

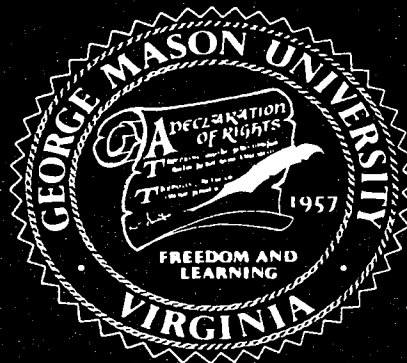
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# GEORGE MASON LAW REVIEW

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## THE LAW AND ECONOMICS OF POST-EMPLOYMENT COVENANTS: A UNIFIED FRAMEWORK

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### INTRODUCTION

Covenants not to compete contained within post-employment contracts have been finding renewed vigor in many sectors of the economy. Especially common in the high-tech sectors of the economy and with respect to upper management in all sectors, these contracts are used by employers to secure what has become the critical cornerstone of the U.S. economy—skills based upon knowledge, extensive training, and experience. Employers regard post-employment restraints as an important if not essential method for protecting their investment in their employees, including not only trade secrets and customer contacts, but also perhaps employee training costs. Many employees dislike post-employment covenants for precisely that reason: After many years of expensive education, employees seeking a return on their investment do not wish to be held captive by employers seeking to restrict their career opportunities.

While covenants not to compete have increasingly become a key part of employment relationships (much to the chagrin of the employees), state case law has lagged behind, failing to forge the tools necessary to deal adequately with the many difficult issues raised by post-employment restraints in a high-tech, knowledge based economy. Consequently, state courts deal

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with covenants not to compete much like they deal with tort cases—in a highly unpredictable and ad hoc fashion.<sup>1</sup>

There are many reasons, of course, for this unpredictability.<sup>2</sup> Courts have engaged in the analysis of covenants not to compete in a highly fact-based manner. Courts may interpret key facts differently because both the facts and the individual ideologies of the judges are not uniform across cases. It thus becomes difficult if not impossible for practitioners to make predictions as to whether any covenant they draft will be enforceable.<sup>3</sup> Second, public policy has not come out too strongly for or against the use of post-employment covenants not to compete. This may be because of tensions between the notion of freedom of contract that runs throughout contract law and paternalistic notions that are equally pervasive.<sup>4</sup> Additionally, freedom of contract is at odds with antitrust law where the covenant may restrain trade.<sup>5</sup>

The discipline of Law & Economics can contribute to a more sound analysis of post-employment restraints by state courts. By providing a uniform theory through which post-employment covenants might be analyzed,

<sup>1</sup> Michael Sean Quinn & Andrea Levin, *Post Employment Agreements Not to Compete: A Texas Odyssey*, 33 TEX. J. BUS. L. 7, 12 (1996). In fact, covenants not to compete are frequently challenged in the context of tort litigation such as trade secret misappropriation. *Id.* at 11.

<sup>2</sup> There are also many proposed solutions. *See, e.g.*, Christine O'Malley, *Covenants Not to Compete in the Massachusetts Hi-Tech Industry: Assessing the Need for a Legislative Solution*, 79 B.U. L. REV. 1215 (1999); Christi L. Johnson, Note, *Travel Masters v. Star Tours: A Recent Texas Supreme Court Decision Highlights the Tension Between the Court and the Texas Legislature Regarding Covenants Not to Compete*, 44 BAYLOR L. REV. 937 (1992); Gary P. Kohn, *A Fresh Look: Lowering the Mortality Rate of Covenants Not to Compete Ancillary to Employment Contracts and to Sale of Business Contracts in Georgia*, 31 EMORY L.J. 635 (1982); Brett D. Pynnonen, *Ohio and Michigan Law on Postemployment Covenants Not to Compete*, 55 OHIO ST. L.J. 215 (1994) (advocating that Michigan adopt Ohio's definition of "reasonableness.").

<sup>3</sup> *Id.*

<sup>4</sup> For a discussion of the tensions between the notions of freedom of contract and paternalism, see Darren Bush, *Caught Between Scylla and Charybdis: Law & Economics as a Useful Tool for Feminist Legal Theorists*, 7 AM. U. J. GEN. POL'Y & L. 395 (1998).

<sup>5</sup> Quinn and Levin list several factors to explain the tension. *See* Quinn & Levin, *supra* note 1, at 11-12. Specifically, factors they list in favor of enforcing covenants not to compete include:

1. encouragement of commercial/industrial investments in the development of technology, the development of sophisticated business methods, and the distribution of training;
2. encouragement of efficient business operation by fostering open internal communications, encouragement of loyalty as a social virtue . . .
4. protection of commercial . . . investment in customer relationships; and
5. freedom of contract.

