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Executive Noncompetes: Keeping Talent in House or At Bay?

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of national cultural values on decisions related to employee training and development. Investigating this and other possibilities remains an important challenge for future research.

Source: Peretz, H., & Rosenblatt, Z. (2011). The role of societal cultural practices in organizational investment in training: A comparative study in 21 countries. *Journal of Cross-Cultural Psychology*, *42*(5), 817–831.

Executive Noncompetes: Keeping Talent in House or at Bay?

Research Brief by Terence Lau, Associate Professor of Management, University of Dayton
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It's a nightmare most companies would prefer not to face. A high-potential executive being groomed for senior management is rotated through various assignments with progressively higher responsibilities. After being named country manager in a high-growth market, the executive suddenly resigns to work for a major competitor. Millions of dollars invested in the employee are lost, and the firm struggles to find a replacement. Even worse is that walking out the door with the departing manager are deep knowledge about firm operations, future product plans, market entry strategies, and relationships with local officials.

When facing such a situation, firms may respond by attempting to keep the departing executive with higher pay and bigger bonuses. But some companies lack deep pockets, and some managers may not be seduced by money. Consequently, companies may resort to litigation to recoup the costs they incur when important executives depart. So it should come as no surprise that many firms have enthusiastically embraced "noncompete agreements" in recent years as a way to deal with executive departures. In brief, noncompetes restrict executive behavior post-employment, specifically prohibiting the executive from working for a competitor after leaving the firm. Noncompetes are highly variable, but typically include a provision for when they kick in (some apply whenever employees leave, while others apply only if employees leave voluntarily), how long they apply (most last for two or three years), and where they apply (some apply just to areas where the old firm competes, while others cover larger territories). Courts and legislatures have expressed concern that noncompetes might limit someone's ability to earn a living. In legal terms, noncompetes occupy strange ground—covenants not to compete are usually indicative of monopolistic tendencies and are generally prohibited. But when employing executives, firms believe that extracting a noncompete is critical for protecting their investments.

However, a fascinating new study by Mark Garmaise (UCLA) throws that belief into doubt. It suggests that firms using noncompetes may actually keep vital talent from flowing into the company rather than the reverse. Garmaise examined the effects of noncompetes in various states because contract law is determined on a state-by-state basis. Pro-employer states permit noncompetes broadly, while pro-worker states don't recognize noncompetes. Some states have evolved their approaches as legislatures respond to judicial decisions interpreting noncompetes. Using a database of executive compensation, Garmaise found that noncompetes are indeed popular, with more than 70% of reporting firms requiring some form of noncompete. Even in states such as California where noncompetes are virtually unenforced by the law, more than half of firms report requiring noncompetes, a testament to their seductive allure, ignorance of the law, or both.

Garmaise's findings contain good news and (more) bad news for firms employing noncompetes. On one hand, his study confirms the notion that when states enforce noncompetes, executive turnover is lower and job tenures longer. Firms in high-enforcement states also tend to spend less in capital expenditures per employee and pay executives less, with a greater chunk of compensation coming from base salary. And when executives in these states do move to other firms, they receive smaller pay increases and assume lower ranked positions, at least compared to executives in states where noncompetes aren't strongly enforced. Employer concerns about being sued in these high-enforcement jurisdictions may lead to greater negotiation power with the departing executive.

Less employee turnover, more executive stability, lower capital expenditures, and less upward pressure on compensation would appear to be good news for firms using noncompetes. But Garmaise found surprising effects when firms use noncompetes in high-enforcement states. For starters, consider the shift toward salary as a percentage of total compensation in these states. As human resource managers know, tying executive compensation to non-salary metrics such as firm performance or share price can be an excellent tool for motivating behavior that supports the firm's strategic objectives. Indeed, Garmaise found that maintaining managers' exposure to the firm's stock price through the use of stock options was less important in high-enforcement states.

Ironically, the study also suggests that executive quality suffers when firms use noncompetes in high-enforcement states—the very thing that noncompetes are supposedly designed to avoid. Garmaise found that while noncompetes bind executives to firms, in doing so they may be changing the quality of their leadership for the worse. Working under a noncompete in a high-enforcement state may cause executives to stop investing in their own development because they are handcuffed to their companies. For example, executives in these circumstances may have less motivation to cultivate industry contacts or attend important trade shows to stay on top of trends—making them less effective over time. So as firms tie employees to noncompetes, they may end up hurting themselves by limiting the transferability of talent, curbing executive motivation, and creating a stagnant labor pool internally.

Perhaps the worst news for firms is that enforcing noncompetes appears to have no effect on R&D investment—a primary reason for noncompetes in the first place. Firms in low-enforcement jurisdictions should therefore be better suited to make those R&D investments, a finding confirmed by comparing the computer industries in California (low enforcement) and Massachusetts (high enforcement). Scholars have long argued that high knowledge spillovers in Silicon Valley give it location-specific advantages. Garmaise's study suggests that public policy toward noncompetes plays a critical role in creating those location-specific advantages. Finally, the study found strong support for the conclusion that noncompetes have no significant effect on firm value or profitability. Given that outcome, and the high costs noncompetes exact on talent transfer and labor flexibility, firms considering noncompetes should proceed with caution.

Garmaise's research offers implications for both states and firms. For states seeking to attract investment, innovative companies, and well-paid employees, enforcing noncompetes may ultimately be counterproductive. For firms seeking to protect their intellectual property and human capital, using noncompetes to restrict employee mobility may backfire and result in a stagnant labor pool. It would be interesting to know if similar results hold true for other popular policies that apply during employment terms, such as non-disparagement and arbitration clauses. If they do, the implications of Garmaise's study will be broadly felt in management practice for decades to come.

Source: Garmaise, M. J. (2011). Ties that truly bind: Noncompetition agreements, executive compensation, and firm investment. *The Journal of Law, Economics and Organization, 27*, 376–425.

Do Happy Leaders Make for Better Team Performance?

Research Brief by Joseph C. Santora, Visiting Professor of Management, ENPC School of International Management, and Mark Esposito, Associate Professor, Grenoble School of Management

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If leadership makes a difference, as many believe, we might expect leaders who display positive moods to alter the attitudes of team members. But what becomes of these changed attitudes? There is a large body of research in the management literature on "employee happiness" and