ESSAYS

SCRUTINY OF EMPLOYEE COVENANTS NOT TO COMPETE UNDER THE RULE OF REASON: AN EMPIRICAL INQUIRY

*Daniel A. Crane**

INTRODUCTION

For over 300 years, the common law has scrutinized employee covenants not to compete for their reasonableness.[1] That is about to change. On April 23, 2024, the Federal Trade Commission announced a rule that will prohibit employers from imposing noncompete agreements on workers.[2] The rule declares all covenants not to compete in the employment context to be unfair methods of competition under section 5 of the FTC Act.[3] If the rule takes effect, thirty million contracts will become illegal.[4] The FTC justifies this rule based on the ostensibly pernicious effects of employee covenants not to compete—

* Richard W. Pogue Professor of Law, University of Michigan. I am grateful for excellent research assistance by Billy Stampfl, Michael Turner, and Lennart Levita and for many helpful comments and suggestions by Alan Meese.

1 *See* Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 629 (1960).

2 *See* Non-Compete Clause Rule, 89 Fed. Reg. 38342 (May 7, 2024) (codified at 16 C.F.R. pts. 910, 912); Press Release, FTC, FTC Announces Rule Banning Noncompetes (Apr. 23, 2024), https://www.ftc.gov/news-events/news/press-releases/2024/04/ftc-announces-rule-banning-noncompetes [https://perma.cc/2NFW-AVDK].

3 Non-Compete Clause Rule, 89 Fed. Reg. at 38342 ("The final rule provides that it is an unfair method of competition for persons to, among other things, enter into noncompete clauses . . . with workers on or after the final rule's effective date.").

4 Eugene Scalia, *The FTC's Breathtaking Power Grab over Noncompete Agreements*, WALL ST. J. (Jan. 12, 2023, 6:50 PM), https://www.wsj.com/articles/the-ftcs-breathtaking-power-grab-noncompete-agreements-rule-capital-investment-wage-gap-job-growth-compliance-11673546029 [https://perma.cc/R9DM-QJGE].

limiting employee opportunities to pursue new job opportunities, inhibiting growing companies from hiring new employees, reducing employee wages, and depriving consumers of the benefits of labor market competition.[5] Critics of the rule dispute these empirical claims,[6] argue that a flat prohibition on employee noncompetes would wipe away many efficient agreements,[7] and contend that the FTC lacks authority to enact such a rule.[8] They also contend that antitrust's rule of per se illegality is typically reserved for restraints that almost invariably harm competition and lack redeeming virtues,[9] and that covenants not to compete do not have that profile.

Buried in the controversy over the FTC's noncompete rule is the question of how employee covenants not to compete (ECNCs) are currently treated in state courts. The FTC notes that three states—California, North Dakota, and Oklahoma—categorically prohibit ECNCs for most or all employees, and that some of the remaining forty-seven states restrict their enforcement in some circumstances (i.e., based on a worker's earnings, for certain occupations, or when the employee is not given adequate notice).[10] Outside of those statutory restrictions, the forty-seven states adjudge ECNCs under the common law's longstanding rule of reason, which asks if the restraint is greater than necessary to protect the employer's legitimate interests or if those interests are outweighed by the harm to the employee or the public

5 Non-Compete Clause Rule, 88 Fed. Reg. 3482, 3537 (proposed Jan. 19, 2023) (codified at 16 C.F.R pt. 910) (statement of Chair Lina M. Khan joined by Commissioner Rebecca Kelly Slaughter and Commissioner Alvaro M. Bedoya).

6 *See id.* at 3542 (dissenting statement of Commissioner Christine S. Wilson); Daniel Gilman & Brian Albrecht, *FTC Proposal Jumps the Gun on Banning Noncompetes*, LAW360 (Jan. 19, 2023, 4:24 PM), https://www.law360.com/articles/1566971/ftc-proposal-jumps-the-gun-on-banning-noncompetes [https://perma.cc/S9SM-U86D].

7 *See* Alan J. Meese, *Don't Abolish Employee Noncompete Agreements*, 57 WAKE FOREST L. REV. 631, 679 (2022).

