

2015

Desirable Restraint: Freeing Employers and Employees from the Blankey Prohibition of California Business and Professions Code Section 16600

Jeremy Talcott

Chapman University, Fowler School of Law

Follow this and additional works at: <http://digitalcommons.chapman.edu/chapman-law-review>

 Part of the [Law Commons](#)

Recommended Citation

Jeremy Talcott, *Desirable Restraint: Freeing Employers and Employees from the Blankey Prohibition of California Business and Professions Code Section 16600*, 19 CHAP. L. REV. 333 (2016).

Available at: <http://digitalcommons.chapman.edu/chapman-law-review/vol19/iss1/11>

This Article is brought to you for free and open access by the Fowler School of Law at Chapman University Digital Commons. It has been accepted for inclusion in Chapman Law Review by an authorized editor of Chapman University Digital Commons. For more information, please contact laughtin@chapman.edu.

Desirable Restraint: Freeing Employers and Employees from the Blanket Prohibition of California Business and Professions Code Section 16600

*Jeremy Talcott**

INTRODUCTION

In California, the conventional wisdom has been essentially settled for over fifteen years. As first hypothesized by AnnaLee Saxenian, the success of Silicon Valley—and relative decline of Route 128—is due to the “culture of mobility” present in Silicon Valley, leading to a “high velocity labor market” and “knowledge spillovers,” as compared to the more traditional, vertically-integrated structure and long-term employment found in Route 128 businesses.¹ Ronald Gilson later attributed that “culture of mobility” to California Business and Professions Code section 16600, which has been read as a near-total ban on covenants not to compete.² However, new research suggests that the time is right to revisit this assumption, and to consider a legislative relaxation of section 16600.

Whether by deliberate intent of the drafter, mere oversight, or by its later strict judicial interpretation, section 16600 establishes California as the state with the least legal enforcement of covenants not to compete.³ Although most other jurisdictions have long provided some enforcement of covenants not to compete, using variations on the English “rule of reason” as a limiting factor, California has adopted a broad public policy against any restraints on the ability of citizens to engage in trade, and the ban on enforcement is almost total.⁴

* J.D., Chapman University Fowler School of Law, May 2016. I wish to thank Professor Tom W. Bell for his guidance with this Comment.

¹ 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, 608–09 (1999); see also ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994).

² Gilson, *supra* note 1.

³ See generally Sheri Wardwell, *Invalidity of Covenants Not to Compete in California Affects Employers Nationwide*, 5 SHIDLER J.L. COM. & TECH. 22 (2009).

⁴ The exceptions are the sale of goodwill of a business and any covenant involving the sale or dissolution of a corporation, partnership, or limited liability company. CAL.

The arguments for and against enforcement of covenants not to compete have presented problems for courts for more than 500 years.⁵ Employers—and, in some cases, employees—have many reasons to desire post-employment restrictions such as covenants not to compete. Covenants not to compete are generally seen as the most effective means of preventing the loss of trade information to a direct competitor.⁶ Further, these protections are thought to promote more efficient operation internally within businesses.⁷ Finally, post-employment restrictions may stimulate internal research and improvement, rather than “employee poaching” with the goal of accumulating competitors’ intellectual property.⁸

Covenants not to compete are often criticized, however, as “contracts of adhesion rising out of the perceived inequality in bargaining power between employers and employees.”⁹ Covenants not to compete also limit the economic mobility of employees, and restrict their ability to work within their chosen field.¹⁰ Allowing employees to leave and form their own similar businesses can lead to increased competition within a field.¹¹ Encouraging the flow of information and ideas among businesses may also improve efficiency across multiple competitors in an industry by limiting duplicative research and development among similar competitors.¹² Covenants not to compete can also restrict employers from hiring the most qualified employees, potentially limiting—or even preventing—human capital from reaching its most effective or efficient use.¹³

In arguing for the benefits of section 16600 with regards to Silicon Valley, Ronald Gilson contends that section 16600 has corrected the failure of the market to reach the most economically rational solution in economic development communities.¹⁴ If the benefit of the “knowledge spillovers” gained from employees hired away from competitors creates a net

BUS. & PROF. CODE § 16601 (West 2015). Agreements preventing the use of trade secrets are also enforceable, so long as they do “not restrain [a party] from engaging in a lawful profession, trade or business within the meaning of section 16600 of the Business and Professions Code.” *Gordon v. Landau*, 321 P.2d 456, 459 (Cal. 1958).

⁵ See Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 626 (1960).

⁶ *Id.* at 627.

⁷ *Id.*

⁸ See Norman D. Bishara et al., *An Empirical Analysis of Noncompetition Clauses and Other Restrictive Postemployment Covenants*, 68 VAND. L. REV. 1, 37 (2015).

⁹ *Id.* at 6.

¹⁰ Blake, *supra* note 5, at 627.

¹¹ See *id.*

¹² See *id.*

¹³ See *id.*

¹⁴ See Gilson, *supra* note 1.

positive benefit for the company when compared to the value of the intellectual property similarly lost to competitors, then section 16600 has forced the most economically rational position onto the community, even if that position is contrary to the desire of each individual company to protect its intellectual property and any associated market advantage over competitors.¹⁵

There are, of course, other associated costs to be weighed, consistent with Bastiat's idea of the "seen and the unseen."¹⁶ Even if the costs and benefits are roughly balanced, it is important to note that section 16600 has one further cost—a significant reduction in both employer and employee freedom to contract. California will not enforce a voluntarily entered restriction on one's employment, creating a restriction on the ability of employees to knowingly bargain for a covenant not to compete with their employers—and receive consideration accordingly—whether in terms of increased compensation or firm-sponsored training.

