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Author(s): Paul H. Rubin and Peter Shedd
Source: *The Journal of Legal Studies*, Vol. 10, No. 1 (Jan., 1981), pp. 93-110
Published by: The University of Chicago Press for The University of Chicago Law School
Stable URL: http://www.jstor.org/stable/724227
Accessed: 10-02-2018 14:07 UTC

HUMAN CAPITAL AND COVENANTS NOT TO COMPETE

PAUL H. RUBIN and PETER SHEDD***

I. Introduction

The common law does not generally enforce contracts in restraint of trade. An exception is made, however, for certain restrictive covenants. One class of such covenants are those signed by an employee who agrees not to compete with his employer for a period of time after termination of employment. Common law judges seemed to view these contracts as creating monopoly power, which was, however, justified by other interests. Stigler, in his analysis of such covenants, also assumes that monopoly power (of masters, in master-apprentice contracts) is the relevant feature.[1] This paper will argue that such contracts were not based on monopoly power, but served different functions. In particular, restrictive covenants were and are necessary in some circumstances to lead to efficient amounts of investment in human capital. Moreover, we will examine the behavior of courts in enforcing such contracts to ascertain if enforcement may be viewed as efficient, in the sense that much of the common law may be considered efficient.

In his seminal work on human capital, Gary Becker has distinguished between "general" and "specific" on the job training.[2] "General training is useful in many firms besides those providing it."[3] "Training that increased productivity more in firms providing it will be called specific training."[4] The concept of human capital has been one of the most fruitful

* Professor of Economics, The University of Georgia.

** Assistant Professor of Business Law, The University of Georgia.

Financial assistance from the Liberty Fund—Center for Libertarian Studies is gratefully acknowledged. Thanks are due to Louis de Alessi, Chris Paul, Richard Higgins, and to an anonymous referee for comments on an earlier version.

[1] George J. Stigler, Restraints on Trade in the Common Law, in The Organization of Industry 255 (1968).

[2] Gary S. Becker, Human Capital (1964).

[3] *Id.* at 11.

[4] *Id.* at 18.

innovations in recent economic theory;[5] moreover, on the job training is empirically very important in explaining observed patterns of earnings.[6] However, there are situations in which a basic result of the Becker model—that employees will pay for general training—will not hold because of peculiar features of training markets. One source of information about the functioning of real-world labor markets is an examination of labor contracts. An examination of these contracts and of the legal treatment of labor relationships should be useful in understanding labor markets. Conversely, an examination of the economics of training markets may shed light on the legal behavior involved. In Part II, we discuss the general nature of the relevant contracts. In Part III, we consider the economics of training markets in more detail. In Parts IV and V, we discuss the way in which the law has dealt with the labor relationship. Part VI considers covenants not to compete ancillary to the sale of a business, and the last part is a summary.

II. The Nature of the Contracts

Throughout this paper, we will be concerned with situations where a contract restricts the activities in which an employee may engage after termination of employment. For various reasons, discussed in more detail below, an employer might want to constrain an employee to work for him for a certain period of time. It is an old and well-established principle of law, however, that courts will generally not order specific performance—that is, a contract requiring an individual to continue to work for a firm for a specified period of time will not be enforced. The reason given for this refusal is generally that of avoiding involuntary servitude; indeed, part of the reluctance may stem from constitutional and statutory bans on indentured servitude. However, another explanation may simply be that enforcement of such contracts would be very expensive, requiring the courts or their agents to monitor the performance of employees to ascertain the amount of effort provided. In some cases where performance is easily checked due to the unique characteristic of the item involved, such as in contracts for the sale of real estate, the courts will in fact order specific performance.[7] However, we need not concern ourselves with the reason for the court's reluctance to enforce such agreements. We begin with the situation in which both parties are aware of this reluctance.

[5] For a survey indicating the importance in economics of this concept, see Mark Blaug, The Empirical Status of Human Capital Theory: A Slightly Jaundiced Survey, 14 J. Econ. Literature 827 (1976).

[6] See Jacob Mincer, Schooling, Experience, and Earnings (1974).

[7] Richard A. Posner, Economic Analysis of Law (2d ed. 1977).

Another method of enforcing compliance by employees is to limit in the employment contract alternatives for the employee. If firm A spends money and resources training an employee to be a skilled basket weaver, this skill is valuable to any firm hiring basket weavers. However, if the employee has signed an enforceable agreement promising not to engage in basket weaving for five years after leaving the employment of firm A, the employee has effectively agreed to work for firm A or to cease weaving baskets for five years. If he is much more valuable as a basket weaver than in any other trade, he will continue to work for A. Thus, restrictive covenants in a labor contract effectively enable parties to contract for long periods of time. An example of such a covenant, taken from a recent contracts casebook,[8] is:

> Restrictive Covenant. The parties agree that Employer's talent packaging business is nationwide in scope and would suffer serious damage and loss of goodwill if Employee entered into direct competition immediately after termination of this agreement with the same customers and based in the same techniques and information used by Employer.
>
> For a period of two years after the termination of this agreement, the Employee therefore covenants that he will not in New York City or Los Angeles, California, directly or indirectly, own, manage, operate, control, be employed by, participate in, or be connected in any manner with the ownership, management, operation, or control of any business similar to the type of business conducted by the Employer at the time of the termination of this agreement.