8 *See, e.g.*, Thomas W. Merrill, *Antitrust Rulemaking: The FTC's Delegation Deficit*, 75 ADMIN. L. REV. 277 (2023); Richard J. Pierce, Jr., *Can the Federal Trade Commission Use Rulemaking to Change Antitrust Law?* 2 (George Washington Legal Stud. Rsch. Paper, Paper No. 2021-42), https://ssrn.com/abstract=3933921 [https://perma.cc/5YL5-JQAR]; *see also* Ryan, LLC v. FTC, No. 24-CV-00986-E, 2024 WL 3879954 (N.D. Tex. 2024) (imposing a national injunction against the noncompete rule).

9 Leegin Creative Leather Prods. v. PSKS, Inc., 551 U.S. 877, 886 (2007) ("Resort to *per se* rules is confined to restraints, like those mentioned, 'that would always or almost always tend to restrict competition and decrease output.' To justify a *per se* prohibition a restraint must have 'manifestly anticompetitive' effects and 'lack . . . any redeeming virtue.'" (first quoting Bus. Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 723 (1988); then quoting Cont'l T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 50 (1977); and then quoting Nw. Wholesale Stationers, Inc. v. Pac. Stationery & Printing Co., 472 U.S. 284, 289 (1985))).

10 Non-Compete Clause Rule, 88 Fed. Reg. at 3494.

interest.[11] The Commission notes that there is some variation among the states in how their courts apply the rule of reason, for example, how narrowly or broadly they define an employer's legitimate interests.[12] The Commission also invokes studies that seek to assess variations among states in the enforceability of ECNCs in order to measure the effects of ECNCs on wages.[13]

But how do these rule-of-reason decisions actually come out? Do most courts uphold the ECNCs, or strike them down? And, to the extent they uphold them, what reasons do they offer for doing so? These questions bear importantly on the justifications for a federal rule categorically banning ECNCs and displacing the historic common law approach. If courts are rubber-stamping ECNCs, then perhaps the rule of reason is little more than a euphemism for approval and federal action is needed to protect employee rights and the public interest in competition. Similarly, if courts are almost always invalidating ECNCs, then that could show that their ostensible justifications are pretextual and that a federal ban will save litigation costs and remove all doubt. On the other hand, if the outcome is more mixed with courts invalidating ECNCs with weak justifications but upholding others where the employer demonstrates reasonableness, that could suggest that there is already effective policing of ECNCs under the common law and that the rule will ban some ECNCs with legitimate efficiency justifications.

This Essay provides some empirical findings bearing on these questions. Based on a hand-coded dataset of 514 state court decisions scrutinizing ECNCs under the rule of reason in the last twenty-five years, I can report the following: state courts have struck down 53%, have pared down 7%, and have upheld 40% of ECNCs after analyzing them substantively for their reasonableness. This suggests that state common law already provides significant protection against overreaching ECNCs, but that, when considered individually, there may be legitimate efficiency justifications for some subset of the ECNCs that will be banned by the rule. To be sure, these findings do not necessarily mean that a total ban on ECNCs is unjustified. The courts may be wrong in justifying the ECNCs that they do, ECNCs may have an *in terrorem* effect even when a court would not uphold them, or the costs of individualized litigation may exceed the benefits. Nonetheless, the actual practice of the common law courts merits consideration in the litigation over the rule's enforceability that inevitably broke out when the rule became final.

---

11 *Id.* at 3494–95 (citing RESTATEMENT (SECOND) OF CONTS. § 188 (AM. L. INST. 1981)).

12 *See id.* at 3495.

13 *Id.* at 3486–87.

I. THE COMMON LAW'S RULE OF REASON THE RULE WOULD SUPPLANT

The English common law on restraints of trade originated in the early fifteenth century in *Dyer's Case*,[14] in which the court invalidated a contractual restriction on competition by an apprentice or journeyman weaver who had likely been "oppressed by a grasping master."[15] Many of the early restraint-of-trade cases involved judicial invalidation of similar efforts by masters to evade guild regulations which permitted apprentices to become "full-fledged members of the guild upon expiration of their traditional term."[16]

