

Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets

Dr. Yifat Aran, research fellow (postdoc) at the Haifa Center for Law & Technology, University of Haifa Faculty of Law & visiting scholar at the Faculty of Industrial Engineering & Management, Technion - Israel Institute of Technology

Abstract

The literature analyzing the relationship between enforceability of covenants not to compete and the success of Silicon Valley is incomplete. The microstructure of the employee stock options market, combined with California's strong public policy against noncompete enforcement, creates an equilibrium in which employees at less successful firms can move to competitors at little or no cost, but valuable employees of successful private firms are, practically, handcuffed just as if they were subject to a powerful noncompete. This limitation on employee mobility is removed once the company holds a liquidity event — such as an initial public offering or acquisition — allowing its entrepreneurial talent to transition to other companies or start new ones.

This article argues that this narrowly tailored retention function provides a more compelling explanation for Silicon Valley's success than does an explanation that has become popular among policymakers in recent years: the unenforceability of noncompete as the sole factor. The article further suggests that companies' current tendency to delay liquidity events, a tendency facilitated by recent changes in the private capital market and the securities regulatory environment, might overly restrict employee mobility and impair the efficient allocation of talent that characterized Silicon Valley for many years.