We have not yet discussed explicitly the reason for desiring to so constrain employees. Presumably, since both parties voluntarily sign the agreement, it must serve to increase the value of resources. In the next part, we discuss the nature of employment relations and show how such agreements may be value maximizing.

III. Types of Human Capital

Specific human capital and general human capital are the polar opposites in markets for types of training. If training is specific, there is only one firm that can employ the trained worker. After training, the worker is worth more to this firm than to any other potential employer. The employer, knowing this, will pay the worker more than any other employer in order to retain the worker and recoup his investment. However, to pay this higher wage, the employer will require the worker to pay for part of the specific training. Employers and workers will thus share the cost and the gain from specific training. In the case of general training, the trained worker faces a competitive market with many bidders for his talent. The

[8] Addison Mueller & Arthur I. Rosett, Contract Law and Its Application 567-68 (1971).

employer, knowing that he will be required to pay the full market price for the trained worker, will not pay for any training. Conversely, the worker, knowing that he will receive the full value of his training, will be willing to pay for it.

In both of these market structures, prices are determinate. Both parties to labor transactions can be certain about the future value of training and can plan their investments accordingly. There is no uncertainty in either case, except for the normal uncertainty about future changes in demand or technology. Training in both cases will be efficient, in the sense that money will be spent on training to the point where the cost of the training will be equal to the present value. No mention has been made of labor contracts because they would have no relevance in the market structures considered. If training is truly specific, the employer needs no assurance that the worker will continue to work for him, for there is no other market in which the employer can sell his skill. If training is truly general, the employee knows that he can recoup his investment by quitting the current employer and going to work for any of a number of other firms. A long-term contract has no value to either party.

Thus, in the two cases analyzed by Becker, there is no need for any contractual term limiting the future market behavior of the worker; market forces will generate solutions without contracts. But in fact many employment contracts do contain clauses limiting the future behavior of employees, and such contracts are common sources of legal dispute.[9] Thus, there must be some aspects of real-world labor markets that Becker's analysis does not fully capture. As we will argue more fully below, the lacuna in the Becker analysis is in terms of types of general training. In particular, there are some types of general training for which the worker will not pay. Assume, for example, that it takes a firm one day to teach a worker the details of a trade secret valuable to many other firms and worth $100,000. The value of the information is so great that the worker cannot pay for it by accepting reduced wages. Moreover, because of difficulties in borrowing with human capital as collateral, there may be no other way for the worker to finance the acquisition of human capital with sufficiently high value.[10] If the worker borrows the money needed to finance the acquisition of the capital, the lender has as security for his loan only the human capital of the worker. However, the inability of the worker to sign a binding contract, which creates the difficulty for the employer, also creates the same problem for the lender. Human capital

[9] In addition to the cases cited below, see Harlan M. Blake, Employee Agreements Not to Compete, 73 Harv. L. Rev. 625 (1960).

[10] George J. Stigler, Imperfections in the Capital Market, 75 J. Pol. Econ. 287 (1967), reprinted in The Organization of Industry, *supra* note 1, at 113.

cannot serve as collateral for loans because of the impossibility of compelling specific performance. In this circumstance, the firm would want the worker to sign a noncompetition clause, for such a clause would indicate that the worker could not use the training acquired elsewhere. Covenants not to compete would be signed by workers who received general training with value sufficiently high so that the worker could not finance the acquisition of this training by accepting reduced wages.

Once the worker has received this training, however, an incentive for opportunistic behavior is created.[11] The worker has an incentive to violate the contract and profit from his training—either by going to work for himself or by going to work for another firm, which will pay him a premium because of the value of his training. In this situation, the worker is attempting to appropriate for himself the value of training for which he did not pay. If workers were able to do this, the incentive for firms to invest in acquiring valuable information would be greatly reduced, for firms would not be able to protect valuable information. We are specifically dealing here with cases where information cannot be protected by patent and trade secrets are therefore used.

Another inefficiency could be created if firms were not able to require contractually workers not to use valuable information elsewhere. If information were not protected by contract, firms might spend resources in other ways to protect this information, a point made by Posner in his discussion of privacy regulation.[12] For example, if a secret process requires three steps, there are two methods of maintaining secrecy. One allows one employee to undertake all three steps but binds him by contract not to use the acquired information elsewhere. An alternative is to teach each of three employees only one of the three steps, so that no one employee will know enough to compete with the firm. It is possible, however, that the production process will be more costly if the second method of protection is used. (If not, then the second method would always be used, and the law is irrelevant.) Thus, if the noncompetition clause is not binding, firms will be forced to use more costly methods of production in some circumstances in order to protect their proprietary information.