The common law's emphasis shifted from invalidation to rule-of-reason scrutiny in the landmark eighteenth-century case of *Mitchel v. Reynolds*, where the court upheld a covenant not to compete that was ancillary to lease of a bakehouse.[17] Important to this reasonableness analysis was that the covenant was limited in geographic scope (the parish) and temporal scope (the duration of the lease), and that it served an evident legitimate purpose: the lessee would not have leased the bakehouse if the lessor could have opened a new bakehouse in competition with the one being leased.[18]

Mitchel was not an employment case, but its rule of reason quickly became regarded by both the English and American courts as the proper analytical matrix to be applied in cases involving ECNCs.[19] The American adoption of the common law regarding ECNCs involved some distinctive adaptations.[20] In considering questions of geographic scope—the old common law idea that "general restraints" were unreasonable but "partial" ones reasonable—the courts had to determine whether the state or the nation should be considered the relevant denominator.[21] Further, the American decisions placed greater weight on protecting the employee from onerous restrictions than did their English counterparts.[22] Despite these differences, the American

14 Dyer's Case, YB 2 Hen. 5, fol. 5b, Pasch, pl. 26 (1414) (Eng.).

15 Blake, *supra* note 1, at 636; *see* Gary Minda, *The Common Law, Labor and Antitrust*, 11 INDUS. RELS. L.J. 461, 475 (1989) (reporting that *Dyer's Case* was the first reported English case on covenants not to compete); *see also* Atl. Cleaners & Dyers, Inc. v. United States, 286 U.S. 427, 436 n.* (1932) (discussing *Dyer's Case* as an early common law case on unlawful restraints on competition by employees).

16 *See* Blake, *supra* note 1, at 634.

17 *Id.* at 630, 637; Mitchel v. Reynolds (1711) 24 Eng. Rep. 347, 347–48 (QB).

18 *See* Blake, *supra* note 1, at 629–30; *Mitchel*, 24 Eng. Rep. at 352.

19 *See* Blake, *supra* note 1, at 638–39 ("Until the end of the nineteenth century both English and American courts regarded *Mitchel v. Reynolds* as the fundamental authority to be applied in employee-restraint cases.").

20 *See* Meese, *supra* note 7, at 641–42.

21 Blake, *supra* note 1, at 630, 643.

22 *See id.* at 643–44.

common law regarding ECNCs applied a rule of reason that considered both whether the employer had legitimate interests in restricting the employee's post-employment competition and the corresponding hardship on the employee.[23]

As outlined in the NPRM, rule-of-reason analysis of ECNCs proceeds in three stages. First, the employer must advance a legitimate business purpose served by the ECNC.[24] This could include protecting trade secrets or confidential information, preventing competitor freeriding on the employer's investments in training the employee, or taking account of the employee's "unique" talents.[25] The next question is whether the ECNC is reasonably tailored to meet the employer's legitimate interests, which includes inquiry into the scope of work covered by the restraint and its geographic and temporal scope.[26] The employer's justification may then be offset by the burden on the employee—such as if it deprives her of the chance to secure her livelihood—and the public interest in competition.[27] The states follow three approaches if the court determines that the covenant is overbroad: equitably reforming the covenant (i.e., cutting it down to a reasonable size); "blue penciling," or striking any defective provisions; and "red penciling," or invalidating overbroad covenants entirely.[28]

The legal structure used to scrutinize ECNCs has remained relatively stable for several centuries,[29] but the outcomes of these cases in recent decades have not been widely studied. One factor that may be coloring the perception of the state court rule-of-reason adjudication concerning ECNCs is the conventional perception of the outcomes of rule-of-reason litigation under section 1 of the Sherman Act, which also traces back its origin to *Mitchel v. Reynolds*.[30] Empirical studies have shown that defendants win rule-of-reason cases almost all of the time—ninety-seven percent of the time according to Michael Carrier's analysis.[31] Those data and perceptions are based primarily on vertical intrabrand restraints cases and do not reflect more recent developments in antitrust law, where the rule of reason is increasingly becoming a

23 *See* Milton Handler & Daniel E. Lazaroff, *Restraint of Trade and the Restatement (Second) of Contracts*, 57 N.Y.U. L. REV. 669, 718 (1982).

24 Non-Compete Clause Rule, 88 Fed. Reg. 3482, 3495 (proposed Jan. 19, 2023) (codified at 16 C.F.R. pt. 910).

25 *Id.*

26 *Id.*

27 *Id.*

28 *Id.*

29 *See* Blake, *supra* note 1, at 629, 638–39.

