

To: Gillian Hadfield, USC Law School  
From: Joel Watson  
Date: January 30, 2009 (revised from January 8)  
Re: Grant Proposal to The Southern California Innovation Project

**Client-Based Entrepreneurship (research with Jim Rauch)**

I propose a grant from the SCIP to conduct research on legal and economic aspects of client-based entrepreneurship. Below is a sketch of the project followed by a brief budget explanation.

There is ample empirical evidence that entrepreneurs often acquire crucial knowledge by working as employees of businesses similar to the ones that they later start. For example, an employee of a software-design firm may acquire knowledge at this firm and then leave the firm to start his/her own software-design company. Part of the knowledge that entrepreneurs acquire when employed, especially in service industries, is knowledge of potential clients for their future businesses and knowledge of the clients' idiosyncratic needs. Employers sometimes try to restrict this type of entrepreneurial activity by including non-compete or non-solicitation covenants in their employment contracts.

Enforcement of restrictive employment covenants has been controversial and there is interesting variation across states. For instance, Gilson (1999) argues that covenants not to compete are much less enforceable in California than in Massachusetts.<sup>1</sup> Examining potential causes of the success of Silicon Valley in California relative to Route 128 in Massachusetts, McMillan (2002, p. 114) claims that "the post employment covenant lies at the root of the differences between Silicon Valley and Route 128."<sup>2</sup> In an influential article favoring enforcement of restrictive covenants, Sterk (1993, p. 406) suggests that allowing such covenants is welfare enhancing. His claim is based on a Coasean argument: "Nothing prevents the employee from bargaining with his employer for release from the covenant. If either the employee himself or other prospective employers value the employee's services more than his current employer does, the employee should be willing to pay the employer to release him from the contract."<sup>3</sup>

This project seeks to understand the incentives and welfare effects of client-based entrepreneurship, including optimal policy in the form of restrictions on non-compete covenants.<sup>4</sup> The core of our proposed modeling exercise is a theoretical evaluation of Sterk's

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<sup>1</sup>Gilson, Ronald J. 1999. "The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete." *New York University Law Review* 74, pp. 575-628.

<sup>2</sup>McMillan, John. 2002. *Reinventing the Bazaar: A Natural History of Markets*. New York: W. W. Norton.

<sup>3</sup>Sterk, Stewart E. 1993. "Restraints on Alienation of Human Capital." *Virginia Law Review* 79, pp. 383-460.

<sup>4</sup>While there are a few attempts to theoretically model break-away entrepreneurship, these models tend to be vague on some contractual aspects and do not focus on the active role that clients play in the contracting and renegotiation process (nor on the efficiency consequences for downstream location choice).

claim, which implicitly assumes frictionless contracting (no costs, perfect information, available liquidity, etc.). In contrast, we focus on realistic liquidity constraints, along with informational constraints in capital markets. Specifically, we assume that workers are liquidity constrained when they have entrepreneurial opportunities, and therefore they cannot transfer to their current firms a large fraction of their anticipated future returns to entrepreneurship. Thus, negotiation between a firm, client, and worker (which may be about whether the work should stay with the firm or become an entrepreneur) is sometimes resolved inefficiently and, in particular, the worker separates when it would have been more efficient for him/her to remain with the firm.

We wish to explore the scope and consequences of this inefficiency. A key element of the inquiry is characterizing a firm and worker's initial employment contract — given that they anticipate the subsequent arrival of clients, the possible separation of the worker, and renegotiation of the employment contract. Another component of the analysis involves determining the choice of downstream clients about where to locate geographically. If different jurisdictions take different stances on the enforcement of non-compete covenants, clients may favor one location over another. Furthermore, we aim to produce results about optimal policy on whether non-compete covenants should be enforced. We also would like to say something about firm characteristics (size, age, etc.) as they relate to entrepreneurial activity and legal constraints.

We have analyzed and drafted a preliminary model of the relationships between firms, employees, and clients. The model has three key elements. First, in a given relationship, production relies on the worker exerting effort, but effort is unverifiable and is therefore difficult to motivate. The worker's incentive to exert effort is greater when the worker starts his own firm, but to do so he must pay a start-up cost. Second, pairs of workers and firms negotiate their initial employment contract — including any restrictive covenants — prior to matching and contracting with their clients. Third, workers may face liquidity constraints that keep them from borrowing money on the basis of expected future returns. In our model, firms, workers, and clients have the opportunity to renegotiate the terms of their relationship, but the liquidity constraint affects the outcome of negotiation.

We have been able to show that a firm-worker pair can use a restrictive covenant in the employment contract to expropriate value from the client. When the worker is liquidity constrained, restrictive covenants in the employment contract are inefficiently renegotiated, leading to an inefficiently low amount of entrepreneurial activity. Limits on the enforcement of non-compete and non-solicitation covenants can increase welfare and also increase the number of clients in a geographical region. Our model also helps us to understand the use of discretionary deferred compensation schemes by employers and cross-industry variation in the propensity of employers to take their disputes with workers over clients to the courts.

Our preliminary model has many shortcomings, so our main theoretical task is to develop a richer, more realistic, more elegant model. One key step is to devise a foundation for the notion that greater value can sometimes be generated in a bilateral worker/entrepreneur-client relationship than can be generated in a trilateral worker-firm-client relationship. This motivates as efficient a positive level of entrepreneurial activity; in other words, it is sometimes efficient for a worker to separate from a firm and become an entrepreneur to serve an existing client. Another key step is to construct a model of capital markets and delineate conditions on the information structure under which a worker/entrepreneur would not be able to obtain a loan to

buy out a non-compete covenant. We also aim to focus more attention on the negotiation/renegotiation process, on the location choices of clients, and on the broader impacts of various legal rules.

Note that this project addresses innovation in two ways. First, the main activity analyzed by the model is entrepreneurial innovation. We are interested in learning how different forms of innovation — in particular, client-based (which involves investment specificity) versus technical (a general investment) — affect outcomes differently. Second, there is a question of innovation on legal rules — that is, designing rules of enforcement (mandatory, default, and associated costs) to optimally discourage inefficient forms of entrepreneurial activity.

This project requires a great deal of work both on the conceptual front (reformulating the model) and on empirical links. Grant support from the SCIP will dramatically increase the quality of the project and quicken its pace. The preliminary results demonstrate that the larger modeling endeavor will be successful. I expect that the project will lead to at least one publishable paper within one year.