



An Economic Framework for Analyzing Covenants Not to Compete

By Elaine Fleming, Steven Herscovici, and Keith R. Ugone – May 31, 2011

Economists should consider this set of principles when evaluating the competitive implications of a covenant not to compete (CNC). A central factor is the speed with which the information that a CNC seeks to protect depreciates over time, space, and scope of activity. These principles should benefit attorneys who are litigating the enforceability of CNCs.

Background

CNCs are employment contracts that “restrict the activities in which an employee may engage after termination of employment.” Paul H. Rubin and Peter Shedd, “Human Capital and Covenants Not to Compete,” 10 *J. of Legal Studies* 93, 94 (1981); see also Edward M. Schulman, “An Economic Analysis of Employee Noncompetition Agreements,” 69 *Denver University Law Review* 97 (1992); Mark J. Garmaise, “Ties that Truly Bind: Non-competition Agreements, Executive Compensation and Firm Investment,” *J. of Law, Econ., and Org.* 1 (2009). According to Peter Whitmore:

Noncompetition clauses typically forbid the employee from competing with the employer within a certain geographical region for a specified length of time after the employment relationship has ended. The clauses may also prohibit the employee from engaging in certain activities, such as contacting all or some of the employer’s customers, for a certain length of time.

Peter J. Whitmore, “A Statistical Analysis of Noncompetition Clauses in Employment Contracts,” 15 *J. of Corporate Law* 483, 484–85 (1989). Generally, with CNCs, employers are attempting to protect their investments, including investments in the human capital of their employees, investments in confidential business information, and trade secrets to which their employees have access.

Some argue that CNCs are pro-competitive. CNCs can lead to efficient levels of investment in confidential business information and the human capital of employees and reduce the costs of alternative and more expensive methods of protecting such investments. In some cases, the stated purpose of the CNC may be to prevent the “unfair competition” that would occur if a departing employee shared with a competitor valuable private information gained at a previous employer.

Some argue that CNCs are anticompetitive. CNCs by their nature restrict the ability of employees to obtain employment and provide services to the industry in which they work. CNCs also restrict the ability of competing employers to obtain the services of experienced employees.

As CNCs have become more common, so has litigation associated with these types of employment contracts. According to estimates reported on Foley & Lardner’s [Trade Secret/Noncompete](#) blog,



“from 2000 to 2009, the number of reported trade secret and/or noncompete cases more than doubled—from 1,010 to 2,366 over the last decade.”

States vary in their willingness to uphold the restraints imposed by CNCs. For example, courts in California have been reluctant to uphold the validity of CNCs. Larry Turner and Daniel Johnson, [*Noncompete Jurisprudence During the Recession*](#), Law360 (2010). Other states, such as Texas, require that CNCs be reasonably limited in geography, time, and scope, such that employers can protect their investments without being overly burdensome on the employees subject to them. Tex. Bus. & Com. Code § 15.51. According to Garmaise, Alaska, Arizona, Connecticut, Hawaii, Rhode Island, Virginia, and Wisconsin enforce CNCs in a similar manner to Texas. *See Garmaise, supra*.

A broad framework for evaluating the terms of CNCs is necessary to balance the benefits associated with well-defined property rights against those associated with labor mobility. Generally, the salient parameters of a CNC relate to duration, geographic coverage, and scope of activities. It is within these three criteria that competition can be either fostered or hindered. As the law has properly ascertained, it is within these three criteria that the economist must evaluate the pro-competitive or anticompetitive nature of a CNC.

Guiding Economic Principles

In the limited space allotted for this discourse, we focus on a central factor: the speed with which the information that a CNC seeks to protect depreciates over time, space, and scope of activity. Privately held, long-lived information may justify a broader CNC, for example, while information that quickly depreciates or becomes publicly available may justify a more narrowly focused CNC or none at all.

Time Frame

Does the information that the CNC covers have a short or long time span before it depreciates in value? If the information depreciates in value quickly, it may not be reasonable to prevent an employee from working in an industry for long periods of time. Conversely, if the information remains valuable for a long period of time, a CNC with a longer time restriction may be considered from an economic perspective.

