. If they are in that economy then, by definition, they are not producing goods in the traditional sense, such as making steel or engaged in traditional agricultural activities.

First, an explanation of what will be referred to herein as “creative” workers. Within the context of a knowledge-based economy these 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 a chemist who researches 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. These are intended to be the sort of high-tech industry employees that are appropriately part of the “high-velocity” labor market described by Alan Hyde.

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. However, these workers are still engaged primarily in servicing other elements of the knowledge economy using their expertise. Examples include bankers at an investment bank, stock analysts, journalists, management consultants, and the trained salespeople at a pharmaceutical company, and service-providing professionals like physicians.⁸⁵ These individuals are not engaged in goods manufacturing, rather they use specialized knowledge and a large degree of human capital to problem solve and promote elements of the knowledge economy. Their job is fuelled by a high level of human capital – both specific and general – and their value is in how they use that knowledge to engage

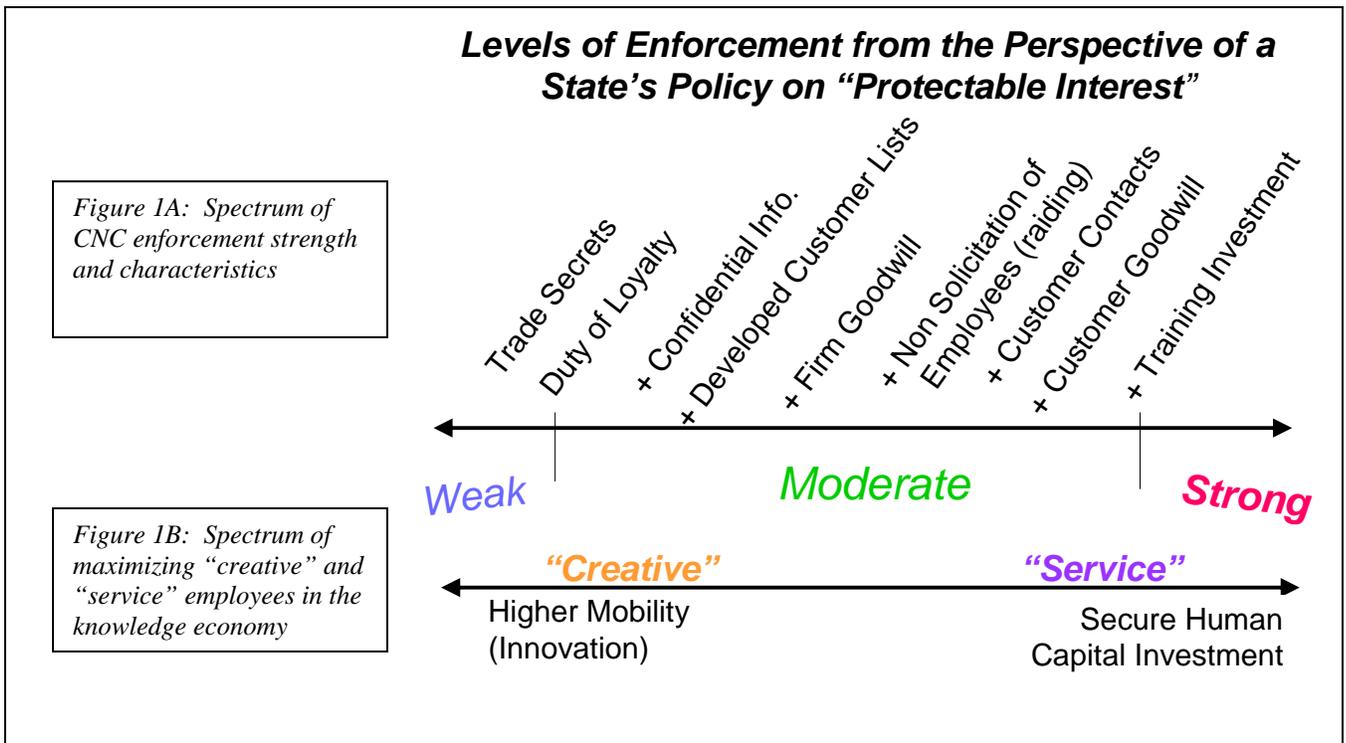
⁸⁵ Technically lawyers would fall into this theoretical category, however attorneys are exempted from restrictions on freedom of employment for ethical and public policy reasons, and sometimes specifically by state statute, from falling under CNC restrictions.

in valuable 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 II.