The argument so far is that firms will use noncompetition clauses in contracts when employees acquire certain types of general training in the course of employment, and that it is worthwhile for the courts to enforce such clauses in order to lead to efficient levels of investment in new technologies and to economize on unnecessarily expensive ways of pro-

[11] Benjamin Klein, Robert G. Crawford, & Armen A. Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J. Law & Econ. 297 (1978).

[12] Richard A. Posner, The Right of Privacy, 21 Ga. L. Rev. 393 (1978).

tecting such information. Without the clauses, workers would have an incentive to behave opportunistically—to try to violate such contracts and capture for themselves the value of the information acquired. However, firms may also have an incentive to behave opportunistically and may try to pay workers less than the full value of their marginal product, even after adjusting for human-capital investments.

Assume that the courts will enforce all covenants not to compete in labor contracts. Some types of employment relationships will involve both types of general training—general training for which the worker will pay in the normal manner, by accepting reduced wages, and general training for which the worker cannot pay because of its high value. If the worker signs a covenant, he would be unable to use any of the training in other jobs. Presumably, the employer would then be forced to finance all of the investment, since it would all be specific. If the worker then left this place of employment, some of his training would be valuable to many firms and its use would not cost the original employer anything. Yet the worker would be constrained from using his training. Not using general training (absent trade secrets) thus imposes a cost. The covenant not to compete should therefore ideally apply only to those types of training involving trade secrets of the employer.

It may, however, be difficult or impossible to draft a contract with sufficient specificity to include only the training that the employer desires to protect. The employer may not know in advance for exactly what sort of work a particular employee is best suited, and thus may not be able to specify contractually which information is to be protected. Moreover, the details of trade secrets often cannot be written down; the secret may consist of a series of actions involving a particular process.[13] Even when the secret can be written down in a contract, the writing itself will seriously compromise the secrecy of information. The contract not to compete will thus necessarily involve some ambiguity. The employer may have an incentive to behave opportunistically and underpay the worker relative to the value of that part of the general training financed by the worker if the employer believes that the covenant will reduce the worker's mobility. It would therefore be inefficient to enforce all restrictive covenants, just as it would be inefficient to enforce none of them. In such circumstances, the courts, in enforcing covenants not to compete, may serve a useful function. Specifically, in disputes about the term of contracts, the courts may attempt to determine just what sorts of information the parties expected to be included in the covenant and to enforce

[13] For some examples, see Oliver E. Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J. Law & Econ. 233 (1979); see also Edmund W. Kitch, The Law and Economics of Rights in Valuable Information, 9 J. Legal Stud. 683 (1980).

the contract accordingly. This is consistent with the view that, in the case of ambiguous contracts, the role of the courts is in general to determine what the parties would have done had they predicted the apparently unforeseen circumstance.[14]

In summary, we have the following situation. Workers will be unable to pay the full value of some training they receive from firms and will therefore sign contracts with clauses banning the workers from competing with former employers. Once the contracts are signed and the workers trained, both workers and employers may have incentives to behave opportunistically: employees to attempt to violate the contracts and sell the information acquired, and employers to underpay workers for general training for which the workers themselves have paid. If the courts are to be economically efficient in enforcement of contracts with these clauses, they must attempt to separate the two types of behavior.

Our explanation of covenants not to compete is in terms of human capital. We argue that such clauses are needed to lead to efficient levels of investment in training when the person receiving training is unable to pay for the human capital by accepting reduced wages. An alternative explanation may be that such contracts serve to smooth out lifetime earnings of employees. Employers might choose to pay employees more than their marginal product in early years of employment and less than their marginal product later, thus providing employees with a smoother income pattern than would payment according to marginal productivity. If this were done, marginal products of employees would at some point become greater than earnings, and employees would have an incentive to seek work in other firms, where they could be paid their full marginal product. If employers did pay employees in this manner, they would want contractual guarantees to prevent the employees from leaving. If this explanation were correct, we would expect to observe contracts with covenants not to compete in virtually all industries, for we might expect all workers to prefer such smoothing and thus all firms to provide it. However, this is not what is observed. As we indicate below, contracts with such covenants occur almost entirely in industries and situations in which training is important, and litigation over contracts invariably involves determination of types of information acquired. Thus, a theory based on income smoothing does not seem to accord with the empirical observations, which indicate that such contracts always involve information acquisition. Therefore, the theory proposed here seems superior. It is of course possible that the litigated cases are a biased sample of all situations in which noncompetition contracts are signed; we have no evidence on

[14] Posner, *supra* note 7, at ch. 4.

the incidence of the contracts except the litigated cases. However, a priori, this does not seem likely.

