Silicon Valley's No-poaching Case: The Growing Debate over Employee Mobility

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When Apple, Google, Intel and Adobe Systems last week agreed to settle a lawsuit accusing them of conspiring to prevent the hiring of each other's employees, they avoided having to testify in court and risk a public glimpse into their strategies. Yet, the case has provoked a heated debate on the damage that no-poaching agreements cause.

The class action lawsuit accused the four Silicon Valley companies of conspiring, between 2005 and 2009, to avoid hiring each other's employees – a practice that the lawsuit says resulted in lower salaries for the affected individuals. About 64,000 employees of those companies sought $3 billion in damages, which would have risen to $9 billion under antitrust law. Estimates are that the companies agreed to settle the case for about $325 million, although they did not formally disclose that figure.

Indeed, the companies have been mostly circumspect about the settlement. Adobe said it "elected to settle this matter in order to avoid the uncertainties, cost and distraction of litigation," according to a *Wall Street Journal* article. The same article quotes an Intel spokesperson as saying: "We are settling this matter to avoid the risks of litigation. We still deny violating any laws or obligations to plaintiffs." Apple and Google declined to comment, the *Journal* added. Facebook's chief operating officer, Sheryl Sandberg, declined an invitation from Google to join the illegal pact, according to a *Reuters* report.

Joseph Harrington, Wharton professor of business economics and public policy, describes a no poaching agreement as "an unreasonable restraint of trade" and thus a violation of Section 1 of the Sherman Antitrust Act of 1890. "In terms of suppressing competition, companies agreeing not to compete for each other's employees is the same as companies agreeing not to compete for each other's customers," says Harrington. "In the latter case, it results in customers paying higher prices because of the lack of competition, and in the former case it results in workers receiving lower wages because of the lack of competition."

He explains how no-poaching agreements can conflict with the law. "If one were to substitute 'customer' for 'employee' in the communications between Steve Jobs and [Google chairman] Eric Schmidt, such communications [would be] the basis for many convictions under Section 1 of the Sherman Act," he says.

"The allegations with regard to the no-poaching agreements between companies in the tech sector are shocking, because if true, this was blatantly illegal conduct," says Janice Bellace, Wharton professor of legal studies and business ethics.

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According to Peter Cappelli, Wharton management professor and director of Wharton's Center for Human Resources, it is hard to imagine any situation where no-poaching pacts can be fair to employees. "That's one of the reasons it is illegal," he says, adding that they violate both anti-trust principles and employment laws. "It benefits the companies at the expense of their employees. Companies could achieve the same results by making it attractive enough for employees not to leave."

Wharton management professor Matthew Bidwell says anti-poaching agreements clearly restrict employee mobility. "When companies collude, it raises their power in the market at the expense of other people," he says. "In this case, by colluding not to hire each other's employees, [these companies] are restricting those employees' opportunities to find jobs elsewhere."

According to Wharton management professor Iwan Barankay, the controversy over no-poaching pacts must consider two factors that determine wages and compensation: employees' productivity and bargaining power. "When employees are more productive, they generate more profits, but how much of these rents they can appropriate for themselves depends on their bargaining power," he says.

Back to Basics

When one talks of a "labor market," it is "a shorthand way of describing conceptually what is occurring," says Bellace. "Employers buy labor on that market, and job seekers sell their labor. Supply and demand then serves to set the price for a given type of labor."

In a free market economy, people want the market to operate as it should, she notes, adding that more than a century ago, the U.S. passed laws to prevent companies from colluding in order that the prices for products remain undistorted. "Most people know of the antitrust laws, and know they prevent companies – in the airlines industry, for example — from agreeing with each other not to sell tickets for flights from point A to point B below a certain price."

That principle of free competition applies to the labor market as well. The main exception applies to the unionized sector, she says, where employees can join together to bargain as one group, and employers can come together to bargain as one group (an employers' federation).

Exceptions exist in some other settings where no-hire agreements are common. Bidwell says headhunting firms that place a candidate with a client will usually agree not to poach anybody from that client for a certain period. Consulting firms also sometimes have agreements not to hire anybody from their clients, he adds.

Several studies show that many of the methods companies use to retain employees have a negative impact on wages, says Barankay. He lists no-poaching contracts, non-compete agreements and the "inevitable disclosure doctrine," where firms in many U.S. states can use trade-secret law to sue former employees to prevent them from joining a competitor.