Courts have long looked critically at covenants not to compete, finding that often there was unequal bargaining power, and as such, the covenant was not truly bargained for.¹⁷ Most jurisdictions have adopted some variation of the English "rule of reason," requiring the restraint to be "both reasonable in scope and necessary to protect a legitimate interest of the employer."¹⁸ Unfortunately, the inconsistent interpretation of what is a "reasonable" restraint on trade has left the law of covenants not to compete in a "state of near chaos."¹⁹ Accordingly, some commentators in other jurisdictions have suggested similar prohibitions to California as the only means to protect employees while maintaining consistency and predictability.²⁰

This Comment proposes that California should consider creating an additional exception to section 16600 for covenants voluntarily entered into, but allowing only legal—not equitable—remedies. Rather than subjecting California to the "chaos" of the "rule of reason," California should enforce covenants not to compete—so long as they were knowingly bargained for—by

¹⁵ *Id.* at 609.

¹⁶ See generally FRÉDÉRIC BASTIAT, *What Is Seen and What Is Not Seen*, in *SELECTED ESSAYS ON POLITICAL ECONOMY* (1995). See *infra* Part III.

¹⁷ Blake, *supra* note 5, at 647–48.

¹⁸ Rachel Arnow-Richman, *Noncompetes, Human Capital, and Contract Formation: What Employment Law Can Learn from Family Law*, 10 *TEX. WESLEYAN L. REV.* 155, 156 (2003).

¹⁹ *Id.* at 155; see also *Arthur Murray Dance Studios of Cleveland v. Witter*, 105 N.E.2d 685, 687 (Ohio Ct. Com. Pl. 1952) ("[Noncompete law] is a sea—vast and vacillating, overlapping and bewildering. One can fish out of it any kind of strange support for anything, if he lives so long.")

²⁰ Arnow-Richman, *supra* note 18, at 169.

applying a “formation analysis” to all such agreements to look for assent and unconscionability.²¹ By also legislating that all such contracts shall remain renegotiable and limiting remedies to only legal damages, California can prevent the total restraint of trade by allowing the employee—or interested potential employers—to “buy out” the covenant from the previous employer.

The time has never been better to call into question the myriad ways that California is overly restrictive of employers under the guise of protecting the rights of employees (of which the interpretation of section 16600 is but one) as California has found growth lagging behind that of other states. Indeed, in 2013, California lost its position as the number one state-exporter of technology, falling behind Texas.²² The technology industry is critical to California’s economy as the single largest category of state exports, accounting for 27.7% of exports during 2012.²³ In 2014, that percentage declined to 24.5%.²⁴

Relaxing the ban on covenants not to compete in California would benefit employers through increased protection of intellectual property and internal efficiency, and would benefit employees through increased firm investment in human capital—such as firm-sponsored training. Employers would be assured the benefit of their investment, either through matching employee offers or from receiving legal damages for the value of the information the employee will be taking. Both parties—and, therefore, the State of California as a whole—would benefit from increased liberty. However, California would retain the certainty of a black-letter prohibition, with limited and enumerated statutory exceptions.

I. THE HISTORY OF CALIFORNIA BUSINESS AND PROFESSIONS CODE SECTION 16600

California’s Business and Professions Code section 16600 has its origins in the work of David Dudley Field, drafter of the New York “Field Code” of civil procedure. New York’s Constitution of 1846 called for a code commission “to reduce into a written and systematic code the whole body of the law of this state, or so

²¹ A similar solution was suggested as a reform for Texas by Rachel Arnow-Richman. *Id.* at 165.

²² Press Release, TechAmerica Foundation, California is Second Largest Tech Exporting State (Feb. 11, 2014), http://s3.amazonaws.com/siteninja/site-ninja1-com/1407957293/original/California_Is_Second_Largest_Tech_Exporting_State.pdf [<http://perma.cc/AWU4-5LW2>].

²³ *Id.*

²⁴ *Trade Statistics*, CAL. CHAMBER COM., <http://www.calchamber.com/international/trade/pages/tradestatistics.aspx> [<http://perma.cc/ERV2-3JR7>].

much and such parts thereof as to the said commissioners shall seem practicable and expedient.”²⁵ After Field’s code was adopted by New York in 1848, Field was appointed to the Code Commission in 1857.²⁶ Along with William Curtiss Noyes and Alexander Bradford, Field drafted a political code, a penal code, and a civil code.²⁷ Although Field published the final draft of his civil code in 1865, it was never enacted in New York.²⁸

Field’s draft codes were attractive to the newly admitted states in the West, especially California. The “chaotic legal environment” of California—where the common law of England had been adopted to replace pre-statehood Spanish and Mexican law, while nonetheless preserving elements of the Mexican land grant system, as well as federal exceptions from the Treaty of Guadalupe Hidalgo—had limited the Legislature’s ability to abolish and repeal all prior law in California.²⁹ Consequently, codification was urged by a series of California Governors throughout the 1860s.³⁰ In 1868, a first effort was made by appointing a commission to “revise and compile” the laws of the State of California.³¹ When its report was submitted in 1870, it included a recommendation to abolish the grand jury system.³² Seemingly uncomfortable with the recommendation, the California Legislature chose to allow the first commission to dissolve, instead creating a new commission empowered to use or discard any work previously accomplished.³³ This second commission was appointed in 1870, and fairly quickly chose to adopt Field’s New York draft codes almost in full, with changes made where necessary to adapt it to previous California legislation.³⁴ The Civil Code was enacted (along with the Penal Code, Political Code, and Code of Civil Procedure) in 1872.³⁵ In 1873, a commission was selected to review the codes, and amendments were proposed where the codes were found to conflict with previously settled California law.³⁶ Interestingly,

²⁵ See CHARLES M. COOK, *THE AMERICAN CODIFICATION MOVEMENT: A STUDY OF ANTEBELLUM LEGAL REFORM* 190 (1981) (quoting N.Y. CONST. art. I, § 17 (1846)).