IV. Legal Analysis: General Considerations

As is commonly the case, the language used in the legal decisions is not fully consistent with the underlying economic rationality. (As is also commonly the case, this inconsistency in language does not mean that the legal decisions are themselves inconsistent with the economics. The latter proposition must be independently tested.) Litigation about contracts not to compete is generally between the employer, who is seeking enforcement of such a contract, and a former employee who has allegedly violated the contract. The courts thus seek to balance the interests of the employer and the employee, as well as making sure public policy is not violated.[15] The legal language, which conflicts with the economic analysis, indicates that contracts will be enforced if their provisions are not "overly harsh" or do not create "undue burdens," remembering always that employees probably have insufficient bargaining power and are often forced to sign contracts of adhesion (standard form contracts) or seek employment elsewhere.[16]

The economic theory of contracts would indicate that all these considerations are irrelevant. At the time a contract is signed, both parties must prospectively expect to benefit from the agreement, independently of their respective bargaining power. If an employer places a restrictive clause in an employment contract, he will reduce the supply of potential employees and thus pay a higher wage to those persons who nonetheless choose to work for him. Employers will not put clauses in contracts unless the gain to the employer from including the clause is greater than the cost in higher wages which the contract will entail.

At the time the contract is signed, the employee expects to benefit from the agreement. Commonly, the employee is given some valuable training. If he signs the contract, he must anticipate that, over the life of the agreement, his wages will be sufficiently increased as a result of the contract so that, net, it is worth signing. This increase in wages will occur for

[15] For a discussion of the balancing between the employer's and employee's interests, see Gillette Co. v. Williams, 360 F. Supp. 1171, 1174 (D. Conn. 1973); Career Placement of White Plains, Inc. v. Vaus, 77 Misc.2d 788, 354 N.Y.S.2d 764, 772 (Sup. Ct., Westchester Co. 1974); and Standard Register Co. v. Kerrigan, 238 S.C. 54, 119 S.E.2d 533, 540 (1961). The needs of the "public" were discussed by the courts in American Hot Rod Ass'n, Inc. v. Carrier, 500 F.2d 1269, 1277 (4th Cir. 1974); Lloyd Damsey, M.D., P.A. v. Mankowitz, M.D., 339 So.2d 282, 283 (Fla. App. Ct. 1976), *cert. denied*. 345 So.2d 421 (Fla. Sup. Ct. 1977); Hefelfinger v. David, 305 So.2d 823, 824 (Fla. App. Ct. 1975); and C. G. Caster Co. v. Regan, 43 Ill. App.3d 663, 357 N.E.2d 162, 165 (1976).

[16] Restatement of Contracts § 514 (1932).

two reasons. First, because the contract makes the human capital that the employee will acquire specific to the firm providing the training (since the employee has contracted not to use this human capital elsewhere), the firm will pay the employee while he is acquiring the human capital. In general, firms will pay for the acquisition of specific human capital. Second, once the employee has acquired the human capital, he is worth more to the firm than he would have been otherwise, and his salary will therefore be higher. It will, however, not be as high as his marginal product to the firm after training, for part of the increment in productivity will have already been used in paying for the training. Thus, if the employee could appropriate for himself this additional human capital, he could earn more than the firm will pay him after training. By assumption, the training is specific only as a result of the contract. Thus, if the contract could be breached, the worker could increase his earnings above what the training firm would pay. Consequently, workers have an incentive to challenge clauses that bind them not to compete after they have received training from the firm. This incentive is no different from the incentive of any party to a contract to get out of it after the other party has completed his obligation and before the first party has completed his. The apparent desire of the court to protect the worker from harsh contractual terms is misplaced.

The other party to the dispute is the employer, who generally argues that his business will be harmed in some way if the employee is allowed to compete with the firm. But firms do not have rights to be free from competition, from former employees or from anyone else. In competitive industries, one more firm entering the market would have no effect on any competitor. In imperfectly competitive industries, the public (and hence economically efficient law) should encourage additional entry. Thus, arguments by firms based on intuitive (and misleading) notions of "fairness" are as economically misdirected as arguments by workers based on "unequal bargaining power." Firms, moreover, would also have incentives to attempt to change retroactively the terms of the initial agreement. Assume, for example, that an employee receives general training from a firm. Presumably, the employee has paid for this training by receiving lower wages during the term of the training. If this training is truly general, the employee might well choose to enter the business in competition with his former employer, or to work for another firm that will pay for the training. The employer presumably considered this possibility in deciding the wage to pay the employee during the training period. However, once the training is given, the employer would have an incentive not to pay the worker the full value of his marginal product. In this circumstance, it would be efficient to deny the employer the right to restrain the employee from competing. We thus have a situation in which neither party to a particular dispute has any incentive to make economically relevant arguments. It is therefore not surprising to find that the language used by the courts in deciding cases involving clauses not to compete is not couched in the terms that an economist would use to analyze the decisions. But failure to use the language of economics does not mean that the decisions are economically incorrect; one of the major advances of the literature applying economics to law has been to demonstrate that the economic logic underlying the law is often implicit[17] rather than explicit, and so might be the case here. Rubin[18] and others have presented models demonstrating that it is sometimes possible for the legal system to reach economically desirable outcomes independently of the knowledge of economics possessed by parties to disputes.

V. Legal Analysis: Specific Rules

Though the terms and ideas expressed in the legal cases are not the terms of economics, the cases seem to follow closely the arguments above. A close reading of the cases involving competition between employers and former employees indicates that economic analysis can explain the decisions reached. Evidence indicates that two types of information may be at issue: customer lists and trade secrets. We will consider each in turn. The cases cited are primarily examples of the points discussed. They are representative, not exhaustive, of the pertinent case law.