IV. Take the Best, Avoid the Rest: Reconciling Theories to Maximize Marginal Benefits for CNC Policy

The theories outlined above in Part II all argue from valid points of view. However, these arguments are, on their face, inconsistent. The next step is to draw on the theories of how covenants not to compete should ideally function and reconcile the drawbacks while accentuating the benefits. This portion of the paper argues that the benefits and efficiencies extolled by both ends of the spectrum can lead to models that lend themselves to effective graphic representation.

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 protectible 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 protectible interests. Figure 1B introduces the element of creative and service employees and illustrates where those types of workers and their implications for positive spillovers (either knowledge transfer or securing human capital investment) are related to different levels of enforcement.



The implication is that *on the margins* of the enforcement spectrum the opposing, yet positive externalities are maximized. If the law and economics approach and the employee mobility approaches are accepted as persuasive, the diagram shows how they are, at least in part, in conflict in terms of how they relate to varying levels of enforcement.

However, 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 the same under a state's policy framework.

The next diagram (figure 2) is a matrix representing the overlap of the two theories and the positive spillovers associated with each. As the theories are shown, 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. If the policy is reversed and noncompetes are not

enforced in a jurisdiction, the model results in a positive spillover of knowledge sharing and innovation for creative employees. However, in that instance there is a negative effect (inefficiency) with respect to general human capital investment in service workers, a priority for that group.

A Model for Maximizing Outcomes

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

Figure 2

Using these models as an analytical jumping off point it is possible to envision crafting a public policy that simply maximizes the spillovers possible from one group of workers or the other by taking an extreme stance on CNC enforcement. The other alternative which is argued for in this paper is to attempt to balance the results and maximize the marginal gains for both classes of workers. The next section discusses these options in detail and makes recommendations in light of the preferred policy outcome and the economic goals of hypothetical states.

V. 50 Ways to Leave Your Employer: What are the Public Policy Implications for States?

In a nutshell, there is no uniformity in the enforcement of post-employment non-competition agreements among states.⁸⁶ There are numerous standards for enforcing the agreements, in part or in whole, when there are reasonable and numerous standards for voiding them as against public policy, often because the terms are overbroad. This paper is not intended to categorize states one by one (nor could it without being many pages longer), rather this section will present recommendations for how states should evaluate their policy toward noncompetes in light of the models discussed above as they relate to a knowledge economy.

Ultimately the logical way for a state to most clearly lay out its chosen noncompete policy goals is to formalize them in a piece of legislation 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. A significant portion of the states do already have a CNC enforcement statute of general applicability (and others have specialized ones concerning various professions).⁸⁷ Specifically, 15 of the 50 states (30%) have enacted, to varying degrees, some sort of statute of general applicability to CNCs. *See* Figure 3, Appendix A.

Accepting that formalizing a noncompete policy and enforcement guidelines in a piece of legislation is a useful development, the first step is to determine how to approach the issue of what policy is most appropriate for a jurisdiction. The answer lies in the nature of a particular state's economic interests. This paper is concerned with how states should adapt their noncompete policies to the changing employee-employer relationship and the rising importance of a knowledge-based economy as the role of producing tangible goods becomes less important over time.⁸⁸ Thus this section's focus is on what factors a state should consider, based on its current needs and future goals when crafting its noncompete policy.

