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JOURNAL REPORTS: LEADERSHIP

Should Noncompete Clauses for Executives Be Legal?

Proponents say they reduce the risk that intellectual property will be expropriated. Opponents say they stifle innovation. The two sides square off.

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Many executives in the U.S. have noncompete clauses in their employment contracts that prevent them from working for a competitor or starting a competing business for a certain period after leaving their current employer.

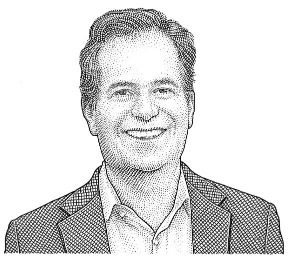
One study estimates that about 64% of executives employed in publicly listed companies in the U.S. are bound by such agreements. Whether such policies are good for the economy, however, is a matter of debate.

Proponents say noncompete agreements reduce the risk that trade secrets and other intellectual property will be expropriated by departing executives and provide greater incentives for companies to train and educate employees. Opponents say noncompetes prevent talent from being leveraged toward growth and progress, which hurts innovation. They also note that President Biden recently called for a ban or limits on noncompete agreements in a recent executive order.

Ted Sichelman, a professor of law and director of the Center for Intellectual Property Law & Markets at the University of San Diego, argues in favor of noncompetes. Orly Lobel, the Warren Distinguished Professor of Law at University of San Diego, makes the case against them.

YES: They protect a company's trade secrets

By Ted Sichelman



Imagine you're a partner at a venture-capital fund considering whether to invest in a startup—call it Alpha—that has developed proprietary, AI-based algorithms to predict market trends.

You discover that Alpha's chief executive officer isn't bound by a "covenant not to compete," a contractual clause that restricts employees from working at competitors for a limited time—usually one or two years—after they leave. How concerned should you be?

Your lawyer should tell you that even if the CEO is bound by a confidentiality agreement, the absence of a noncompete agreement would make it much easier for the CEO to move to a competitor and use Alpha's algorithms with few or no repercussions. Although Alpha could bring a trade-secret action against the CEO, these suits are usually difficult to win without a paper trail of evidence.

A noncompete, on the other hand, is relatively simple to enforce and eliminates the expense and uncertainty of litigation by virtually guaranteeing the CEO won't run off with Alpha's crown jewels. Indeed, about two-thirds of executives in public U.S. companies are bound by noncompetes.

Specifically, noncompetes significantly reduce the risk that trade secrets, other intellectual property and customer relationships will be expropriated by departing employees. They also provide greater incentives for companies to invest in training and educating employees, including executives, knowing that competitors will be precluded from easily free-riding off that specialized knowledge.

To be sure noncompetes often stem the flow of talent and information across companies, which can decrease overall productivity and output. Yet standard economic theory and traditional legal doctrine have always weighed noncompetes' costs against their benefits.

The loss of intellectual property, customer relationships and investments in training is usually more costly to companies than not being able to hire key executives away from competitors for a few years. That's partly because companies in most industries can hire highly qualified executives from firms that aren't direct competitors.

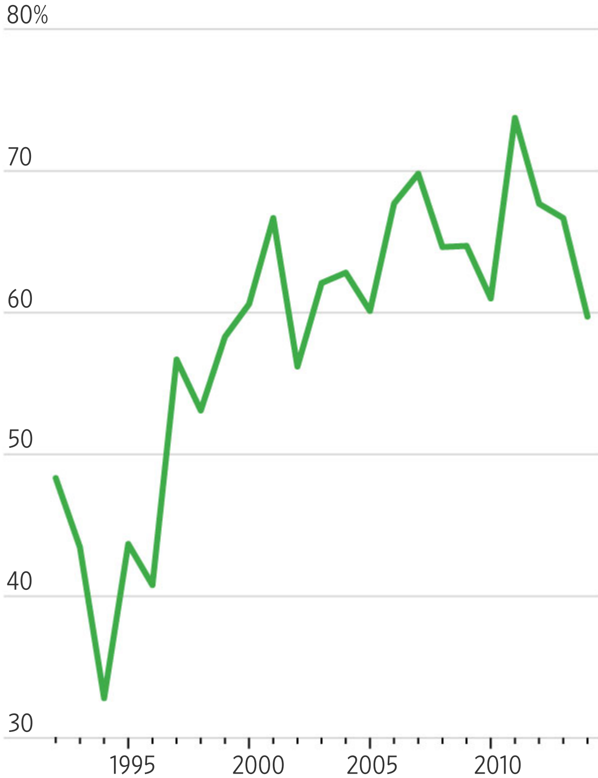
Additionally, there is reason to believe that noncompetes don't hinder job mobility as much as commonly believed. Studies indicate that companies regularly decline to enforce noncompetes against departing employees and even less against high-ranking corporate executives.

To boot, as Vanderbilt University Prof. Randall Thomas appositely states, "CEOs are not vulnerable rank-and-file workers forced to take on onerous contractual restrictions to earn a living."

Noncompetes Grow

While the percentages have varied from year to year, the average use of noncompete agreements for new CEOs crept higher from the early 1990s to 2014

Percentage of new CEOs with noncompete agreements



Sources: Omesh Kini, Georgia State University; Ryan Williams, University of Arizona; David Yin, Miami University; based on company filings with the Securities and Exchange Commission

In an article published in the University of Chicago Law Review last year, Jonathan Barnett, a professor at the University of Southern California's Gould School of Law, and I show that widely cited studies purporting to show that restricting noncompetes would be beneficial are flawed in numerous ways, invariably as a result of misunderstanding the applicable law. Similarly, we argue that the claim that Silicon Valley rose to prominence because of California's supposed ban on the enforcement of noncompetes—which actually wasn't the case at the time of the rise of Silicon Valley because there were multiple exceptions—ignores a host of more salient factors, such as the availability of venture capital, a focus on more general-purpose hardware and software, warm weather and even luck. Finally, we note that the best evidence shows that noncompetes—when presented to job candidates before they accept offers—tend to raise wages because candidates typically demand compensation in return for signing them.