30 *Id.* at 628.

31 Michael A. Carrier, *The Rule of Reason: An Empirical Update for the 21st Century*, 16 GEO. MASON L. REV. 827, 827–28, 837 (2009) (finding that plaintiffs fail to establish a prima facie case in ninety-seven percent of rule-of-reason cases).

genuine analytical mode rather than its older usage as a "euphemism for nonliability."[32] Still, FTC Chair Lina Khan has made clear her aversion to the rule of reason, arguing that it undercuts antitrust enforcement.[33] Indeed, the Commission quoted then-Professor Posner's 1977 claim that rule-of-reason assessment was "euphemism for nonliability" when explaining its rejection of its predecessors' embrace of a rule-of-reason approach to section 5 enforcement.[34] Even though the common law rule of reason as to ECNCs may be significantly more demanding than traditional section 1 rule-of-reason analysis,[35] suspicions that state court rule-of-reason analysis of ECNCs may be a rubber stamp for employer interests may underlie the Rule. It remains to be seen whether those implicit suspicions have any bearing in reality.

* * *

Empirical Study and Findings

In order to study contemporary state court rule-of-reason determinations regarding ECNCs, I asked my research assistants (RAs) to run queries in Westlaw's "State Cases" database with the terms "noncompete 'covenant not #to compete' /p employ!" for the twenty-five-year period 1998–2022, excluding the three states (California, North Dakota, and Oklahoma) identified by the FTC as holding employee covenants not to compete categorically invalid. Once the RAs had created the initial dataset, they were instructed to create a subset of cases that satisfied the following criteria: (1) a common law analysis (not a decision on the meaning of a state statute, unless the state statute itself requires something like rule-of-reason analysis); (2) an actual covenant not to compete, not a confidentiality or antisolicitation agreement; (3) arising in an employment context, as opposed to the sale of business

32 Richard A. Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. CHI. L. REV. 1, 14 (1977); *see* Daniel A. Crane, *The Radical Challenge to the Antitrust Order*, 59 WAKE FOREST L. REV. 399, 402–03 (2024) (explaining the recent shift toward more balanced rule-of-reason analysis).

33 Lina Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontents*, 11 HARV. L. & POL'Y REV. 235, 274 (2017) ("The shift from per se rules and presumptions to the rule of reason and other standards-based tests has dramatically undercut antitrust enforcement.").

34 *See* FED. TRADE COMM'N, STATEMENT OF THE COMMISSION ON THE WITHDRAWAL OF THE STATEMENT OF ENFORCEMENT PRINCIPLES REGARDING "UNFAIR METHODS OF COMPETITION" UNDER SECTION 5 OF THE FTC ACT 5 n.31 (2021) (quoting Posner, *supra* note 32, at 14).

35 *See* Meese, *supra* note 7, at 646–47.

or other commercial context; and (4) decided on the merits whether the covenant was enforceable or not.[36]

The resulting dataset consisted of 514 cases. In other words, our study reveals that, between 1998 and 2022, state courts engaged in rule-of-reason analysis to determine the enforceability of employee covenants not to compete in 514 decisions.

As to outcomes, the RAs were asked to code the judicial decisions using three categories: upheld, invalidated, or mixed outcome (for cases in which the court upheld the covenant not to compete in part but narrowed its scope). The results were these: upheld in 205 cases, invalidated in 273 cases, and mixed outcome in 36 cases. Even if the mixed outcome cases are added to the upheld cases, the empirical evidence shows that courts are invalidating employee covenants not to compete under the rule of reason more often than they are upholding them.