*Id.* Quinn and Levin also list five policies which disfavor enforcement:

1. traditional Anglo-American common law skepticism about restraints of trade;
2. American societal, pseudo-constitutional preference favoring personal freedom;
3. encouragement of labor's economic mobility;
4. realism about freedom of contract where there is inequality of bargaining power and at least quasi-adhesionary contracts; and
5. American cultural stated preference for the small over the large, the apparently weak over the ostensibly strong, and the individual over the organization.

*Id.* at 12.

Law & Economics analysis holds promise in fostering greater predictability in this realm.

This article sets forth a unified framework for analyzing post-employment restraints that can assist plaintiffs, defendants, and courts in evaluating issues raised by such covenants. The article commences with a brief introduction describing the history of post-employment covenants under the tracks of early common law and nascent U.S. antitrust law. The article next discusses the modern treatment of post-employment covenants by state courts. The article then outlines the ideological tenets that provide the basis for an approach to analyzing post-employment covenants—namely, those of the Law & Economics School and its analysis of contract law. The article then establishes the factors that the authors would use to analyze covenants not to compete. The article concludes that the authors' approach provides greater predictability to disputes arising from post-employment covenants and that their approach enhances the efficiency of such contracts by reducing the risk that the careful drafting of the contract was all for naught.<sup>6</sup>

## I. TWO SOURCES OF LEGAL PRECEDENT

Post-employment restraints traverse two distinct areas of law, contracts and restraints of trade. State courts have used traditional principles of contract law to analyze covenants not to compete, occasionally incorporating elements of the common law from restraints of trade. In contrast, federal courts have analyzed post-employment restraints largely under the Sherman Act.<sup>7</sup> The Sherman Act originally codified the early common law of restraints of trade in the late nineteenth century, but jurisprudence under the Sherman Act has developed significantly over the last century. The Supreme Court recognized these common roots in *National Society of Professional Engineers v. United States*,<sup>8</sup> where the Court explained that both the Sherman Act and state law regarding common law restraints of trade can be traced to a common origin.<sup>9</sup>

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<sup>6</sup> Many have cautioned that careful drafting of non-compete clauses is necessary to ensure the enforceability of the contract. See, e.g. David L. Gregory, *Courts in New York Will Enforce Non-Compete Clauses in Contracts Only if They are Carefully Contoured*, 72 N.Y. ST. BAR J., Oct. 2000, at 27.

<sup>7</sup> 15 U.S.C. §§ 1-7 (1997). Section 1 provides in part that “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce. . . is declared to be illegal.”

<sup>8</sup> 435 U.S. 679 (1978); see also *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1 (1911) (relying on common law precedents to give meaning to the Sherman Act).

<sup>9</sup> “The Rule of Reason, with its origins in common-law precedents long antedating the Sherman Act, has served” the purpose of giving “shape to the [Sherman Act’s] broad mandate.” *Nat’l Soc’y of Prof’l Eng’rs*, 435 U.S. at 688 (discussing *Mitchel v. Reynolds*, 1 P. Wms. 181, 24 Eng. Rep. 347 (Q.B.

### A. *The Common Law Origins of Post-Employment Restraints*

The early common law essentially separated agreements in restraint of trade into three distinct categories: general restraints of trade, partial restraints of trade, and restraints on future employment.<sup>10</sup> General restraints of trade consisted of those agreements that always impeded trade in some way and had no clear benefit to competition.<sup>11</sup> These agreements were void per se.<sup>12</sup> Partial restraints of trade were those agreements ancillary to the sale or transfer of a business interest.<sup>13</sup> Although these agreements certainly constituted a restraint of trade, the English courts generally upheld such agreements, so long as they were reasonably tailored to the scope of the connected transaction.<sup>14</sup> Finally, restraints on future employment were the same as modern day covenants not to compete, and were held invalid, irrespective of the scope of the restriction, because of their negative impact on economic freedom.<sup>15</sup>

#### 1. Early Common Law Treatment of Post-Employment Restraints

At common law, restraints on future employment were deemed invalid per se because they circumvented the customary rules of apprenticeship.<sup>16</sup> During the fifteenth and sixteenth centuries in England, the apprenticeship system was a major component of the overall economy.<sup>17</sup> In fact, during this period, craft guilds were the dominant vehicles of economic activity in England.<sup>18</sup> These guilds were comprised of three basic groups: the masters, the journeymen, and the apprentices.<sup>19</sup> The goal of the apprenticeship system was to provide the master craftsman with a small labor force, and provide young men with a means of technical training to introduce them to the skills of the given trade.<sup>20</sup> The relationship between ap-

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1711)).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* This proposition is inferred from the cited material based on the explanation of partial restraints discussed later.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* In general, the theory was that if the partial restraints were reasonably tailored, then their impact on economic freedom and competition would be minimal.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 632-634.

<sup>17</sup> *Id.* at 632.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 633.