²⁶ *Id.* at 191.

²⁷ See Mildred V. Coe & Lewis W. Morse, *Chronology of the Development of the David Dudley Field Code*, 27 CORNELL L.Q. 238, 243–45 (1942).

²⁸ See Mathias Reimann, *The Historical School Against Codification: Savigny, Carter, and the Defeat of the New York Civil Code*, 37 AM. J. COMP. L. 95, 100–01 (1989).

²⁹ Gilson, *supra* note 1, at 615–16.

³⁰ *Id.* at 615.

³¹ Rosamond Parma, *The History of the Adoption of the Codes of California*, 22 L. LIBR. J. 8, 14 (1929).

³² *Id.*

³³ *Id.* at 15.

³⁴ *Id.* at 18.

³⁵ *Id.* at 19.

³⁶ *Id.* at 15–17.

the commission included Stephen J. Field, brother of David Dudley Field and an Associate Justice of the United States Supreme Court.³⁷

Regardless of David Dudley Field's true intent while writing his New York draft codes, it seems clear that California's intent and understanding upon adopting them was that they did not significantly alter the common law, but instead codified it and made it accessible to the general public.³⁸ According to the Commission:

The primary object of its chief author and advocate, David Dudley Field, was to restate in systematic and accessible form the common law as it has been modified to suit American conditions, to settle questions upon which disputes had arisen and to introduce such reforms as might seem necessary to make the legal system harmonious and free from anachronism.³⁹

Even if David Dudley Field had intended to make significant alterations to the common law, it is not clear that the California Code Commission would have then had the authority to adopt those significant changes. As was also noted by the Commission itself: "It must be borne in mind that *this Act does not provide for the adoption of any new system of law, but simply reenacts the existing law*, with some few modifications, amendments, and additions."⁴⁰

Section 1673 in the 1872 California Civil Code copied verbatim the language of section 882 of Field's draft New York Civil Code. The section read as follows:

Section 1673. Every contract by which any one is restrained from exercising a lawful profession, trade, or business of any kind, otherwise than is provided by the next two sections, is to that extent void.⁴¹

Those two exceptions, which had previously been sections 884 and 885 of Field's draft New York Civil Code, provided the following:

Section 1674. One who sells the good will of a business may agree with the buyer to refrain from carrying on a similar business within a specified county, city, or a part thereof, so long as the buyer, or any person deriving title to the good will from him, carries on a like business therein.⁴²

³⁷ *Id.* at 17.

³⁸ *Id.*

³⁹ Maurice E. Harrison, *The First Half-Century of the California Civil Code*, 10 CAL. L. REV. 185, 186 (1922).

⁴⁰ W.W. Pendegast et al., *First Report of the Joint Committee to Examine the Codes*, in CALIFORNIA CODE COMMISSION, REPORTS 1868-1874 (1907) (emphasis in original).

⁴¹ CAL. CIV. CODE § 1673 (1872) (current version at CAL. BUS. & PROF. CODE § 16600).

⁴² *Id.* § 1674.

Section 1675. Partners may, upon or in anticipation of a dissolution of the partnership, agree that none of them will carry on a similar business within the same city or town where the partnership business has been transacted, or within a specified part thereof.⁴³

At the time that Field wrote the draft code, the courts in England and most states applied the rule of reason to contractual restrictions on the conduct of a trade or business.⁴⁴ In America, however, from very early on there was heavier emphasis placed on the protection of the employee.⁴⁵ Nonetheless, American courts generally did not apply a per se rule of invalidity on post-employment restraints.⁴⁶ The comment to section 833 of the draft New York Civil Code noted that “contracts in restraint of trade have been allowed, by modern decisions, to a very dangerous extent.”⁴⁷ However, the two cases referred to within that comment both involved noncompetition covenants associated with the sale of a business.⁴⁸ It is impossible to know if Field intended these sections to function as a complete ban on post-employment covenants not to compete.⁴⁹ These sections did not appear in the preliminary draft of the New York Civil Code, and were added sometime late in the process.⁵⁰ The comments to Field’s draft New York Civil Code, the California Code Commissioner’s 1871 draft, and the 1872 official California Civil Code make no mention of post-employment covenants not to compete.⁵¹ These codes would eventually be moved to the California Business and Professions Code when it was adopted in 1937, where they were relabeled sections 16600 and 16601.

Whether it was intended or not, California courts subsequently read section 16600 as broadly as it is written.⁵² Though the earliest cases only discussed anticompetitive arrangements between businesses, by the 1930s, California courts began using the statute to void employment agreements and similar contracts that sought to restrict former employees from using knowledge gained while employed or engaging in

⁴³ *Id.* § 1675.

⁴⁴ Blake, *supra* note 5, at 643.

⁴⁵ *Id.* at 643–44.

⁴⁶ *See generally* Blake, *supra* note 5.