A. *Customer Lists*

A list of customers is often a valuable commodity. Many businesses, for example, require salesmen to call on customers periodically. These salesmen can develop close relationships with their customers and learn their demands. If the salesmen leave their employment and go into business for themselves or for a competitor, they may solicit business from these customers. Judging from the number of cases involving this practice, it seems common. Moreover, disputes regarding customer lists can arise where no contractual prohibition on competition by past employees exists as well as in cases with agreements not to compete. How does the law handle such disputes?

In general, the legal results are quite close to what economic analysis would predict. The most important distinction in law is the amount of

[17] Posner, *supra* note 7.

[18] Paul H. Rubin, Why Is the Common Law Efficient?, 6 J. Legal Stud. 51 (1977).

effort required to develop customer lists. If the list of customers is generally available to firms engaged in a particular business or is a list of one-time customers, the courts have refused to protect the firm's property in this list. Courts have held as unreasonable a covenant not to compete signed by a real estate salesperson[19] and one signed by a desk clerk for a car rental agency.[20] These covenants were declared unenforceable since the courts found that these employees had no special knowledge about the employer's past, present, or potential customers. Furthermore, in the real estate and car rental industry, the customers tended to be transient rather than repeat customers. If a customer is not likely to seek the employer's services or products a second time, there is insufficient reason to restrain potential competition from former employees. Forbidding past employees to compete would not create any useful incentives.

Conversely, if a firm can show that it spent time and resources in developing its customer list, a past employee who has signed an otherwise reasonable covenant not to compete will generally be banned from using this information.[21] If resources are required to establish a list of customers and if the list is not protected, there will be an incentive to invest too few resources in developing lists. Thus, this rule seems economically efficient. Moreover, it seems to be the main rule used by the courts in determining whether to afford protection to an employer. Many other criteria are mentioned by the courts,[22] but a close reading of the cases indicates that the effort spent by the firm in acquiring the customer list will almost always govern.

Another area of interest is the geographic scope of restrictive covenants. The legal analysis is in terms of the "reasonableness" of the scope of the covenant. The cases again indicate, however, that the underlying rationale is fully consistent with the economic analysis. When the information acquired by the employee is simply information about customers, the allowed geographic scope of the restriction is the area containing these customers. For example, a contract may forbid an employee to compete

[19] Vander Werf v. Zunica Realty Co., 59 Ill. App.2d 173, 208 N.E.2d 74, 77 (1965).

[20] Behnke v. Hertz Corp., 70 Wis.2d 818, 235 N.W.2d 690, 693 (1975).

[21] See House of Tools & Engineering, Inc. v. Price, 504 S.W.2d 157, 159 (Mo. App. Ct. 1973); and Cascade Exchange, Inc. v. Reed, 278 Or. 749, 565 P.2d 1095, 1098 (1977). Even though a list of customers may not be secret, an employer may have an urgent need to prohibit a former employee from soliciting the customers he has dealt with when that employee was the sole contact between the customer and the business. A typical example of this situation is the route salesperson who calls on the customers and delivers the products ordered. See Miller v. Frankfort Bottle Gas, Inc., 136 Ind. App. 456, 202 N.E.2d 395, 398 (1964).

[22] If an employee has memorized a list of customers, for example, he may solicit these customers, but if he has copied the list in writing he may not. For a general discussion of these cases, see Annot., 28 A.L.R.3d 7 §§ 14-15 (1969).

in a geographical area (city, state, nation), but the employee may have dealt with customers only in one part of that area. Under this circumstance, the court will void the contract not to compete.[23] Restricting potential competition is reasonable only to the extent that a former employee has learned information from the employer that was costly to acquire. If an employee knew the employer's customers in the northeastern part of a city but had no knowledge of the employer's customers elsewhere, there is no reasonable basis for restraining this employee's future competition in other areas.[24]

An employee dealing with customers will learn two things. First, he will learn the nature of the business and, perhaps, some interpersonal sales skills. This training will be general; any firm that requires dealing with customers would pay for the same skills. Second, the employee will learn the particular desires and habits of the customers of this particular firm. This training is also general; any other firm in the same business would find the information valuable. If the firm spent resources in acquiring this information, however, it is likely to be of the sort that is too valuable for the employee to pay for. If so, the information should be protected. Thus, the courts, in looking at the expense required for a firm to develop the information in customer lists, are probably correctly singling out where, in the employment relationship, the covenant was meant to apply. Similarly, in the geographic cases, by forbidding competition with former customers, the courts are probably preventing the salesman from using capital for which he did not pay. By allowing competition with customers in other areas, the courts are allowing the salesman to utilize the general skills he acquired during his employment which were not considered in the noncompetition covenant. Thus, the analysis in the customer-list cases seems quite consistent with the economic discussion presented in the earlier part of this paper.

