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Non-compete covenants, litigation and garden leaves☆

Alcino Azevedo[a], Paulo J. Pereira[b,*], Artur Rodrigues[c]

[a] Aston Business School, Aston University, Aston Triangle, Birmingham B4 7ET, UK
[b] CEF.UP and Faculdade de Economia, Universidade do Porto, Rua Dr. Roberto Frias Porto 4200-464, Portugal
[c] NIPE and School of Economics and Management, University of Minho, Campus de Gualtar, 4710-057 Braga, Portugal

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ABSTRACT

We develop a dynamic model which assesses non-compete covenants (NCC) and garden leaves (GL) and examine the effect of the uncertainty, embargo period and severance payment on the manager's behavior and the reimbursement amount that is due to the firm if there is a violation of the NCC. We find that if the firm wants to deter the manager from leaving, the NCC is more effective than the GL when the industry uncertainty is low, or the embargo period is long, or the salary of the manager now or when working outside the industry is low, or the salary of the manager when working for the competitor or the gain of the competitor due to the arrival of the manager is high. Otherwise, the GL is more advisable. However, contrary to the usual higher tolerance about GL, our results show that, overall, NCC are less harmful than GL.

1. Introduction

"The former employee who departs with confidential business information is the most exasperating of all competitors ".[1] Human resources are assets over which firms cannot exercise ownership (Garmaise, 2011). The value created by employees with technical know-how and key knowledge of markets and costumers grew enormously. Yet, employees are leaving more frequently their jobs to work for competitors or to start their own businesses. Thus, from the employer's point of view, non-competition covenants (NCC) in employment agreements often do make sense.

A NCC is a contract which preserves firms' private business information from their former employees whose departure may lead to unfair competition. It became increasingly popular to guard against the risk of losing confidential information to competitors after the termination of the employment. Confidential information means knowledge not publicly known in a given industry which confers a competitive advantage over the firms which do not own it.[2]

A typical NCC states that after the termination of the employment for any reason, the employee will not work in the same or similar business activities, for herself or for anyone else, within a designated geographical area during a given time period (Hutter, 1981). NCC are popular for long time (Blake, 1960; Starr, Bishara, & Prescott, 2017) and, for instance in the US, are used not only in the information technology (IT) industry but also in other industries such as insurance, banking and law, and even in less-skilled knowledge industries such as hairdressing (Kräkel & Sliwka, 2009).[3,4] There is also US data suggesting that about half of the technical professionals are asked to sign a NCC (Marx, 2011). The need of a NCC is however partly a function of the probability of opportunistic behaviors in the employment relationship. The greater the probability of particular types of opportunism, the greater is the need of a NCC (Barney, Busenitz, Fiet, & Moesel, 1994).

A NCC has value for the employers because, during the embargo period, it protects sensible business information, but destroys value for the employees because, over the embargo period, they are not allowed to work for the competitors of their former employer, where their knowledge and expertise are more appreciated and they could earn a higher salary. In the limit, employees may choose not to join a firm due to the restrictive nature of the NCC, preventing the organization from

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* Corresponding author.
E-mail addresses: a.azevedo@aston.ac.uk (A. Azevedo), pjpereira@fep.up.pt (P.J. Pereira), artur.rodrigues@eeg.uminho.pt (A. Rodrigues).

[1] Belmont Laboratories, Inc. v. FTC, 103 F.2d 538, 542 (3d Cir. 1939).
[2] For instance, trade secrets, goodwill embedded in customer lists and other intangible assets.
[3] See New York Times: http://www.nytimes.com/2014/06/09/business/noncompete-clauses-increasingly-pop-up-in-array-of-jobs.html.
[4] The first known decision involving an employment covenant was in 1414, now known as the *Dyer's Case*, where a master tried to extend the period of subservience of an apprentice, restricting his rights to work as a craftsman. For a further discussion on the history of the NCC see: Blake (1960) and Bryenton (1964).

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gaining an initial competitive advantage. Thus, a fair negotiation of a NCC should include a severance payment which (at least) offsets the opportunity cost of the manager related with the termination of the employment and the constrains of the covenant. It has been also argued that the advantages of NCC to the public are the protection of proprietary interests, facilitation of investments in R&D and encouragement of human capital (personnel) development, whereas the disadvantages are the potential of limiting competition, impeding the dissemination of information and retarding the economic mobility of employees (Anenson, 2005).

For instance, Gilson (1999) and Hyde (2003) suggest that one of the main reasons for the success of the high technology industrial district in Silicon Valley and the failure of the one in Massachusetts' Route 128 was the differential enforcement of covenants not to compete. The different legal environments led to higher employee turnover and, therefore, more firms in California (see also Buente, 2012; Bishara & Orozco, 2012). Furthermore, Conti (2014) investigates the effect of NCC on the type of R&D activity firms undertake, using a dataset on the US patent applications, and concludes that these contracts reduce the outbound mobility and knowledge leakages to competitors, making the high-risk R&D projects relatively more valuable than the low-risk ones and, therefore, inducing firms to choose riskier projects. Kobeissi, Sun, and Wang (2010) study how state regulation of NCC agreements affect the payment methods, premiums and abnormal returns on M&As.