⁴⁷ COMM’RS OF THE CODE, THE CIVIL CODE OF THE STATE OF NEW YORK 255, at § 833 (1865).

⁴⁸ *See id.* (citing *Dunlop v. Gregory*, 10 N.Y. 241 (1851) and *Whittaker v. Howe*, 49 Eng. Rep. 150 (M.R. 1841)).

⁴⁹ Gilson, *supra* note 1, at 617–18.

⁵⁰ *Id.* at 618.

⁵¹ *Id.* at 618–19.

⁵² *See* Tait Graves, *Nonpublic Information and California Tort Law: A Proposal for Harmonizing California’s Employee Mobility and Intellectual Property Regimes Under the Uniform Trade Secrets Act*, UCLA J.L. & TECH. 1, 11 (2006).

competitive business.⁵³ It has since become the stated strong policy of California courts to disfavor any restraints on trade.⁵⁴ Accordingly, covenants not to compete in employment agreements are per se illegal unless a clear statutory exception exists.⁵⁵

The public policy aims regularly cited by California courts are the protection of both California citizens' right to pursue "the profession, trade or business of his or her choosing," as well as the "employer's ability to compete for skilled employees."⁵⁶ California's reading comports with the words of the statute, and it seems almost certain that any change to the interpretation of section 16600 will have to be made legislatively.⁵⁷

The vast majority of states, however, enforce covenants not to compete so long as such restraints are reasonable.⁵⁸ Even

⁵³ *Id.* at 6.

⁵⁴ See *Tiedje v. Aluminum Taper Milling Co.*, 296 P.2d 554, 556 (Cal. 1956) (holding that any agreement contrary to public policy or the express meaning of a statute cannot serve as the foundation for any action in California).

⁵⁵ See *Edwards v. Arthur Andersen LLP*, 189 P.3d 285, 297 (Cal. 2008).

⁵⁶ *Wardwell*, *supra* note 3, at ¶ 4.

⁵⁷ *Arthur Andersen LLP*, 189 P.3d at 293 ("[We] leave it to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to the prohibition-against-restraint rule under section 16600.").

⁵⁸ *Wardwell*, *supra* note 3, at ¶ 1 n.2 (listing states that apply some version of the common law "rule of reason" as follows: "Alaska (*Data Mgmt., Inc. v. Green*, 757 P.2d 62, 65 (Alaska 1988)); Arizona (*Am. Credit Bureau, Inc. v. Carter*, 462 P.2d 838, 840 (Ariz. Ct. App. 1969)); Arkansas (*Dawson v. Temps Plus, Inc.*, 987 S.W.2d 722, 727 (Ark. 1999)); Connecticut (*Van Dyck Printing Co. v. DiNicola*, 648 A.2d 898, 902 (Conn. Super. Ct. 1993)); Delaware (*Faw, Casson & Co. v. Cranston*, 375 A.2d 463, 467 (Del. Ch. 1977)); District of Columbia (*Ellis v. James V. Hurson Assocs.*, 565 A.2d 615, 617 (D.C. Cir. 1989)); Florida (FLA. STAT. § 542.335); Georgia (*Sysco Food Servs. of Atlanta, Inc. v. Chupp*, 484 S.E.2d 323, 325 (Ga. Ct. App. 1997). *But see* Ga. Const. Art. III, Sec. VI, Par. V(c)). See Hawaii (*Technicolor, Inc. v. Traeger*, 551 P.2d 163 (Haw. 1976); see also *The 7's Enters., Inc. v. Del Rosario*, 143 P.3d 23, 36 (Haw. 2006)); Idaho (*Dick v. Geist*, 693 P.2d 1133, 1135 (Idaho Ct. App. 1985)); Illinois (*Lawrence & Allen, Inc. v. Cambridge Human Res. Group, Inc.*, 685 N.E.2d 434, 441 (Ill. App. Ct. 1997)); Indiana (*Norlund v. Faust*, 675 N.E.2d 1142, 1153 (Ind. Ct. App. 1997)); Iowa (*Revere Transducers, Inc. v. Deere & Co.*, 595 N.W.2d 751, 762 (Iowa 1999)); Kansas (*Weber v. Tillman*, 913 P.2d 84, 89 (Kan. 1996)); Kentucky (*Hall v. Willard & Woolsey, P.S.C.*, 471 S.W.2d 316, 317 (Ky.1971)); Maine (*Brignull v. Albert*, 666 A.2d 82, 84 (Me. 1995)); Maryland (*Ecology Servs., Inc. v. Clym Env't Servs., LLC*, 952 A.2d 999, 1007 (Md. Ct. Spec. App. 2008)); Massachusetts (*Boulangier v. Dunkin' Donuts Inc.*, 815 N.E.2d 572, 577 (Mass. 2004)); Michigan (*St. Clair Medical, P.C. v. Borgiel*, 715 N.W.2d 914, 918-19 (Mich. Ct. App. 2006)); Minnesota (*Dynamic Air, Inc. v. Bloch*, 502 N.W.2d 796, 799 (Minn. Ct. App. 1993)); Mississippi (*Empiregas, Inc. of Kosciusko v. Bain*, 599 So.2d 971, 975 (Miss. 1992)); Missouri (*Cont'l Research Corp. v. Scholz*, 595 S.W.2d 396, 400 (Mo. Ct. App. 1980)); Nebraska (*Chambers-Dobson, Inc. v. Squier*, 472 N.W.2d 391, 397 (Neb. 1991)); Nevada (*Camco, Inc. v. Baker*, 936 P.2d 829, 833 (Nev. 1997)); New Hampshire (*Smith, Batchelder & Rugg v. Foster*, 406 A.2d 1310, 1312 (N.H. 1979)); New Jersey (*Solari Indus. v. Malady*, 264 A.2d 53, 57 (N.J. 1970)); New Mexico (*Lovelace Clinic v. Murphy*, 417 P.2d 450, 453-54 (N.M. 1966)); New York (*Morris v. Schroder Capital Mgmt. Int'l*, 7 N.Y.3d 616, 620 (N.Y. 2006)); North Carolina (*Chemimetals Processing, Inc. v. McEneny*, 476 S.E.2d 374, 376 (N.C. Ct. App. 1996)); Ohio (*Raimonde v. Van Vlerah*, 325 N.E.2d 544, 546-47 (Ohio 1975)); Pennsylvania (*Hess v. Gebhard & Co.*, 808 A.2d 912, 920 (Pa. 2002)); Rhode Island

