Restrictive covenants in employment contracts – an unnoticed hindrance to growth in Europe

A significant percentage of European employees have a restrictive covenant in their employment contract. These covenants restrict the employee for a period of time after the termination of the employment relationship. They may be divided into 4 main categories:

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<tr>
<th>Non-compete</th>
<th>preventing an employee from entering into competition against the employer</th>
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<tbody>
<tr>
<td>Non-dealing</td>
<td>preventing an employee from accepting business from current or former clients</td>
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<tr>
<td>Non-solicitation</td>
<td>preventing an employee from contacting current or former clients, though not preventing the employee from accepting business if the client is not induced and</td>
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<tr>
<td>Non-poaching</td>
<td>preventing an employee from soliciting former colleagues to join him in his new enterprise.</td>
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All 4 categories of restrictive covenants are presumably legal and in use in all EU member states.\(^1\)

From a legal point of view, restrictive covenants are generally accepted as part of the protection of the employer against unfair competition from former employees. This need for protection is balanced against the freedom of the employee to work and make a career.

The current legal position is problematic:

1. The balance of interests makes it impossible for the employee to predict whether or not the restrictive covenant in his contract is legal: and if it is legal, how far reaching the covenant is. May he take the job he is offered? Or on which conditions may he start his own business?

The uncertainty and the often serious consequences of non-compliance result in the fact that many employees choose to respect a restrictive covenant even though it is not legal or too far reaching.

2. Society has a clear economic interest in free competition and that as many competent employees as possible start their own business or join a start up.

Generally, the interests of society are not taken into account when courts are balancing the interests of the employer and the employee.

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\(^1\) We are not familiar with any comparative studies of the use of restrictive covenants in all the countries of the EU. With regard to legal matters, the electronic book: Non-Compete Clauses An international Guide provides a good overview of the legal position in a number of European Countries. http://www.iuslaboris.com/files/documents/Public%20Files/Publications/2010_Publications/non-compete-clauses-an-international-guide.pdf
The interests of society are relevant and should be taken into account when restrictive covenants are assessed (legally and politically). But what will be the result of such an assessment?

**Knowledge on the effects of restrictive covenants on the economy of firms and on society**

In 1994, the American sociologist, AnnLee Saxenian, published the book, ”*Regional advantage: Culture and Competition in silicon valley and route 128.*” She examines the growth of the two high tech clusters Silicon Valley in California and the area Route 128 in Massachusetts. In the beginning of the 1960’s, Route 128 was undisputedly the biggest high tech cluster in the U.S. But in the following decades, Silicon Valley grew much faster and was able to overtake Route 128. In short, Saxenian found that the firms of route 128 in general were characterised by keeping their development inside the firm, whereas in Silicon Valley, complex networks grew in and out of the firms, and this was important for the Silicon Valley cluster growth.2

In 1999, professor of law and business Ronald Gilson took the conclusions of Saxenian even further by pointing out the fact that, whereas the laws of Massachusetts tolerate restrictive covenants in employment contracts, these covenants have been strictly forbidden in California since the 19th century.3 The ban on restrictive covenants enables employees at the established firms to quit and start their own firms or join start-ups. The ban makes the business milieu of Silicon Valley more adaptable and growth-stimulating – important keys to success.

The work of Saxenian and Gilson has been succeeded by a number of scientific papers examining the importance of restrictive covenants in employment contracts on the growth of high tech clusters.4

In the paper “*Ties that Truly Bind*” Garmaise concludes, inter alia: “*Our study of the time-series and cross-sectional variation in non-competition enforceability across the U.S. states demonstrates the importance of these legal regulations for executive mobility, executive compensation and firm investment. We show that increased enforceability leads to fewer executive within-industry transfers, lower and more salary-based compensation, reduced post-transfer compensation, lower R&D spending and reduced capital expenditures per employee*”5