[23] For examples of covenants not to compete that were overbroad on geographical terms, see American Hot Rod Ass'n, Inc. v. Carrier, 500 F.2d 1269 (4th Cir. 1974); On Line Systems, Inc. v. Staib, 479 F.2d 308 (8th Cir. 1973); Rector-Phillips-Morse, Inc. v. Vroman, 253 Ark. 750, 489 S.W.2d 1, 61 A.L.R.3d 391 (1973); Britt v. Davis, 239 Ga. 747, 238 S.E.2d 881 (1977); Howard Schultz & Assoc. v. Broniec, 239 Ga. 181, 236 S.E.2d 265 (1977); Fuller v. Kolb, 238 Ga. 602, 234 S.E.2d 517 (1977); and Trilog Associates, Inc. v. Famularo, 455 Pa. 243, 314 A.2d 287 (1974), wherein the Pennsylvania Supreme Court wrote:

> The restrictive covenants have no limitation on territory and thus are broader than is necessary for the protection of Trilog. Famularo in effect promised not to practice his profession *anywhere for anyone* in developing a shareholders' record system . . . Such covenants, unrestricted in territorial application, are not necessary to protect any valid interest of the former employer and are unreasonable restraints of trade.

314 A.2d 287, 294.

[24] For a thorough discussion of this type of geographical restraint as well as others, see Annot., 43 A.L.R.2d 94, §§ 108-152 (1955).

B. *Trade Secrets*

In general, trade secrets are given substantially more protection than customer lists. The common law has made it unlawful for an employee to disclose details about the employer's trade secret whether or not a covenant not to compete exists. Therefore, often the critical issue is the existence of a valid trade secret. It is not always clear whether important information, which has been developed by the employer, attains trade secret status. One way an employer can be assured of protection is to have the employees with access to this confidential information sign reasonable agreements not to compete.[25]

Courts have allowed employers to place a much broader geographical scope on restricting the use of trade secrets than on the use of customer lists. The crucial issue is whether the employer needs this expansive protection or whether the covenant not to compete is unduly harsh on the employee's ability to secure gainful employment. When considering the employer's confidential information, such as trade secrets, many courts have decided in favor of the employer's protection despite a very broad territorial limitation. For example, in a Georgia case involving the well-known Orkin Exterminating Company,[26] the State Supreme Court discussed a restrictive covenant that applied a noncompetition limitation to the entire geographical area where the company was in business. In essence, this restraint amounted to a nationwide ban on the employee's right to participate in the pest control industry. Since the employee had obtained knowledge about Orkin's secret processes and since the company could have sent the employee anywhere to work, the Georgia Supreme Court held that the broad geographical restriction remained reasonable and enforceable. The following represents the court's logic:

> The mere fact that while the employer does business in the entire territory, the employee did not work all the territory, would not render it unreasonable to bar the employee as provided in the contract [cite omitted]. It is shown by this record that the employee had access to business information, data, technical developments and other restricted information belonging to the employer. Thus it is shown that the restriction is necessary to protect the employer. The evidence shows that this business is highly competitive and secret, which requires continued changes in engineering and technical skill. This employee is shown to have had access to such information, and he was given courses of training which could be used against the employer. In the light of this undisputed evidence, the fact that

[25] Water Services, Inc. v. Tesco Chemicals Inc., 410 F.2d 163 (1969), wherein the court held: "But since it may be difficult to determine, as a matter of law, what is a trade secret, the covenant not to compete is a pragmatic *solution to the problem of protecting confidential information.*" (Emphasis added.) *Id.* at 171.

[26] Orkin Exterminating Co., Inc. v. Mills, 218 Ga. 340, 127 S.E.2d 796 (1962).

the employee did not actually work in all the territory embraced in the restriction is immaterial. His knowledge of the employer's business as thus acquired could be effectively used to the detriment of the employer throughout the territory embraced since the employer was doing business in that entire area. The employee was trained for the kind of work carried on throughout the area covered by the restriction and under the contract he was subject to be sent to all parts of that area. We hold that the restrictive covenant upon which this action is brought is legal, valid and enforceable.[27]

Restrictive covenants have been enforced to protect an employer's investment of time and money in developing expertise in the pest control[28] and in the wet-shave razor industries.[29] However, courts have refused to enforce covenants not to compete based on protecting the employer's confidential information in the car rental business,[30] the real estate sales business,[31] and the travel agency business.[32] These latter cases involved companies that did not possess specialized information. Indeed, the courts held that what the employees had learned during their employment could have been learned from any similar company. If an employer argues for enforcement of a noncompetition agreement based on confidential information and fails to distinguish between confidential information and information available to the general trade, the covenant not to compete will likely be an unreasonable and unenforceable restraint on competition.[33]

Even though a company may have information that is subject to protection, covenants not to compete will not be enforced automatically. Of course, such agreements must not be overly burdensome as to the activity, time, and geographical restraints. Furthermore, the employer must be thorough in restricting those employees who have had access to the confidential information from competition. In other words, the employer

[27] *Id.*, 127 S.E.2d 796, 797-798. Cf. Welcome Wagon International, Inc. v. Hostesses, Inc. 199 Neb. 27, 255 N.W.2d 865 (1977), wherein the court limited a similar covenant not to compete to the territory where the employee had actually worked instead of the broader area where the employer transacted business.