While the data reveal variance in enforcement rates across the states, they also suggest that different jurisdictions are neither rubber-stamping nor summarily invalidating ECNCs, but instead subjecting them to balanced rule-of-reason scrutiny. Eighteen states had at least ten observations during the study period, and for those I calculated the percentage of ECNCs upheld (treating both upheld and mixed outcome as upholding). The upheld/mixed outcome percentage ranged from a low of 25% in Wisconsin to a high of 75% in Florida, with most states clustering between 35% and 58%.[37] It is unsurprising that Florida topped the chart for enforcement, since it is deemed a strong enforcement state that prioritizes employer and business interests over employee mobility.[38] Nonetheless, during the study period, Florida courts upheld six ECNCs, narrowed the scope of three, and invalidated three. Half of the ECNCs scrutinized did not escape unscathed. Similarly, in the second-most ECNC-friendly state—Ohio—seventeen were upheld, seven invalidated, and three cut down, giving employees a fair chance of getting out of or significantly narrowing an ECNC. This suggests that even in the most ECNC-friendly states, rule-of-reason scrutiny involves balanced analysis and genuine contestability. Conversely,

36 My RAs did not assess whether a court was purporting to use its own state's jurisprudence or a choice-of-law provision requiring application of another state's substantive law.

37 The upheld/mixed outcome percentages for the eighteen states are as follows: Arkansas, 36%; Connecticut, 45%; Delaware, 58%; Florida, 75%; Georgia. 27%; Illinois. 41%; Indiana, 50%; Massachusetts, 71%; Minnesota, 58%; Missouri, 70%; New York, 44%; North Carolina, 35%; Ohio, 74%; Pennsylvania, 52%; Tennessee, 50%; Texas, 39%; Virginia, 33%; Wisconsin, 25%.

38 J.J. Prescott, Norman D. Bishara & Evan Starr, *Understanding Noncompetition Agreements: The 2014 Noncompete Survey Project*, 2016 MICH. ST. L. REV. 369, 390 n.95; Norman D. Bishara, *Fifty Ways to Leave Your Employer: Relative Enforcement of Covenants Not to Compete, Trends, and Implications for Employee Mobility Policy*, 13 U. PA. J. BUS. L. 751, 772–78 (2011).

even the most anti-ECNC jurisdictions upheld some restrictive covenants. Wisconsin—famous for its "red pencil" antipathy to ECNCs[39]—still upheld three out of twelve.

II. QUALITATIVE INTERPRETATION

Beyond the raw numbers, review of the outcomes of state court decisions on ECNCs provides some qualitative information relevant to the assumptions underlying the rule. In most of the reported decisions, the court provided a detailed explanation of its reasons for invalidating, upholding, or modifying the ECNCs. Several clear pattens emerge.

First, the courts that invalidated ECNCs did so mostly on the basis of the employer's failure to demonstrate a legitimate interest, such as trade secrets or protectable customer relationships, and because of overbreadth. ECNCs were especially likely to fail because they were too broad geographically or lasted too long. Courts also reacted negatively to employer efforts to claim confidentiality interests as to matters that were public knowledge, or when the employer made vague and unparticularized assertions about confidentiality or trade secret interests or human capital investments. Courts were looking for specific, substantiated evidence pertaining to the particular employer at issue, not generalizations or unsupported assertions. On the other hand, few ECNCs were invalidated based on the burden on the employee.

Conversely, when courts upheld ECNCs, they typically did so because the employer provided concrete evidence about trade secrets, other confidential business information, or human capital investments in the employee, such as education or training. Successful employers also were able to make a convincing case for the correspondence between the concrete interests they cited and the features of the ECNC, including duration, coverage, and geographic scope. Here are some representative examples of cases in which employers succeeded in establishing reasonableness:

A software company established that the former employee had access to confidential "product plans, product functionality, product schedules and marketing plans, including competition strategies," and that allowing the portability of that information to a competitor during the year after the employee left would have detrimental effects on the competitiveness of the employer given its status as a small firm in the market.[40]

---

39 *See* WIS. STAT. § 103.465 (2023).

40 *See* Marcam Sols., Inc. v. Sweeney, No. 981142J, 1998 WL 1284184, at *1–2 (Mass. Super. Ct. Mar. 25, 1998).