Consider the case of an employee who is responsible for purchasing a firm’s most important input, which is viewed in the industry as a commodity (for example, Number 2 heating oil). Assume that the employee has signed a CNC preventing him from working in the industry for a period of two years after his employment with his current employer ends. The employee wishes to work in a similar position for another firm and argues that any confidential information that he may have access to depreciates in value quickly because input prices change frequently and can even change on a daily basis. The employee additionally argues that any information related to the firm’s input prices would be quickly outdated, and he should not be precluded from working in the industry for the two-year period stated in the CNC. The employer argues that the employee has developed relationships with suppliers and has had access to trade secrets, such as existing supplier agreements, incentives, and production plans.

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In this case, when evaluating the CNC from an economic perspective, the economist should assess how quickly the input price information depreciates over time and whether the information related to supplier agreements, incentives, and production plans can be considered as generally known across the industry or if they are more accurately considered to be firm-specific information. Obviously, each case has its own special set of facts and circumstances, but in the above example, the existence of rapidly changing input prices that the employee tracks for the firm would weigh in favor of a shorter CNC, holding other considerations constant.

Geographic Coverage

Is the information covered by the CNC more valuable in a particular region (for example, the sales region in which an employee works) than it is over a larger geographic area (for example, the entire United States)? CNCs that prevent an employee from working outside a given region after the employee leaves a firm may be overly restrictive if the employee has access to information that is pertinent to only a smaller area. In these instances, the information depreciates quickly with respect to geographic coverage.

Consider the case of an East Coast regional sales manager working in the office supply industry. The sales manager has signed a noncompete clause stating that he will not work in the same industry within the United States for a period of 12 months after his employment with his current employer ends. After working for his employer for 10 years, he resigns to work for a competitor on the West Coast. The employee argues that he should not be prevented from working in the industry because he is working in a different region and, as one consideration, would not be able to “poach” any of his former employer’s customers. The former employer argues that regardless of the employee’s ability to poach customers, he has had access to the firm’s selling tactics and strategies, including but not limited to the firm’s strategy, margins, and sales practices. This prior access will put the firm at a competitive disadvantage because it competes with the former employee’s new firm nationally.

In this case, when evaluating the CNC from an economic perspective, the economist should assess whether the information that the regional sales manager has acquired depreciates over space, such as geographic area, and whether knowledge about competitive factors on the East Coast would put his former company at a competitive disadvantage on the West Coast. The existence of different competitive conditions in different geographic areas, or the likelihood that underlying competitive conditions can change fairly rapidly or persist only for a short time, would weigh in favor of a CNC with a more narrow geographic coverage, holding other considerations constant.

Scope of Activities

Is the information covered by the CNC equally valuable across a broad scope of activities within the firm or industry, or is it valuable only to a more narrowly defined segment of the firm or industry? If a CNC is not tailored to the specific nature of the confidential business information that the employer wishes to protect, then a broadly written CNC that prevents the employee from working in the industry generally, regardless of the job that the employee would perform for another employer in the industry,



may be overly restrictive. This is especially true if the information depreciates quickly with respect to scope.

Consider the case of an engineer who works at a medical device firm that develops only cardiovascular-related devices. The engineer leaves the firm for another company that makes a range of medical devices, including cardiovascular ones, but her focus at the new firm will be on joint-replacement devices. The employee signed a CNC at her previous firm, stating that she would not work for a competing firm for a period of 18 months after her employment ended. The employee argues that the CNC is overly burdensome because she will not work on any cardiovascular-related devices. The previous employer argues that the engineer had access to confidential and trade secret information, which would put it at a disadvantage if that information were shared with the new employer.

In this case, when evaluating the CNC from an economic perspective, the economist should assess, often in conjunction with a technical expert or other supporting testimony, whether the development of cardiovascular devices is sufficiently similar to the development of joint-replacement devices such that it would be likely that the engineer would divulge confidential information in the normal course of work. In the suggested framework, the question is whether the confidential and trade secret information to which the employee is asserted to have had access depreciates when applied to different products.

Conclusion

To ensure the pro-competitive benefits associated with CNCs are achieved and outweigh any claimed anticompetitive impacts, the relevant provisions of any CNC should be narrow (or not used at all) in those situations where the value of private information depreciates quickly. In such situations, the cost associated with the restrictions likely would not outweigh the benefits associated with the mobility of labor, holding other considerations constant.

This guidance can be applied to a diverse set of confidential business information, and the framework discussed here can be applied to a range of firm activities, including the nature of a firm's production function, such as its technical relationships, the cost and substitutability of inputs, cost-minimization strategies, procurement/supplier relationships, optimization techniques, strategic planning, customer contracts, pricing and profit margins, frequency of renegotiations, and the make-versus-buy decisions that firms face.

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