[28] See Orkin Exterminating Co., Inc. v. Wilson, 501 S.W.2d 408, 411 (Tex. App. Ct. 1973).

[29] See Gillette Co. v. Williams, 360 F. Supp. 1171, 1177-1178 (D. Conn. 1973).

[30] See Behnke v. Hertz Corporation, 70 Wis.2d 818, 235 N.W.2d 690, 693 (1975).

[31] See Miller v. Fairfield Bay, Inc., 446 S.W.2d 660, 663-664 (Ark. Sup. Ct. 1969).

[32] See United Travel Service, Inc. v. Weber, 108 Ill. App.2d 353, 247 N.E.2d 801, 803-804 (1969). For a thorough listing of cases involving the enforceability of restrictive covenants with regard to occupations, see Annot., 43 A.L.R.2d 94, §§ 26-65 (1955).

[33] United Travel Service, Inc. v. Weber, 108 Ill. App.2d 535, 247 N.E.2d 801, 803 (1969); Frederick v. Professional Building Maintenance Industries, Inc., 344 N.E.2d 299, 301 (Ind. App. Ct. 1976); and Crouch v. Swing Machinery Co., 468 S.W.2d 604, 605-606 (Tex. App. Ct. 1971).

must be careful to indicate the importance of this information by taking steps to maintain its secrecy.[34]

Employers will sometimes attempt to restrain employees who have learned no special knowledge from their employment. As argued above, if all human capital provided is general capital, we would expect the employee to pay for this capital by accepting reduced wages. The employer might nonetheless have an incentive to attempt to restrain such an employee from competition in order to reduce wages after training has occurred. The courts are generally unwilling to allow such restraint to occur, as would be consistent with economic efficiency.[35]

VI. Sale of Business

When a business is sold, a common clause in the contract of sale binds the seller from competing with the buyer—a clause similar to those discussed above in connection with employment contracts. However, the courts are much more lenient in interpreting these contracts. They are much more likely to enforce contracts not to compete by sellers of businesses than by employees of firms. The explanation given by legal authorities for this greater leniency is usually in terms of the greater wealth and greater bargaining power of the seller of a business relative to a former employee. A typical statement of the legal reasoning is:

> The average, individual employee has little but his labor to sell or to use to make a living. He is often in urgent need of selling it and in no position to object to boiler plate restrictive covenants placed before him to sign. To him, the right to work and support his family is the most important right he possesses. His individual bargaining power is seldom equal to that of his employer. Moreover, an employee ordinarily is not on the same plane with the seller of an established business. He is more apt than the seller to be coerced into an oppressive agreement. Under pressure of need and with little opportunity for choice, he is more likely than the seller to make a rash, improvident promise that, for the sake of present gain, may

[34] See Servomation Mathias, Inc. v. Englert, 333 F. Supp. 9, 14 (M.D. Pa. 1971). In this case the employer made a manual of secret recipes available to several employees. Some of these employees had signed agreements not to compete; some had not. The court denied enforcement of the restrictive covenants on the ground that the employer had failed to sufficiently protect its confidential information. The result may well have been different if all the employees with access to the recipe manual had signed similar contracts not to compete.

[35] Since Section 1 of the Sherman Antitrust Act, 15 U.S.C.A. § 1, declares certain restraints of trade to be illegal and Section 2 declares certain monopolies to be illegal, the issue of antitrust law's application to postemployment agreements not to compete has arisen. See Harvey J. Goldschmid, Antitrust's Neglected Stepchild: A Proposal for Dealing with Restrictive Covenants under Federal Law, 73 Colum. L. Rev. 1193 (1973); Henry H. Janssen, Antitrust Considerations in Proceedings against Former Employees Who Compete against Their Former Employer, 31 Bus. Law. 2063 (1976); Charles A. Sullivan, Revisiting the "Neglected Stepchild": Antitrust Treatment of Postemployment Restraints of Trade, 1977 U. Ill. L. Forum 621; and Note, 31 Okla. L. Rev. 759 (1978).

tend to impair his power to earn a living, impoverish him, render him a public charge or deprive the community of his skill and training. The seller has the proceeds of sale on which to live during his period of readjustment. A seller is usually paid an increased price for agreeing to a period of abstention. The abstention is a part of the thing sold and is often absolutely necessary in order to secure to the buyer the things he has bought. Usually the employee gets no increased compensation for agreeing to the abstention; it is usually based on no other consideration than the employment itself.[36]

Clearly this argument is incorrect in economic terms. A party, whether an employee or a seller of a business, will not sign a contract unless he expects to gain from the agreement. Whether it is efficient to enforce a contract is independent of the relative wealth or bargaining power of the signers.