states that adopted civil codes similarly based on Field's draft code—and containing identical language—have instead interpreted their statutes to enact the common law ban on “unreasonable” covenants.⁵⁹ While California's reading of the language admittedly seems more correct, the case law appears to support the idea that most jurisdictions find value in at least some enforcement of covenants not to compete. It is worth considering, then, whether the near-total ban on covenants not to compete has served as a net benefit to California employees and employers, or if some enforcement of these types of post-employment restrictions might lead to a more economically beneficial outcome.

II. PREVIOUS RESEARCH OF SILICON VALLEY AND SECTION 16600

In her book *Regional Advantage: Culture and Competition in Silicon Valley and Route 128*, AnnaLee Saxenian famously attributed the success of Silicon Valley—and relative decline of Route 128—to the “culture of mobility” present in Silicon Valley, leading to a “high velocity labor market” and “knowledge spillovers,” as compared to the more traditional, vertically-integrated structure and long-term employment found in Route 128 businesses.⁶⁰ Silicon Valley had a “regional network-based industrial system that promotes collective learning and flexible adjustment [due to its] dense social networks and open labor markets”⁶¹

In his 1999 article *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, Ronald Gilson undertook to explain the differing business cultures of Silicon Valley and Route 128 near Boston.⁶² Gilson contended that section 16600 directly led to the optimal collective economic strategy in Silicon Valley, overcoming the desire of each individual firm to act in their own

(Durapin, Inc. v. Am. Prods, Inc., 559 A.2d 1051, 1053 (R.I. 1989)); South Carolina (Cafe Assocs., Ltd. v. Gerngross, 406 S.E.2d 162, 164 (S.C. 1991)); Tennessee (Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 644 (Tenn. Ct. App. 1999)); Texas (Tex. Bus. & Com. Code §§15.50-.52 (2001)); Utah (Kasco Servs. Corp. v. Benson, 831 P.2d 86, 95 (Utah 1992)); Vermont (Roy's Orthopedic, Inc. v. Lavigne, 454 A.2d 1242, 1244 (Vt. 1982)); Virginia (New River Media Group, Inc. v. Knighton, 429 S.E.2d 25, 26 (Va. 1993)); Washington (Knight, Vale & Gregory v. McDaniel, 680 P.2d 448, 451-52 (Wash Ct. App. 1984)); West Virginia (Reddy v. Cmty. Health Found. of Man, 298 S.E.2d 906, 915 (W. Va. 1982)); Wisconsin (WIS. STAT. ANN. § 103.465 (2009)); Wyoming (Hopper v. All Pet Animal Clinic, Inc., 861 P.2d 531, 543 (Wyo. 1993))”); see also BRIAN M. MALSBERGER, COVENANTS NOT TO COMPETE: A STATE-BY-STATE SURVEY (5th ed. 2006).

⁵⁹ See Wardwell, *supra* note 3, at ¶ 1 n.4 (noting that Montana and Oklahoma have both interpreted nearly identical statutes as adopting the common law rule of reason).

⁶⁰ Gilson, *supra* note 1, at 579.

⁶¹ SAXENIAN, *supra* note 1, at 2.

⁶² Gilson, *supra* note 1, at 593–94.

self-interest by benefitting from the knowledge spillover of other firms while restricting any knowledge lost through mobility of their own employees.⁶³

Fundamental to Gilson's argument is the idea that high-velocity employment creates an ecosystem in which the per-firm benefit of innovation and growth will exceed the per-firm cost of intellectual property dilution caused by the inability to retain employees.⁶⁴ However, even Gilson admits that a blanket prohibition may only be beneficial to particular industries, and discourage innovation and investment in others.⁶⁵

As noted above, California remains relatively unique in its almost complete prohibition on post-employment covenants not to compete.⁶⁶ Other jurisdictions appear hesitant to adopt a similar strategy with regards to post-employment covenants not to compete in the hope of replicating the success of Silicon Valley. It is possible that even very large costs incurred by Silicon Valley companies through intellectual property dilution have so far been outweighed by other regional advantages.⁶⁷ Indeed, there were many other factors that led to the growth of Silicon Valley, such as government investment, partnerships with universities, and the culture of the region.⁶⁸ Additionally, the sheer size of the agglomeration economy that formed in Silicon Valley may be difficult to replicate elsewhere, allowing it to retain an advantage in attracting investment.⁶⁹ In *Working in Silicon Valley*, Alan Hyde called it "hardly plausible" that section 16600 could have been enough to explain the success of Silicon Valley over Route 128.⁷⁰

III. UNINTENDED EFFECTS OF SECTION 16600 ON BUSINESS AND EMPLOYEE TRAINING

The competing values involved in enforcing covenants not to compete (as with all the common law "restraints of trade") have long been debated.⁷¹ For employers, covenants not to compete represent what is perhaps the most effective method of protecting valuable trade information and consumer relationships from

⁶³ *Id.* at 596.

