Briefly Noted

Hurd on the Street?

BY RICHARD A. BOOTH | *Villanova University School of Law*

California employment practice has been much in the news lately. First, Hewlett Packard sued its former chief executive officer Mark Hurd to prevent him from taking a job as co-president of Oracle. HP had previously fired Hurd over expense account indiscretions and allegations of sexual harassment and paid him a hefty severance in HP stock. The theory of the lawsuit was that Hurd would inevitably use or disclose HP trade secrets in his work for Oracle. Another news item was the Justice Department's Antitrust Division charge that six big tech companies — Apple, Google, Intel, Adobe, Intuit, and Disney/Pixar — colluded not to recruit each other's employees via cold calls.

Both cases have now been settled. But what is puzzling is that they arose in the first place. A simple non-compete agreement would have been enough to prevent Hurd from going to work for Oracle or to prevent cross-border workforce raids. Did the lawyers whiff? And why is that other tech giant, Microsoft, curiously absent from the list of offending companies?

Good for tech? | The answer to this puzzle is that, under California law, a non-compete agreement is unenforceable because of a statute the state adopted shortly before it joined the Union in 1850. (The only other state that bans such agreements is North Dakota.) So instead of contractually binding Hurd not to go to work for one of HP's competitors, HP was forced into the fallback position of arguing that the courts should block Hurd's joining Oracle because, if he were to do so, he would disclose HP trade secrets to his new employer.

There is nothing new about this tactic. California firms have sought to end-run the law in this way many times. They seldom succeed.

It may seem odd that California — a state whose economy depends on intellectual property and the home of Silicon Valley — would have prospered under such a law. How can a business hope to succeed if employees are free to come and go with the know-how they acquire on the job?

Ironically, it seems the law may be quite good for business — especially the technology business. Arguably, the law prohibiting non-compete agreements was a major factor in the rise of Silicon Valley (and possibly the demise of Boston's Route 128 technology corridor). The techie tendency to job-hop may have led to sharing information and know-how that facilitated more rapid innovation than would otherwise have been possible. (For more, see "Should Noncompetes Be Enforced?" p. 6.)

Moreover, and perhaps even more important, California companies have had to find other ways to keep their employees from running off with the competition. It turns out that equity compensation is a far better way to assure the loyalty of employees than a non-compete agreement. An employee who receives stock or options as part of his compensation package usually cannot sell until a year or more has elapsed. In addition, stock and options are forfeit in most cases if the employee leaves the company.

Needless to say, this system works fine as long as the employees think the company will prosper. But if the employees have no faith that the business will succeed, equity compensation will do little to keep them around. One might see this as a shortcoming of equity compensation. With a non-compete agreement, a struggling business can keep its employees from abandoning ship by preventing them from joining the competition. But what is the sense in that? Do we not want employees to exit unpromising ventures sooner rather than later, thus allocating human resources more quickly and efficiently? This may be uniquely important in the computer industry where there is danger of developing a technology that is obsolete before it even gets to market. But it makes sense for all business.

This is not to say that the only effect of equity compensation is to induce the rats to leave a sinking ship. Equity compensation is just as likely to lead rats onto a ship that can be saved if the prospect of gain is significant. Indeed, one might prefer to sign on with a company whose stock price is depressed. If the business has promise, they will come — or stay. Equity compensation induces an employee to focus on how his efforts will contribute to the success of the business. Moreover, it induces employees to keep an eye on each other. If the value of my options depends on how you do your job, peer pressure is likely to rise. And when employers understand that it is important for employees to have faith in the firm, it even induces employers to listen to employees.

But wait. There's more.

Equity compensation saves cash and thus permits startups to compete for talent more vigorously than would otherwise be possible. In contrast, an employee who must agree to a non-competition agreement must in effect invest more of his human capital in the venture and thus will insist on more pay.

In addition, equity compensation forces

Richard A. Booth holds the Martin G. McGuinn Chair in Business Law at the Villanova University School of Law

the company to seek liquidity. If a company does not go public or get sold, employees cannot ever cash out. One might argue that it is not necessarily a good thing to start a business with the primary goal of selling it. But one cannot sell a business unless it produces something of value. So the need to plan for liquidity keeps a business focused on what matters.

Some critics have suggested that technology companies have used equity compensation too liberally, arguing that few employees can have much effect on stock price. But is it not a bigger problem when employees cannot have much effect on stock price? Yet another advantage of equity compensation is that it induces firms to maintain an efficient size. If a firm grows too large, too diversified, or too unfocused, equity compensation will become less attractive for employees who see less connection between their work and the bottom line. Thus, equity compensation will tend to induce spin-offs and other divisive transactions when they make sense.

In the end, a non-compete agreement simply cannot compete with equity compensation. A carrot always beats a stick.