A bed retailer's six-month covenant not to compete was upheld on grounds that it took the employer six months to train the employee to the point of making a profit and the employer revised its confidential pricing and promotional information approximately every six months.[41]

A tax preparer's five-year covenant not to compete was upheld because it was justified by the employer's legitimate interest in maintaining the confidentiality of its customer lists, the restraint was limited to a five-mile radius around the employer's location, and the employee received a bonus and a raise in exchange for agreeing to the ECNC.[42]

An intelligent data storage company established that its former employee "had access to customer lists, pipeline reports, and customer trip reports" and that allowing the former employee to compete would impair the employer's goodwill and cause friction in its relationships with customers.[43]

An information technology engineer was required to develop close relationships with customers, and the employer was justified in prohibiting the engineer from working for a competitor on those customers' accounts for a two-year period.[44]

A temporary employment agency employee had access to and used "customers' lists, sales projections, sales figures, margin figures, pricing calculations, bids, estimates, and other proprietary and financial information" of the employer, and the employer had a legitimate interest in protecting those assets from disclosure.[45]

An aircraft component repair company had given the employee specialized training specific to the employer and was justified in prohibiting that employee from using that training for a competitor for a six-month period.[46]

These examples, and others in the upheld column, involve a wide variety of employer industries, employee activities, and features of the ECNCs (for example, durations from six months to five years, or geographic scopes of a few miles to hundreds of miles or even worldwide). The common aspect of the upheld cases was not industry, employee activity, or covenant features, but rather the employer's articulation of

41 Bed Mart, Inc. v. Kelley, 45 P.3d 1219, 1223 (Ariz. Ct. App. 2002).

42 Hoffnagle v. Henderson, No. CV020813972S, 2002 WL 652374, at *3–4 (Conn. Super. Ct. Mar. 21, 2002).

43 *See* Cereva Networks, Inc. v. Lieto, No. CIV.A. 01-3835, 2001 WL 1228040, at *1, *4–6 (Mass. Super. Ct. Oct. 12, 2001).

44 Techworks, LLC v. Wille, 770 N.W.2d 727, 732, 734 (Wis. Ct. App. 2009).

45 D.L. Ricci Corp. v. Forsman, Nos. C8-97-1597, C8-97-1969, 1998 WL 202595, at *1, *3 (Minn. Ct. App. Apr. 28, 1998).

46 Aero Kool Corp. v. Oosthuizen, 736 So. 2d 25, 25–26 (Fla. Dist. Ct. App. 1999).

a concrete and demonstrated business justification for the restraint, and the restraint's proportionality to that justification.

CONCLUSION

The key takeaway from our study is that the common law courts are taking their job of applying the rule of reason to ECNCs seriously. Their approach is individualized rather than categorical. In any jurisdiction, an employee who wishes to challenge an ECNC has a significant likelihood of having it invalidated or narrowed. More ECNCs are invalidated than enforced, and the ones that are enforced are not rubber-stamped.

At the same time, courts do find many ECNCs to be justified, not based on a priori reasoning, but based on the particularized interests of the employer concretely demonstrated on the record. The FTC's new rule will categorically bar hundreds of contracts that the state courts, upon reasoned consideration, find efficient.

For three reasons, I will stop short of saying that this is sufficient reason to find the rule undesirable as a matter of policy. First, the courts that uphold ECNCs as efficient may be basing their decisions on faulty reasoning. The common law courts may be asking the wrong questions, applying faulty economic logic, overweighting employer interests, underweighting employee or public interests, or otherwise getting it wrong. Just because the courts are diligently applying the tests that they have applied for four hundred years does not mean that they are making optimal decisions.

Second, the cases that are litigated may not be reflective of the impact of ECNCs generally. There is obviously a selection issue—the cases that are litigated to judicial decision are the ones where the employer and former employee (or, quite often, her new employer) have the motivation and resources to duke it out. There are hundreds of litigated cases but millions of ECNCs. The cases in which the employer establishes reasonableness may be a thimbleful compared to the number of unlitigated cases in which employers use ECNCs to trap employees with little sophistication or resources in underpaying jobs or to limit competition with rivals.

Finally, even if it is conceded that the FTC rule will bar some number of efficiency-enhancing ECNCs, a flat prohibition may nonetheless be efficient if it creates greater certainty and reduces litigation costs and false negatives.

Despite these preemptive rejoinders, the thrust of this Essay's findings should remain salient in the litigation over the FTC ECNC rule. Whatever else one may say about the common law decisions, the courts have already protected the interests of employees and the public by invalidating ECNCs in the majority of cases and narrowing them in

many others. Whether it desirable to jettison the significant minority of ECNCs the courts find reasonable and efficient is the open question.