A buyer would want and be willing to pay for a noncompetition clause because the seller may have particular knowledge that, should he compete, may reduce the value of the business to the buyer. The types of knowledge are the same as in the employment contracts. Thus, the seller may have built up good will and contacts with customers such that, should he go into competition with his former business, he will capture most of the customers. Second, he may have trade secrets that were sold with the business. Should he begin competing, the value of these trade secrets to the buyer would be less than the bargained-for price. In these circumstances, if the seller is not able to enter into a binding noncompetition contract, the value of the business would be reduced, and fewer businesses would be sold. Prohibition of covenants not to compete by sellers of businesses would thus impede the flow of resources into higher valued uses, since, absent such covenants, buyers would pay less for businesses and thus some would not be sold.

Why would the courts be more willing to enforce covenants ancillary to the sale of a business than covenants ancillary to employment contracts? In the discussion of employment contracts, we argued that either party to the contract—the firm or the employee—might have an incentive to behave opportunistically. The employee might attempt to capitalize on the information that he acquired but did not pay for, and the employer might

[36] H & R Block Inc. v. Lovelace, 208 Kan. 538, 493 P.2d 205, 211, 50 A.L.R.3d 730 (1972), as quoted from Arthur Murray Dance Studios of Cleveland v. Witter, 105 N.E.2d 685, 703-704 (Ohio Com. Pl. 1952). And see Davis v. Ebsco Industries, Inc., 150 So.2d 460, 463 (Fla. Dist. Ct. App. 1963), wherein the court wrote: "Further, the rule that covenants restraining of from entering into certain employment will not be enforced where the services are not special, unique, or extraordinary does not apply where the restrictive covenant is made in connection with the sale of a business." For a discussion of this unique services principle as it applies to restrictive covenants in employment contracts, see Margaret N. Kniffin, Employee Noncompetition Covenants: The Perils of Performing Unique Services, 10 Rutgers Camden L. J. 25 (1978).

attempt to use a covenant to avoid paying the employee for some training for which the employee did pay. Since there were opportunities for both parties to cheat on the agreement, the courts were required to examine the behavior of both parties to the contract. This is not true in the case of the sale of a business. The seller of a business can behave opportunistically by opening a competing business in violation of the agreement. The buyer of the business, however, has no further obligations to the seller once the purchase is complete and thus has no chance to behave opportunistically. If there is a dispute after sale of a business, it is likely to be a result of opportunistic behavior on the part of the seller. Hence the courts are probably correct in being more willing to enforce these contracts than those involving the employment relationship.[37]

VII. Summary and Conclusions

In the model of human capital proposed by Gary Becker, there is no need for covenants ancillary to labor contracts banning employees from competing with employers after termination of employment. If human capital is general, workers will pay for training and employers will be indifferent to the future use of this capital. If training is specific, the training will be useful only in the firm providing the training and so workers will be unable to use this training elsewhere. In actuality, however, we observed that many employment contracts are written with covenants forbidding the employee to compete with the employer after the termination of employment. The existence of these contracts is evidence that the standard model of human capital is incomplete; there must be forms of human capital not considered.

The argument advanced here is that there are two types of general training. In some cases, the value of general training is sufficiently high so that the trainee is unable to pay for such training, especially by accepting reduced wages during the training period. When this is the case, a firm will commonly have the employee sign an agreement not to use this training in a competing business. If it were not for the possibility of signing such agreements, firms would find their incentives for investment in valuable information reduced. However, with such contracts there are incentives for both parties to the agreement to behave opportunistically. Employees have an incentive to violate the agreement by using the information in competing businesses; firms have an incentive to underpay employees who have acquired information for which the employees have themselves paid, by claiming that all information is covered by the covenant. The courts seem to have been successful in determining which types of con-

[37] See Annot., 46 A.L.R.2d 119 §§ 160-162 (1956).

tracts should be enforced. In the case of a contract restricting competition by the seller of a business, the buyer has no chance to behave opportunistically; thus the greater willingness of the courts to enforce these contracts (relative to employment contracts) is also consistent with the analysis presented here.

This research may also have policy implications. Kottke[38] and others[39] have recently argued that courts should be less willing to enforce covenants not to compete than has been true in the past to make entry into concentrated industries easier. The evidence adduced here, however, indicates that the courts have done a good job of determining which covenants should efficiently be enforced. If these suggestions were adopted, the major effect would probably be to reduce the incentive of firms to invest in acquiring economically valuable information and to increase litigation costs.

Covenants not to compete are a part of the law of "unfair competition." A previous analysis of the part of this law dealing with advertising regulation[40] has demonstrated the usefulness of economic analysis in understanding this branch of the law, and the analysis here indicates that it is also useful in understanding employment contracts. Additionally, this paper demonstrates that the traditional economic analysis of human capital is somewhat incomplete, and that there are types human capital other than those analyzed by Gary Becker. Thus, an analysis of the legal cases has enabled us to understand better the economics involved in training markets. The legal analysis and the economic analysis were complementary.

[38] Frank Kottke, The Promotion of Price Competition Where Sellers Are Few 115-18 (1978).

[39] See note 35 *supra*.

[40] See Ellen R. Jordan & Paul H. Rubin, An Economic Analysis of the Law of False Advertising, 8 J. Legal Stud. 527 (1979).