⁶⁴ *Id.* at 609.

⁶⁵ *See id.* at 627.

⁶⁶ *See supra* Part I.

⁶⁷ *See* Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment*, 27 BERKELEY J. EMP. & LAB. L. 287, 309 (2006).

⁶⁸ *See* ALAN HYDE, *WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET* 33 (2003).

⁶⁹ Bishara, *supra* note 67.

⁷⁰ HYDE, *supra* note 68.

⁷¹ Blake, *supra* note 5.

being easily appropriated by competitors.⁷² This protection provides incentives to improve internal operations and stimulate research, and allows companies to “achieve the degree of freedom of communication” that leads to the highest internal efficiency.⁷³ On the other hand, covenants not to compete reduce employee mobility and freedom to pursue a chosen trade.⁷⁴ Much of the evolution surrounding covenants not to compete has reflected the evolution in industrial technology and business methods, as well as the “ebb and flow of such social values as freedom of contract, personal economic freedom, and business ethics.”⁷⁵

In the absence of a post-employment covenant not to compete, employees are likely to take their knowledge to competing firms in the same industry.⁷⁶ Conversely, employers are more likely to hire away employees from other firms, seeking the knowledge that they will inevitably bring, as opposed to investing in research and development.⁷⁷ Accordingly, firms in California are forced to turn to other methods to protect their intellectual property. Although trade secret laws exist, they are often insufficient to prevent the dilution of intellectual property.⁷⁸ Gilson himself recognizes that the Uniform Trade Secrets Act (UTSA)—which has been adopted by forty-seven states, including California—provides “less effective protection than may at first appear.”⁷⁹ Under the UTSA, litigants are required to establish imprecise distinctions between “trade secrets” and “tacit knowledge,” resulting in litigation that is likely to be expensive and slow, and unlikely to be resolved by summary judgment.⁸⁰ Indeed, this difficulty in enforcing trade secret protection may also explain why many California firms have simply adopted a policy of foregoing legal challenges under trade secret law when employees leave.⁸¹

The relative ineffectiveness of enforcing trade secret law in California only compounds the issue of internal firm inefficiency caused by the inability to enforce post-employment covenants not to compete.⁸² For example, it has been said that “Apple [is] one of

⁷² *Id.* at 627.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* at 626–27.

⁷⁶ *Id.* at 626.

⁷⁷ Bishara, *supra* note 67, at 310.

⁷⁸ See Yuval Feldman, *Experimental Approach to the Study of Normative Failures: Divulging of Trade Secrets by Silicon Valley Employees*, 2003 U. ILL. J.L. TECH. & POL’Y 105, 110–11 (2003).

⁷⁹ Gilson, *supra* note 1, at 597; see also CAL. CIV. CODE §§ 3426–3426.11 (West 2015).

⁸⁰ Gilson, *supra* note 1, at 599.

⁸¹ HYDE, *supra* note 68, at 30.

⁸² See Gilson, *supra* note 1, at 608.

the most secretive companies in the world.”⁸³ Employees are prevented from discussing projects, even among other internal departments.⁸⁴ Without internal compartmentalization, the intellectual property dilution caused by a single employee leaving to a competitor might be great. Arguably, Apple, better than any other company, has found a way to “embrace secrecy,” and turn it to its own advantage.⁸⁵ However, this internal compartmentalization may hamper the ability of California companies such as Apple to work efficiently, remove incentives to maximize the knowledge base of individual employees, and discourage intra-firm collaboration.

It is clear that there is still a strong desire among Silicon Valley companies to have a mechanism to retain top employees. In May 2014, a “who’s who of Silicon Valley companies” announced the settlement of a class action lawsuit alleging “anti-poaching agreements” between Apple, Google, Intel, Intuit, Adobe, Pixar, and others.⁸⁶ The lawsuit involved agreements affecting at least 60,000 workers over a four-year period.⁸⁷ The rise of such surprisingly “formal and far reaching” anti-poaching agreements within Silicon Valley has occurred because other jurisdictions have an “easier legal alternative” in enforceable covenants not to compete.⁸⁸

Evan Starr at the University of Illinois at Urbana-Champaign has released what is the most current and wide-ranging empirical study on the effect of covenants not to compete on firm-sponsored training.⁸⁹ Starr’s work provides evidence that there is a causal relationship between the enforcement of covenants not to compete and the availability of firm-sponsored training.⁹⁰ Gary Becker’s classic theory of general human capital argues that workers should bear the cost of the

⁸³ Tom C.W. Lin, *Executive Trade Secrets*, 87 NOTRE DAME L. REV. 911, 914 (2012).

⁸⁴ See, e.g., Jim Edwards, *What Apple Employees Say About the Company’s Internal Corporate Culture*, BUS. INSIDER (Oct. 9, 2013, 9:45 PM), <http://www.businessinsider.com/what-apple-employees-say-about-the-companys-internal-corporate-culture-2013-10?op=1> [<http://perma.cc/PL2H-CV2E>].

⁸⁵ ADAM LASHINSKY, *INSIDE APPLE: HOW AMERICA’S MOST ADMIRED—AND SECRETIVE—COMPANY REALLY WORKS* 31–47 (2012).