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4 The research has been reviewed and summed up by Michael S. Dahl and Jørgen Stamhus in the desk survey “*Økonomiske effekter af konkurrenceklausuler*”. Unfortunately, it only exists in a Danish version. [http://vbn.aau.dk/en/publications/oekonomiske-effekter-af-konkurrenceklausuler(c4f116d4-30ea-4f09-9f5c-0814bed24ff4).html](http://vbn.aau.dk/en/publications/oekonomiske-effekter-af-konkurrenceklausuler(c4f116d4-30ea-4f09-9f5c-0814bed24ff4).html) See also the article “*Should Noncompeetes Be Enforced?*” by professor in law Allan Hyde. He is also the author of *Working in Silicon Valley: Economic and Legal Analysis of a High-Velocity Labor Market*.
In the paper “Job-Hopping in Silicon Valley” Fallick, Fleischmann and Rebitzer concludes that workers in the Computer industry of California changes jobs more often than in other businesses.  

In the paper “Non-Compete Covenants: Incentives to Innovate or Impediments to Growth” Samila and Sorensen conclude, inter alia, that: “More specifically, our results demonstrate that not only does the enforcement of non-compete agreements limit entrepreneurship ... but also it appears to impede innovation.”

In the paper “Regional disadvantage? Non-compete agreements and brain drain” Marx, Singh and Fleming concludes: “We construct inventor career histories using the U.S. patent record from 1975 to 2005 and demonstrate a brain drain among patenting inventors from states that enforce employee non-compete agreements to those that do not. Non-compete enforcement appears to drive away inventors with greater human and social capital. We address causality-related concerns with a difference-in-difference study design based on an inadvertent reversal of Michigan’s non-compete enforcement policy.”

In the paper “The Firm Strikes Back: Non-compete Agreements and Mobility of technical Professionals” Marx concludes inter alia: “In-depth interviews with 52 randomly sampled patent holders in a single industry, coupled with survey of 1,029 engineers across a variety of industries, reveal that ex-employees subject to non-competes are more likely to take career detours—that is, they involuntarily leave their technical field to avoid a potential lawsuit. Moreover, firms strategically manage the process of getting workers to sign such contracts, waiting for workers’ bargaining position to weaken.”

In the paper “Labor Mobility, Social Network Effects, and Innovative Activity” Kaiser, Kongsted and Rønde concludes: “Our study documents a positive relationship between the number of workers who join a firm and the firm’s innovative activity. This relationship is stronger if workers join from innovative firms. We also find evidence for positive feedback from workers who leave for an innovative firm, presumably because the worker who left stays in contact with their former colleagues. This implies that the positive feedback (“social network effects”) that has been found by other studies not only exists but even outweighs the disruption and loss of knowledge occurring to the previous employer from the worker leaving. Summing up the effects of joining and leaving workers, we find ample evidence for mobility to be associated with an increase in total innovative activity of the new and the old employer.”

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7 Sampsa Samila, Olav Sorensen, Non-compete Covenants: Incentives to Innovate and Impediments to growth, DRUID Working Paper 10-02.
The research shows that restrictive covenants have a clear and considerable negative impact on the growth of high tech clusters/firms. From the point of view of a specific firm, it might seem as a good idea to bind employees with restrictive covenants, but from society's point of view the restrictive covenants are poison to growth especially in high tech industries. The restrictive covenants:

- impede employees from starting their own business
- impede employees from changing jobs in order to fulfil their potential
- impede start-ups from finding the best employees in the first difficult phase
- encourage venture capital and talented employees to move to states or countries where these covenants are forbidden
- is poison for the ever ongoing process of reinventing products, production and the way business is done in high tech clusters
- is poison for any high tech economy

We have had restrictive covenants for hundreds of years in order to protect legitimate business interests. Can we take this protection away? Of course we can:

- the firms of California and other US states run just as well without them
- the European firms are already well protected by patent laws and other rules protecting trade secrets and other legitimate business interests
- the mobility of employees has positive effects for both the companies they are leaving and their new employers
- restrictive covenants are just one among many restrictions on free competition that have existed and will be removed in order to secure economic growth and prosperity in Europe
- can we afford not to ban restrictive covenants?

In order to secure the growth of the European economies, it is necessary that the European Parliament and European Commission:

1. initiates research into the effects of restrictive covenants on the European economy
2. inform the member states about the research on restrictive covenants’ effects on the economy
3. initiates a law-making process in order to establish a total ban on restrictive covenants in the contracts of European employees.

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