Barankay notes that when companies use such methods to retain employees, their increased bargaining power vis-a-vis their employees could depress wages. "But it can also reflect a drop in productivity," he says. "This can be due to what economists call 'unpriced externalities,' which are so essential in innovative companies: Firms do not take into account the benefits of information and knowledge sharing across firms that raise overall productivity in the economy."

Barankay illustrates how that situation affects productivity: "Imagine an exchange of two engineers between Apple and Google. The Apple engineer joining Google takes some ideas and insights with her, which helps raise profits at Google and vice versa for the Google engineer joining Apple. So overall productivity goes up in the economy. Yet because neither of these firms reap all the benefits from this gain, they prefer to prevent that swap."

There are other casualties of preventing talent mobility. "Actually, we should be less worried about the big firms like Apple and Google [and more worried] about what it means to small startup companies," Barankay says. "These no-poaching and non-competes shift the balance of power towards large companies that can prevent newcomers from bringing ideas to the market" because talented engineers and designers are tied up in the large companies.

Bidwell says much of his research shows that mobility isn't always a good thing. "It takes a long time to learn the culture and build the relationships [that allow us] to be effective in our current organization. Every time we change a job, we have to start out all over again." In theory, Bidwell adds, a productive economy is one where employees are in the "right jobs" – the jobs that both fit their interests and make the best use of their abilities. "When you restrict that mobility, to some extent you are restricting the employees' ability to get those matches," he says.

Collusion: an Inexpensive Option

The disclosures that have spilled out so far about the no-poaching agreements are telling. According to the *Journal* article, Google cofounder and CEO Sergey Brin testified in a court deposition that, "Steve being agitated was not unusual" – a reference to the late Apple CEO Steve Jobs's phone calls to Google executives about not "poaching" workers. The case also claimed incriminating email exchanges that the *Journal* reproduces. Google's then CEO Eric Schmidt emailed another Google executive to say they should only confer on agreements not to recruit from other companies "verbally, since I don't want to create a paper trail over which we can be sued later."

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Such collusion is an inexpensive way to retain employees, says Bidwell. "When employees have less opportunity, there is not nearly as much need to pay them a high wage." Such restriction of competition is great for the companies but it is bad for the employees, he adds. "When it comes to markets for goods and services, it has been clear for over 100 years that collusion is economically damaging. There is no reason to believe it wouldn't be exactly the same in the labor markets."

Going back to the Sherman Act, Harrington says the parallel between product and labor markets breaks down in some scenarios. Companies invest in their employees through, for example, training, while they do not typically invest in their customers, he points out. That could "provide some offsetting benefits for a 'no poaching' policy." He says that if employees leave after having been invested in, then companies may decrease the investments they make – a move that would be harmful to both employees and shareholders.

Harrington finds the above scenario analogous to that of resale price maintenance, whereby a manufacturer can control the price at which retailers sell its product. "The courts have decided that resale price maintenance is not per se unlawful and is instead considered under the rule of reason, in which case both its benefits and costs are considered in determining its legality," he says. "The rationale is that a manufacturer and consumers can benefit from having retailers not compete too aggressively in price if it serves to enhance non-price competition, such as the provision of service prior to the time of sale."

Similarly, with the Silicon Valley case, "an agreement not to poach will promote investment in employees, and that could be a mitigating factor," says Harrington. "While I'm skeptical that such an argument will prove to justify a 'no-poaching' policy, it could be considered in evaluating the policy."

Some employers might privately argue that no-hire pacts are a way to prevent indiscriminate poaching and unaffordable wage inflation. Cappelli, however, says that argument to keep wages down doesn't hold, "especially in the current economic context of rising inequality where wage earners are falling behind." Laws to help companies protect intellectual property already exist, he adds.

Indeed, according to Harrington, it is unjustifiable for companies to argue that no-poaching policies are necessary to prevent excessive wage inflation. "While competition for employees is expected to lead to higher wages, it is not in the self-interest of the companies to bid wages up to the point that it is unprofitable," he says. "They will bid wages up to the point that is most profitable for them in light of what other companies are offering in terms of pay. Competition will reduce profit − shifting money from shareholders to employees − but it will not entirely eliminate profit, much less result in losses."