⁸⁶ Jon Xavier, *Silicon Valley Anti-poaching Settlement: Big Money & Missed Opportunities*, SILICON VALLEY BUS. J. (May 1, 2014, 6:52 AM), <http://www.bizjournals.com/sanjose/news/2014/05/01/silicon-valley-anti-poaching-settlement-ig-money.html?s> [<http://perma.cc/SAD8-8J3R>].

⁸⁷ *Id.*

⁸⁸ *Id.* (quoting Orly Lobel, a law professor at the University of San Diego, and author of a book on economic analysis of the law and human capital).

⁸⁹ See Evan Starr, *Consider This: Firm-Sponsored Training and the Enforceability of Covenants Not to Compete 1* (Jan. 25, 2015) (unpublished working paper), <https://sites.google.com/site/starrean/research> [<http://perma.cc/437L-P8LW>].

⁹⁰ *Id.*

acquisition of the job-related knowledge that makes them employable.⁹¹ However, numerous papers have noted that firms routinely pay for general training.⁹² More importantly, this training does not seem to result in commensurate wage cuts to cover the cost of that training, creating a net benefit for the employee of wages plus additional, valuable knowledge.⁹³ So long as the training of employees causes larger increases in productivity than in the wages of the trained employees, it is economically rational for firms to provide training.⁹⁴ However, increasing employee mobility provides a disincentive, in that it prevents firms from providing (and employees from receiving) the most economically efficient level of firm-sponsored training.⁹⁵

This idea is not new. Others have noted that covenants not to compete are generally unlikely to be desirable tools in perfectly competitive labor markets.⁹⁶ However, when workers cannot acquire the necessary training independently—such as in jobs that require sharing firm-specific, confidential information—the enforceability of covenants not to compete shifts the incentive to the firms to provide training.⁹⁷ In circumstances such as these, a firm must have some mechanism to ensure that the employee will not simply appropriate the value of the training by leaving to a competitor before the company has recouped the value of that training through increased employee productivity.⁹⁸ Enforceability of covenants not to compete provides the mechanism that allows employers to recover that value.⁹⁹

Starr's work suggests that if California (the lowest enforcing state) were to adopt the policy of Florida (the highest enforcing state), then the most impacted occupations in California could receive a 16% increase in the likelihood of receiving firm-sponsored training. It is especially notable that the effect is most noticeable among high-technology firms, such as those in Silicon Valley. This increased training is especially prevalent in the initial years of an employee's tenure in those jurisdictions

⁹¹ *Id.* at 8.

⁹² *Id.*

⁹³ See John M. Barron et al., *Do Workers Pay for On-the-Job Training?*, 34 J. HUM. RESOURCES 235, 235–52 (1999).

⁹⁴ See generally Daron Acemoglu, *Why Do New Technologies Complement Skills? Directed Technical Change and Wage Inequality*, 113 Q.J. ECON. 1055 (1998).

⁹⁵ See John H. Bishop, *Underinvestment in On-the-Job Training?* 1 (Cornell U. Sch. Ind. Lab. Rel., CAHRS Working Paper No. 91-03, 1991), <http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1334&context=cahrswp> [<http://perma.cc/5EPF-MU86>].

⁹⁶ See Paul H. Rubin & Peter Shedd, *Human Capital and Covenants Not to Compete*, 10 J. LEGAL STUD. 93, 95 (1981).

⁹⁷ *Id.* at 96.

⁹⁸ *Id.* at 97.

⁹⁹ *Id.* at 97–98.

where an employer will be able to recover the value in productivity of any training provided.¹⁰⁰ While there is often academic concern about “wage compression” when employees are restrained from accepting competing offers of employment by a covenant not to compete, the increased productivity of employees often also leads to higher wages, acting as a counter-balance.¹⁰¹ There is also evidence that in some professions employees earn more due to a position of increased trust with their employer.¹⁰²

This seems to comport with the predictions made by Eric Posner et al., in *Investing in Human Capital: The Efficiency of Covenants Not to Compete*, where they posited that enforcement of covenants not to compete as written should still lead to the most efficient outcomes in human capital investment.¹⁰³ Importantly, so long as covenants not to compete remain open to negotiation, employees and potential employers retain a mechanism to ensure that employees’ skills will be put to the most efficient use.¹⁰⁴ This is done by placing a value on the training provided, while also allowing a value to be placed on the knowledge that is gained or lost by the defection of an employee to a competitor.¹⁰⁵ They determined that enforcement of covenants not to compete could still lead to both ex post and ex ante efficiency by preventing overinvestment in human capital where specific performance is an enforceable remedy and underinvestment in human capital when there are zero liquidated damages.¹⁰⁶ Posner et al. determined that courts should expand recognized interests to include firm-sponsored training when evaluating covenants not to compete, yet remain wary of overreaching by employers attempting to extract rents from prospective employees through crafting overly broad covenants not to compete.¹⁰⁷ In addition, so long as covenants not to compete remain renegotiable, the effect on labor mobility is slight.¹⁰⁸

¹⁰⁰ See Starr, *supra* note 89, at 39.

¹⁰¹ *Id.*

¹⁰² See Kurt Lavetti et al., *Buying Loyalty: Theory and Evidence from Physicians* 4 (Feb. 1, 2014), <http://ssrn.com/abstract=2439068> (finding that physicians with covenants not to compete had contracts with output incentives that are more than twice as strong, were over 40% more productive, earn 14% higher wages, and have within-job earnings growth that is 21 percentage points higher, despite being of the same average quality as physicians without covenants not to compete, with these effects increasing in magnitude with the enforceability in each state).