In general, we found that there isn't a single, valid study demonstrating that noncompetes—when subject to sensible legal limits—are detrimental for the economy on balance. In fact, many policymakers have neglected conflicting empirical studies showing the benefits of noncompetes.

In sum, noncompetes raise offsetting costs and benefits for the innovation economy. The common law's age-old approach to noncompete agreements—enforcing them only so long as they are reasonable in duration, scope and geography—rightly balances the positive and negative effects of such clauses and is consistent with our best understanding of noncompetes' impact as a matter of theory and evidence.

In contrast, simply abolishing noncompetes altogether in this country, as some advocate, would very likely diminish investment and productivity precisely in those worthwhile economic and innovative activities the U.S. has taken so long to cultivate—an unwise policy to say the least.

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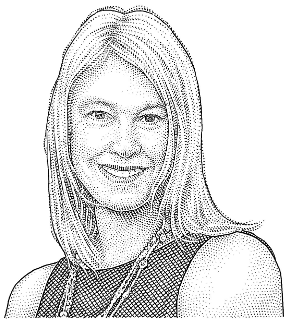
NO: They reduce wages and job mobility

By Orly Lobel

A healthy U.S. economy depends on talent mobility and flexibility. Competitive job markets not only boost wages and workplace equality, they help spur innovation



and entrepreneurship. Competition over talent keeps employees motivated to take their creative energies where they are most useful.

A ban on the use of noncompete clauses in employment contracts—for both executives and lower-level workers—would help foster competitive job markets in the U.S., clearing the way for talent to flow toward growth and progress.

There is ample empirical evidence that noncompetes decrease both wages and the ability of workers to change jobs. After Hawaii passed a law in 2015 banning noncompetes in the high-tech industry, new-hire salaries in the sector increased by 4% and job mobility rose 11%. Similar findings on how noncompetes reduce mobility have been found when studying both executives and highly skilled employees who hold patents.

For women and minorities, the harm of noncompetes is amplified. By decreasing outside offers and the ability of female and minority executives to improve their salary through recruitment and retention offers, noncompete policies help maintain existing pay gaps. In some cases, noncompetes could even dissuade victims of sexual harassment or discrimination from reporting abuse out of fear they won't be able to take their talents elsewhere.

What has been less understood in the public debate over noncompetes is how they harm entrepreneurship and innovation.

Enforcement of noncompetes favors incumbent firms by making it harder for startups to recruit experienced executives. Markets, in turn, become more concentrated. There are cases where a new employer can negotiate the release of an executive from a previous employer's noncompete. But more often, established companies with ample resources can use noncompete litigation strategically, chilling movement of talent to startups that lack the resources to contest noncompetes in court.

SHARE YOUR THOUGHTS

Should the U.S. restrict noncompete agreements for high-wage workers? Why or why not? Join the conversation below.

In terms of the economy, the benefits of a competitive labor market outweigh the risks of losing intellectual property, as evidenced by the innovation coming out of Silicon Valley.

California Business & Professions Code section 16600, which bans any contract that restrains a person from engaging in a profession, trade or business, has been in place since 1872, and California courts have been steadfast in upholding it, deeming noncompetes between employers and employees void. Nevertheless, Silicon Valley has some of the highest per-capita patenting activity, startups and venture-capital investment, and has experienced more high-skill job growth than other regions of the country. In Southern California, the bustling industries of biotech and pharmaceuticals, alongside Hollywood's entertainment and music industries, prove that this is also true in other sectors, as well. California shows that intellectual-property laws—including patent, copyright, trademark, nondisclosure agreements and trade-secrecy litigation—offer sufficiently strong protections and incentives to protect innovation without the high costs of locking up valuable talent. Noncompete agreements, like other antitrust agreements, are meant to do as they say—prevent competition.

There may be rare cases when both employer and employee benefit from a noncompete, but public policy is about what is best for an economy overall. And new research studying the macro impact of noncompetes finds that even for executives, the optimal policy is a ban on noncompete agreements.

In January, Stanford Law Prof. Mark Lemley and I wrote a report for the Day One Project, outlining why the U.S. needs a tough, consistent federal strategy to eliminate noncompetes, which are now regulated at the state level. Subsequently, President Biden issued an executive order on promoting competition in the American economy, and the first item of action is a call to ban or limit noncompetes.

While some proposals on prohibiting noncompete policies have focused on the lower-skilled labor market, these efforts miss the bigger picture. The reason to ban noncompetes isn't simply to protect the ability of low-income workers to make a living in low-skill jobs. Rather, a ban on noncompetes is designed to enrich the talent pool at all levels of the labor market and to fuel healthy competition for skilled, as well as unskilled, talent.

A ban on noncompetes therefore should be understood as innovation policy. When noncompetes are pervasively used, they slow down mobility of entire markets, and the negative effect on wages spills over to entire industries, even across state lines.

Prof. Lobel is the Warren Distinguished Professor of Law at University of San Diego and the author of books including "Talent Wants to Be Free" and "You Don't Own Me." She can be reached atreports@wsj.com.