⁸⁶ 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, Bush and Hafen, *supra* note 43, at 408-17.

⁸⁷ *See generally*, Malsberger, *supra*, note 21. For a discussions of the states which 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* 3 (Fall 2003).

⁸⁸ Mandel, *supra* note 9.

A. Mobility Maximizing Public Policy

This approach would entail little or no noncompete enforcement and is most appropriate for a state primarily desiring 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 employer 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 high-tech firms like software microchip makers which benefit from high-velocity labor markets.⁸⁹

The downside is that this approach is not favored by employers and, as a result, would also induce a reduced amount of 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, those service-based enterprises for which the ability to hold confidential client relationships, sales information, and research is key to their continued success 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 for a competitor or to start a competing enterprise before the investment in human capital is recouped by the employer.⁹⁰ 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 is the policy of California's Business and Professions Code §16600 that is credited with creating the proper legal framework for Silicon Valley's so-called high-velocity labor market and the resulting technological innovation.⁹¹ 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, in part because so many extra legal factors are involved, and the drawbacks of disallowing CNCs might outweigh the benefits of a policy that encourages a potentially small

⁸⁹ See Hyde, *The Wealth of Shared Information*, *supra* note 24.

⁹⁰ Rubin and Shedd, *supra* note 27, at 96.

⁹¹ See HYDE, WORKING IN SILICON VALLEY, *supra* note 44.

economic driver, especially when the economy is in the initial stages of industry agglomeration.⁹²

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 – which require confidentiality and prefer a minimum of knowledge spillover to competitors. Strong enforcement would perhaps include extending protection specifically to training and client goodwill and contact. 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.

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.⁹³ 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 and other financial service industries located in the New York City area.

C. A Model Hybrid Jurisdiction

This state would maximize the marginal positive spillovers presented in Part IV. Specifically, it treats CNCs for workers in the knowledge-based economy differently depending on whether the worker is a service and creative employee. Notably, as it stands now this model state CNC policy does not exist.

Of the three models discussed in this part, this one is the most complicated to implement. While the previous two are attractive for their simplicity in choosing one extreme of the

⁹² See Gilson, *supra* note 19.

⁹³ Stone, *supra* note 16.

spectrum, this option attempts to maximize the benefits of the extremes by drawing distinctions within the labor market in a knowledge economy. To do so 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 way to draw such lines. While such line drawing within the labor market as a whole may be difficult, such an approach is not without precedent. Colorado's approach is to make covenants not to compete illegal – complete with criminal sanctions – except for certain permissible situations.⁹⁴ Those include exceptions 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 “Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.”⁹⁵ The later provision is essentially an attempt to allow selective noncompete enforcement for a segment of the labor force.

Similarly, a state following this hybrid model would draft a statute that, in the knowledge economy context, 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 confidential information and client relationships. The reverse would be true for creative knowledge employees where the statute would ban noncompete enforcement for that specific category.

Another feature of this model is that in its focus *on the nature* of the employee's work, and not simply the industry in which he or she is employed, it allows for a single firm to employ both knowledge-based creative and service workers. This policy would force an employer to choose which employees fall into one category or the other and 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, take general human capital with them, and innovate. Simultaneously, knowledge economy service workers and their

⁹⁴ Colo. Rev. Stat. 8-2-113 (2004).

⁹⁵ *Id.* at ¶¶C and D.

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.

V. Conclusion

One thing this paper should make obvious is that there is not a one-size-fits-all framework for how a state should develop its public policy concerning covenant not to compete enforcement. It should also make clear that there are challenges to producing a noncompete policy embodied in a statute intended to simply 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.

This leads to the conclusion that, in contrast, 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 A

(Source: Brian M. Malsberger ed., *Covenants Not To Compete, A State-By-State Survey* (2004); Kurt H. Decker, *Covenants Not to Compete* (2d. ed. 1993; Cum. Supp. 2004); and independent case and statute research.)

Figure 3