End run | Although the ban on non-compete agreements has served California well, it has not stopped California companies from seeking to handcuff employees using the trade secret theory as an end run. Although business prospers if all agree to eschew non-compete agreements, it is thus all the more in the interest of an individual employer to restrain his own employees if he can. So law matters here. Employers would never agree to forgo the supposed benefits of non-compete agreements. And if they did, they would have every incentive to cheat.

To be fair, HP had little choice but to sue Hurd. For the HP board of directors to do nothing would have been seen as a breach of fiduciary duty. Moreover, HP may really possess specific trade secrets that need protection. But if so, HP could have insisted that Hurd agree not to work for *specified* competitors, as did Carly Fiorina when she left HP. That agreement was probably enforceable under California law, which bans only contracts that prohibit an employee from engaging in a lawful profession, trade, or business in any capacity.

Fortunately, the California courts have had little difficulty seeing the inevitable disclosure theory for what it is: an after-the-fact agreement not to compete that restricts employee mobility and that constitutes a threat to a public policy that has served the state well since 1850. Nevertheless, to mangle Oliver Wendell Holmes, the Hurd case threatened to make some bad law. If HP had prevailed, it could have set a precedent that other employers could use at will.

ILLUSTRATION BY KEVIN TUMA

Non-compete partnership? The Justice Department case against the six big tech companies was an equally important victory for the cause of innovation. The defendant companies argued that without an agreement not to cold call competitor employees, it would have been impossible to enter into various joint ventures. It may also be that, as partners, the companies assumed a duty to each other not to take advantage of the situation.

It is unlikely that the Justice Department would have been much impressed by that argument given the recent Supreme Court decision in *American Needle* that seems to limit the single entity defense, such as in the production of hats and other logowear. In other words, the big six could have argued that since it was legal for them to form partnerships with competitors for the purpose of developing new products, it should also be legal to agree not to compete with each other for employees. If indeed they were partners, then they would owe a fiduciary duty to each other that might have precluded them from raiding each other's work force. If they did owe each other such a duty, then presumably a contract that spells out a duty that already exists would be permissible. But maybe not. That was essentially the argument that the Supreme Court rejected in *American Needle*. That the teams comprising the National Football League need to collaborate to produce football games does not imply they are free to restrain trade in other ways where it may not be necessary to do so.

Still, the case against the six big tech companies illustrates the worrisome possibility that, even in California, employers may try to avoid the law against non-compete agreements simply by agreeing not to hire competitor employees. In contrast, Microsoft, which is based in Washington state, can and does require its employees to sign a non-compete agreement. So Microsoft has no need to collude with competitors about hiring, though it would probably be legal for Microsoft to do so anyway. After all, every (legal) contract is a restraint of trade. So no harm, no foul.

The bottom line is that California and the cause of innovation dodged a couple of bullets. As we all know, California is different. Let us hope it stays that way. To mangle another Wendell—Phillips, in this case—eternal vigilance is the price of being different. R

Residential Dynamic Pricing and 'Energy Stamps'

BY AHMAD FARUQUI | *The Brattle Group*

In just about any market-driven economy, prices play a central role. They balance demand and supply and ensure economic efficiency in the allocation of scarce resources such as capital, labor, fuel, and other raw materials.

Prices can play the same role in the market for electricity. However, throughout the developed world, the central role of prices in electricity is limited to wholesale markets and retail markets involving commercial and industrial customers. The residential market, in contrast, predominantly uses flat-rate pricing, which ignores the temporal variation in the cost of providing electricity. In the United States, residential sales account for roughly a third of national electricity consumption and a somewhat greater proportion of peak demand. Thus a large amount of economic efficiency is lost in the power sector.

"Smart meters" that measure a consumer's use of electricity by time of day and the nation's move toward developing a "smart grid" that would more efficiently transmit and distribute power during times of peak use make time-varying pricing of electricity technically feasible. But despite the emergence of these technologies, long-standing resistance to time-varying pricing has grown more intense. Various groups opposed to the rollout of dynamic prices have united under the banner of consumer protection to demand that flat-rate pricing of electricity remain the norm. They are not opposed to "opt-in" time-of-use or dynamic pricing, but under no condition will they countenance default or universal application of dynamic pricing.

Their concerns are voiced forcefully in a whitepaper, "The Need for Essential Consumer Protections," produced by several parties including, notably, the Consumers Union, a group that has not been involved in electricity rate-making proceedings. One of the big issues cited in the whitepaper is the adverse impact that dynamic pricing could have on low income customers. Recall that low income customers in all states are beneficiaries of a federal program known as the Low Income Home Energy Assistance Program. In addition, in states such as California and Pennsylvania and in the District of Columbia, low income customers also get a discount on the price of electricity. The concerns about adverse bill effects voiced in the whitepaper are presumably incremental to the discounts being offered through such programs.