<sup>20</sup> *Id.*

prentice and master was a contractual one: the master agreed to provide essential training to the apprentice in exchange for low wage labor over a given period of time, usually seven years.<sup>21</sup> At the end of the contractual period, the apprentice would be free, as a journeyman, to practice his trade, eventually becoming a master.<sup>22</sup> Essentially, the goal was to produce highly skilled and competent masters, thus increasing productivity and overall economic efficiency.

Sometimes, masters, in an attempt to decrease the amount of competition present in a given trade and geographical area, would force their apprentices to enter into agreements that made it difficult or impossible for them to become masters.<sup>23</sup> Such agreements, like modern covenants not to compete, restricted the apprentice's ability to set up shop in direct competition with the master, and were viewed as general restraints that acted to directly decrease competition and hinder economic freedom.<sup>24</sup> During this time period, it appears that the desire to promote economic freedom and the importance of allowing highly trained apprentices to participate competitively in their trades were crucial factors in the rejection of past-employment restraints by the early English courts.

*Dyer's Case*<sup>25</sup> provides a good example of the typical view of restrictive covenants at the time. *Dyer's Case* is the first known case dealing with restrictions on the individual practice of a craft.<sup>26</sup> In *Dyer*, the plaintiff brought a writ of debt against the defendant, a dyer by trade.<sup>27</sup> The defendant Dyer asserted that, according to his "indenture," or apprenticeship contract, the debt was to be forgiven so long as he did not practice his trade in the plaintiff's town for six months after his training.<sup>28</sup> He further claimed that he had satisfied this requirement.<sup>29</sup> Although the case was allowed to proceed, and no further proceedings are reported, the Lord of the English court hinted that the defendant might have demurred because the restriction was illegal at common law.<sup>30</sup>

Written about 150 years after *Dyer*, four cases demonstrate that the early common law view against restraints on future employment per-

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21 *Id.*

22 *Id.*

23 *Id.* at 634.

24 *Id.* Generally, the attempts by the courts and lawmakers to prevent the imposition of such restrictions led to the inferences made.

25 Y.B. Mich. 2 Hen. 5, fol. 5, pl. 26 (C.P. 1414).

26 Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 636 (1960).

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.* "By God, if the plaintiff were here he should go to prison until he paid a fine to the King." *Dyer's Case*, Y.B. Mich. 2 Hen. 5, fol. 5, pl. 26 (C.P. 1414) (cited in KURT H. DECKER, COVENANTS NOT TO COMPETE 22 (1993)).

sisted.<sup>31</sup> In an anonymous case, decided in 1578, a master required his apprentice to agree not to employ the craft for four years after his training was complete.<sup>32</sup> The court held that the obligation was void.<sup>33</sup> Twenty-four years later, in *Colgate v. Bacheler*, the defendant's son obligated himself to pay the plaintiff twenty pounds if he engaged in the trade of a haberdasher within the county of Kent, primarily in the cities of Canterbury or Rochester, prior to a certain date.<sup>34</sup> The court specifically noted the restraint was not a broad one, but ruled that it was unlawful "to restrain the practice of a trade 'at any time, or 'at any place'."<sup>35</sup> Although the reports of such cases are sketchy, and the courts do not provide specific explanation as to why the decisions were made, they demonstrate the early English view that all restraints against future employment were invalid.

In 1587, a plaintiff blacksmith who brought an action against another blacksmith for breach of a covenant not to compete was thrown in jail for doing so in the case of the *Blacksmiths of South-Mims*.<sup>36</sup> The restriction had no time limitation and a broad geographic boundary that extended beyond the town.<sup>37</sup>

In 1614, in the *Ipswich Tailor's* case<sup>38</sup> the tailor's guild sued another tailor for failing to first serve in an apprenticeship capacity in the town and for not being sanctioned by the guild. The court ruled that the restriction was invalid because "at common law, no man could be prohibited from working in any lawful trade."<sup>39</sup>

The historical context of these cases indicate that they arise from economic fears arising from deep labor shortages and systems of apprenticeship that were designed to ensure that apprentices did not rise to compete against their masters. In the mid 1300s, the "Black Death" caused labor to be exceptionally scarce.<sup>40</sup> Thus, each and every employee had great value. Unemployment was unlawful<sup>41</sup> for anyone under 60 years of age, and any

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31 Blake, *supra* note 26, at 634-635.

32 *Id.* at 634.

33 *Id.* at 635.

34 *Id.*

35 *Id.*

36 2 Leo. 210, 74 Eng. Rep. 485 (C.P. 1587).

37 DECKER, *supra* note 30, at 24.

38 77 Eng. Rep. 1218 (K.B. 1614).

39 *Id.* (quoted in DECKER, *supra* note 30, at 24).

40 DECKER, *supra* note 30, at 22.

41 Unemployment at the time could have been perceived as an exercise in market power by someone who was seeking to increase wages. Note that the Act of 1548 proscribed criminal penalties for any laborer who conspired or agreed to raise wages or reduce hours, 2 & 3 Edw. 6, ch. 15, *confirmed by* 22 & 23 Car. 2, ch. 19 (1670).