¹⁰³ Posner et al., *Investing in Human Capital: The Efficiency of Covenants Not to Compete* 3 (U. Chi. L. & Econ., Working Paper No. 137, 2004), <http://ssrn.com/abstract=285805>.

¹⁰⁴ *Id.* at 25.

¹⁰⁵ *Id.* at 3.

¹⁰⁶ *Id.* at 2.

¹⁰⁷ *Id.* at 25.

¹⁰⁸ *Id.* (noting, additionally, that in California, deferred compensation is commonplace

IV. POLICY RECOMMENDATIONS FOR CALIFORNIA

In light of these differing market pressures, the question becomes one of degree. At what point does the value of the employee knowledge lost because of training they will never receive outweigh the value gained by employers who benefit from competitor technology obtained through “knowledge spillovers”? While this Comment has sought only to look at the effects within California as compared to other jurisdictions, it may also be possible that California has benefitted to some extent by the very uniqueness of the ban on post-employment covenants not to compete. So long as they are enforced in other jurisdictions, California becomes an attractive location for former employees to “flee” and create a direct competitor to their previous employer—especially where that previous employer would have been able to enforce a reasonable covenant not to compete in the original jurisdiction. However, once established, these companies then face the same threat from their own employees. In this way, section 16600 might bias California to small, high-velocity startup companies, at the cost of long-term employer and employee stability.¹⁰⁹ The merits of this distinction are beyond the scope of this Comment, and left to later research.

While valid policy reasons might exist for California to prevent its citizens from bargaining away their future ability to work in the field of their choosing, a subtle relaxation of section 16600 would return an incentive to train internal employees, while leaving in place the ability to “poach” outside talent when it would lead to the more efficient outcome.¹¹⁰ By limiting the remedies to legal remedies, instead of equitable, California businesses would be able to accurately weigh the cost-benefits of hiring outside talent versus training internal talent, by providing a means of effectively “buying out” the covenant not to compete from new employees. Additionally, subjecting any covenant not to compete to a “formation analysis” allows California courts to still police covenants not to compete for overreaching by employers, and protect California employees by retaining the ability to void contracts for either lack of assent or unconscionability.

Perhaps the largest potential downfall to any relaxation of section 16600 would be the loss of “knowledge spillovers” that Saxenian and Gilson have credited for the success of Silicon Valley.¹¹¹ But to the extent that “knowledge spillovers” between

and often said to serve the same effect as liquidated damages for an enforceable covenant not to compete).

¹⁰⁹ HYDE, *supra* note 68, at 31.

¹¹⁰ *See supra* Introduction.

¹¹¹ *See supra* Part II.

companies are lost, new avenues for “knowledge spillovers” within companies may grow, increasing internal efficiency while reducing costly trade secret and patent litigation. Indeed, even if California were to legislatively provide for the enforcement of post-employment covenants not to compete in the future, many of the same arguments for inter-firm sharing of knowledge and the benefits of employee mobility would remain equally valid.¹¹² Especially in the tech industry, research suggests that many such knowledge “spills” are anything but unintentional, with clear patterns of knowledge being voluntarily exchanged across industries, and even across countries.¹¹³ Even in jurisdictions where covenants not to compete are fully enforceable, firms are likely to engage in cost-benefit analyses of sharing knowledge—even with direct competitors—where such actions are economically beneficial to the companies involved.¹¹⁴

CONCLUSION

While the information presented here may not conclusively “tip the scale” enough to prove that California’s prohibition on covenants not to compete has caused harm exceeding any value created through “knowledge spillovers,” it should stimulate discussion as to whether the near-complete prohibition is in fact a net positive gain for California. Indeed, if the costs and benefits of the ban on covenants not to compete are roughly equal, then it seems that the preferable state would be to allow people the liberty to enter into covenants not to compete voluntarily, rather than ban them outright.

To protect the arguably valid public policy concerns of unequal bargaining power that California courts have long considered when rejecting both the “rule of reason” or any “narrow restraint exception” while interpreting section 16600, the Legislature can provide a limited exception that allows post-employment covenants not to compete when subjected to a “formative analysis,” looking for assent and unconscionability, as well as by providing that all such contracts will be renegotiable and limited to legal—rather than equitable—remedies.

At a time when California finds itself struggling to stay competitive with other states and facing a decline in technology exports, California should consider a legislative exception for

¹¹² See generally ORLY LOBEL, *TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS, AND FREE RIDING* (2013).

¹¹³ Melissa M. Appleyard, *How Does Knowledge Flow? Interfirm Patterns in the Semiconductor Industry*, in *THE STRATEGIC MANAGEMENT OF INTELLECTUAL CAPITAL AND ORGANIZATIONAL KNOWLEDGE* 537, 548 (Chun Wei Choo & Nick Bontis eds., 2002).

¹¹⁴ *Id.*

2016]

Desirable Restraint

349

voluntarily entered covenants not to compete as one small measure to increase the attractiveness of Silicon Valley for the investment of venture capital, the establishment of new businesses, and to lessen incentives for established companies to leave for states that are seen as more “employer favorable.” Both employers and employees should encourage a measure that would create incentives for firm-sponsored investment in human capital, as well as lead to increased internal efficiency. Finally, everyone should welcome the increased liberty that results when both employer and employee are able to bargain for and voluntarily enter into mutually agreeable terms of their employment relationships—including enforceable post-employment covenants not to compete.