Ahmad Faruqui is principal of The Brattle Group, an economics, finance, and regulation consulting firm.

Alternative reality | It remains to be seen what effect this whitepaper will have on state regulators, who hold the key to allowing or denying any changes in rate design. Suppose the whitepaper's arguments are accepted not only by state regulators but by policymakers in all halls of government, who then proceed to apply them to the entire U.S. economy. An alternative reality would emerge, quite different from the real world that exists today. What would the alternative reality look like?

For one thing, parking meters in inner cities would charge the same hourly rate all day long, every day of the year, instead of the current system where meters commonly do not charge after work hours or on weekends. The consequence would be that motorists would have a tough time finding parking during working hours, an inferior outcome than what we have in the real world.

In the alternative reality, airline prices would be the same regardless of when you booked your flight or when you flew. Business travelers needing to book a seat at the last minute would be disappointed and vacationers looking for special deals would find none, again an inferior outcome as compared to the real world. The same uniformity would be applied to hotel rates and car rentals. It would not matter whether you checked in on a weekday or a weekend.

The San Francisco–Oakland Bay Bridge would revert back to charging the same rates around the clock as it was doing prior to July 1 of this year. In London, where congestion pricing was instituted in 2003, there would be no additional fee of £8 to park during the daytime hours on weekdays.

Grocery shoppers would expect to pay the same price for produce regardless of whether it is in-season or out-of-season. When filling up for gas at the pump, motorists would pay the same price year round. Moviegoers would pay the same price for a matinee as for the late show.

ILLUSTRATION BY KEVIN TUMA

may encourage over-consumption of electricity, just as food stamps are sometimes criticized for encouraging unhealthy eating. However, food stamps recognize that the laws of demand and supply are not suspended for the poor. They have to shop wisely among the various food items in the grocery store and they also have to factor in seasonal price variation.

With our hypothetical "energy stamps," all electricity customers would face time-varying rates and have an incentive to use less energy during peak hours and more energy during off-peak hours. Low income customers would be able to offset any increase that occurs in their utility bill by using the stamps. While this would not be a first-best solution in terms of ensuring economic efficiency, it would be a pragmatic second-best solution.

Of course, government agencies would still have to figure out how much to pay the recipients, establish who would be a recipient, identify the program administrator, and establish a funding mechanism. Those are important tactical questions that can be resolved if governments agree on strategy — that the poor need to be given a safety net that allows them to consume a certain amount of electricity.

Energy stamps would allow for the universal application of dynamic pricing to electricity. They would help improve system load factors and costs. Lower prices would ensue for all customers and that would be the best form of consumer protection. R

There would be no more early bird specials at restaurants and parking garages. And so on.

Would prices for various goods and services be higher or lower, on average, in the alternative reality we have just sketched than in the real world? The alternative reality would be characterized by excess capacity and poor load factor, because prices would no longer be used to spread out periods of intense demand. As a result, the alternative reality would be a world of higher prices.

The conclusion is that flat-rate pricing for everyone leads to high prices for everyone. That may well be the world's worst-kept secret. By comparing outcomes in the alternative reality to the real world, we have rediscovered a well-known truth: "There is no free lunch."

By contrast, time-varying prices, whether simple time-of-use or fully dynamic, act like a shock absorber. They help reduce or eliminate the need for expensive peaking capacity and lower (average) costs for everyone.

Dynamic pricing and the poor | So why do we have hardly any residential electricity consumers on dynamic pricing, despite the reduction in advanced metering infrastructure costs that has occurred during the past decade? Even when smart meters have been shown to be cost-effective, policymakers are often stumped by the popular argument that time-varying prices will harm low income customers and those on fixed incomes.

It does not seem to matter that little empirical evidence is presented to buttress the argument. Nor does it matter that there is plenty of evidence to the contrary. Instead, the media headlines talk about low-income customers being forced by high prices to unplug their appliances during peak periods, endangering their health and possibly killing themselves.

If society is concerned about the plight of its less fortunate members and regards certain items as necessities, it could provide an income subsidy to the poor through an "earned income tax credit." This would allow them to afford the necessities of life. However, in the current era of fiscal difficulty and budget deficits at both the federal and state levels, it may be difficult to fund the tax credits.

A second-best solution would be to design a product-specific subsidy for electricity, similar to food stamps. The disadvantage of this approach is that it

READINGS

- "The Ethics of Dynamic Pricing," by Ahmad Faruqui. *Electricity Journal*, July 2010.
- "The Need for Essential Consumer Protections: Smart-Metering Proposals and the Move to Time-Based Pricing," published by AARP, National Consumer Law Center, National Association of State Utility Consumer Advocates, Consumers Union, and Public Citizen. August 2010.