Managers often breach NCC agreements arguing that they were illegal and this behavior is considered admissible by courts. A typical litigation concerns cases where one business hires the employee of the other in apparent violation of a NCC (Anenson, 2005). A well-known case is that which involved Kai-Fu Lee, a renowned well-connected computer scientist and former worker of Microsoft in China, who was later appointed president of Google in China and, shortly after, Microsoft revealed that he was subject to a NCC. Microsoft went to court in Seattle, Washington, which issued a restraining order forbidding temporarily Kai-Fu Lee to work on projects for Google similar to those he performed for Microsoft.[5,6] In the IT industry, the fear of workers being poached is such that some large firms, including Google, Apple, Yahoo and Genentech, have informally agreed not to hire managers from firms they view as partners (Helfdt, 2009a, 2009b).[7]

Courts tend to see NCC very unfavorably, particularly in the US and the UK (Callahan, 1985). For instance, some US states, such as California, Alabama and Alaska, forbid the use of these contracts, whereas Texas and Michigan restrict significantly their use (Den Hertog, 2003). Also, in the UK in the 1980s, courts' decisions on NCC were so frequently unfavorable that this contract was gradually replaced by the so-called garden leave (GL). A GL has a similar restriction as the NCC regarding working for a competitor, and can prevent the employee from working at all, but during the embargo period the employee is paid full salary, including benefits, by her (soon to be) ex-employer.[8] Recent evidence shows that the UK courts are still more supportive of GL than of NCC (Klein & Pappas, 2009).

There is however an interesting case with PepsiCo where, despite the absence of a NCC agreement, the court imposed an injunction to one of its former employees that prevented him from working for a competitor, advocating that due to the nature of his work at PepsiCo it would be impossible for him not to take advantage from confidential information.

The empirical literature on NCC is yet limited and focuses mainly on the US labor market and, in particular, on three occupations: physicians (Lavetti, Simon, & White, 2014), engineers (Marx, 2011; Marx, Singh, & Fleming, 2015) and CEOs (Garmaise, 2011; Bishara & Starr, 2016; Schwab & Thomas, 2006). For instance, Marx (2011) suggests that about half of the technical professionals in the US are asked to sign a NCC. Additionally, he concludes that ex-employees that were tied to a NCC are more likely to take *career detours* and that firms manage strategically the timing of the NCC agreement, waiting for the employee's bargaining power to weaken. Marx et al. (2015) conclude that about 70.2% of firms use NCC with their top executives, and their enforceability reduces significantly the executive mobility. Schwab and Thomas (2006) find that about two-thirds of the CEO employment contracts have a NCC, and that the correlation between the length of the embargo period and the severance payment awarded to a departing CEO is weak. More recently, Starr et al. (2017) show that in 2014 about 20% of the labor force have employment contracts with a NCC, and almost 40% of the labor force have signed at least once a NCC agreement, being these agreements more popular in high-skill and high-paying jobs.

A manager can sign a NCC when hired, after being hired or when leaving the firm. But if a NCC is to be signed, it should be studied very carefully in order to be enforceable in case of litigation. We note that the "unnecessarily long time span of the agreement" is the main reason why NCC are very often considered illegal in the US. If there is litigation, courts inquire whether the contract is socially and economically "reasonable" (Gaby Hardwicke Solicitors, 2011). Because there is not yet a well-established formal theoretical framework to assess the firm-manager competing interests related to NCC. Hence, courts do not have a formal theoretical guide to follow in order to judge the legitimacy of NCC and determine the effect on firm's value of a violation of this contract, which may lead to "ad-hoc" decisions, increases litigation uncertainty and enhances both inefficiencies in the labor market and distortions in the employment relationships (Bitė, 2011).

We develop a theoretical valuation model for a NCC. Although quite distinct in multiple aspects, this work intersects with those of the literature on executive compensation, which examine the relationship between market conditions and executive turnover, or the association between stock option policy and managers retention, or the role of the severance payment in the optimal corporate governance structure (e.g., Peters & Wagner, 2014; Almazan & Suarez, 2003; Dahiya & Yermack, 2008; Edmans & Gabaix, 2009). It also relates to the labor law literature devoted to NCC and GL in employment agreements (e.g., Callahan, 1985; Anenson, 2005; Bishara & Orozco, 2012; Mack, 2015; Horvitz, 2016), and the labor economics literature, for instance with research on the relation between the use of NCC and the labor market mobility, or the association between the use of NCC and the innovation pace (e.g., Den~Hertog, 2003; Garmaise, 2011; Kräkel & Sliwka, 2009; Marx, 2011; Conti, 2014; Tang, Wang, & Zhou, 2016).

Our paper contributes to the finance literature in several ways. Firstly, it presents the first theoretical model that assesses the firm-manager competing economic interests associated with the usage of NCC in employment agreements considering uncertainty. Secondly, our model quantifies the effect of a violation of the NCC embargo period on the firm's value and the manager's wealth, which turns it also useful for courts to set the fair reimbursement amount that is due to the firm in case of litigation. Thirdly, we extend our model to the valuation of a GL and provide a comparative analysis which enables the characterization of the market conditions in which the NCC might be preferred to the GL, and vice versa. We show that both the firm and the manager behavior is largely influenced by the optionality nature of the NCC.

This work provides a formal theoretical guide for the negotiation of NCC and GL in employment contracts. It may have therefore a positive effect on the popularity of these contracts in the future, by preventing litigation or reducing litigation uncertainty, namely that which is

[5] In 2000, Kai-Fu Lee had signed an agreement providing that, for a period of one year after leaving Microsoft, he would not "accept employment or engage in activities competitive with products, services, or projects… on which [he] worked or about which [he] learned confidential or proprietary information or trade secrets while employed at Microsoft. "

[6] For further details see also: Bakerand Hosteller LLP Executive Alert, September 2005.

[7] For further information see: http://www.nytimes.com/2009/06/03/technology/companies/03trust.html? and http://www.nytimes.com/2009/06/04/technology/companies/04trust.html?.

[8] The employee is to some extent on a "paid vacation ".