The need to retain employees involved in critical projects — such as a new product launch — is "a legitimate concern for companies and for the economy at large," says Harrington. "If some worthwhile projects are not pursued because of the risk that they will be disrupted or delayed through the loss of critical employees, then all parties − employees and shareholders − are harmed by those foregone projects."

Having said that, Harrington shows why such an argument does not necessarily hold. "With any practice for which there is both a legitimate rationale and anti-competitive effects, the courts ask whether there is an alternative practice that achieves the legitimate objective without the anti-competitive side effects. And, if there is [a viable alternative], then the original practice is prohibited in favor of the less noxious alternative."

According to Harrington, such an alternative to a "no-poaching" policy exists in the latest case. "[Companies could] sign critical employees to long-term contracts that ensure their continued participation until a project is completed," he says. "In other words, the company needs to come to an agreement with employees rather than with rival companies." That, he feels, is the middle path for companies and their employees – one which protects each other's interests.

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Companies have other ways to retain employees, says Bidwell, such as deferred compensation and vesting periods of stock ownership where the benefits accrue after a pre-determined period. “The broader point is that employers could restrict that mobility with better terms, wages and opportunities for their employees,” he says. “They would rather not do that, [choosing] instead to restrict that mobility, making it hard for their employees to find opportunities elsewhere.”

“The unique problem” in California, Cappelli adds, is the difficulty in enforcing non-compete agreements or contracts that prevent employees from working for competitors. “In terms of carrots and sticks, companies could make it attractive enough for employees not to leave and also more difficult for them to walk away with intellectual capital,” he says.

Enforcing Non-compete Agreements

Each state has its own view of the validity of non-compete agreements, notes Bellace. Some states will only enforce a non-compete agreement if it is for limited duration (e.g., a year or less), in a limited region (e.g., northern California) and in a specific job area. That is to ensure that the company does not force the person to remain employed with it. “Imagine a non-compete agreement that says that the employee agrees not to work for any company in the tech industry in the United States for five years,” she says. “If the employee wants to leave Apple, what would the person do for five years? Move to another country? Get a job outside of tech? [That may be possible], but their skills and experience are in the tech industry.”

Employers have options here, “but they do cost something,” Bellace adds. “If a company wants to keep an employee and fears he/she might leave to go to another company which is offering a better salary or better opportunities, there is a lawful device that can be used — namely, the non-compete covenant.”

Bellace advises companies to use non-compete agreements that conform to the state’s view of what is permissible. They could then pay compensation for the employee’s agreeing to the restriction. Another option is to backload compensation, where the employee gets a bonus at the end of a period during which he or she agrees to stay with the company. “Then it is up to the employee to decide whether he/she prefers to stay that length of time [to get the bonus], or whether the outside offer is more attractive. This is exactly the calculation that a free market wants because it is setting the price of labor at the market rate.”

Thus, according to Bellace, if Apple wanted to constrain employees in their ability to accept jobs at companies such as Google, it could have asked them to sign a non-compete covenant. “If the employees were reluctant to do so, Apple could have upped its offer of financial compensation, or the quid pro quo – I offer you ‘x’ in return for your agreeing to do ‘y,’” she says. “If Apple’s offer was high enough, employees would have signed the non-compete.”

Against the backdrop of the latest class action suit, Bellace says, “It may be that Apple did not want to pay such amounts and preferred the cheaper method of getting other companies to agree not to poach employees. It’s understandable – but it’s illegal.”

A *San Jose Mercury News* article reproduced one 2005 email exchange in which Jobs reportedly warned Brin about recruiting Apple workers: “If you hire a single one of these people, that means war.”

Now, however, a bidding war for talent seems around the corner. According to the article, experts on Silicon Valley’s economy say the no-poaching controversy could have a ripple effect on the booming job market for engineers and other technology workers. “This settlement should result in much higher salaries for folks who are in high-demand positions,” Rob Enderle, principal analyst with Enderle Group, a San Jose-based market researcher, told the *Mercury News*. “You will start to see bidding wars between companies, and those will start to drive salaries up.”

According to Cappelli, the latest case could have a telling impact on Silicon Valley’s image. “It does enormous damage to the idea of Silicon Valley as a place where merit really wins out and people can manage their own careers," he says.