The Coase Theorem

First, read Chapter 3 of Polinsky, *An Introduction to Law & Economics*. You might also want to read Chapter 4, which applies the Coase Theorem to a situation similar to that in the questions on pollution that I gave you with the readings for the first class. When you have a basic understanding of the Coase Theorem, read the case below and think about the questions on the last pages.

Sarnoff v. American Home Products

785 F.2d 1075 (7th Cir. 1986)

POSNER, Circuit Judge.

Sarnoff [was an executive] of an Illinois corporation, E-Z Por, which American Home Products bought in 1979. . . . In 1981 American Home Products, which had an incentive plan under which a committee of outside directors made awards to outstanding employees, wrote . . . Sarnoff that the committee had awarded [him] 600 shares of stock . . . for 1980, to be delivered in 10 annual installments beginning at the end of their employment. The letter told the recipient to read the conditions of the award as disclosed in the incentive award plan, a copy of which was enclosed; stated that any legal questions arising under the plan would be decided under the law of New York; and requested the recipient to sign and return a copy of the letter in order to signify acknowledgment of the notification and "acceptance of New York Law as governing Plan interpretations." One of the conditions of the plan was that if the recipient left the employ of American Home Products and became an officer, director, employee, owner, or partner of an entity that "conducts a business in competition with the Company or renders a service (including, without limitation, advertising agencies and business consultants) to competitors with any portion of the business of the Company," he would forfeit the portion of the award not yet delivered to him. To get the entire award the former employee would thus have to comply with the no-competition condition for 10 years after he left American Home Products. . . .

Sarnoff signed and returned the copies of the letter and shortly afterward quit American Home Products. Sarnoff formed . . . Ensar Corporation, which sells housewares, including bottle openers and can openers. From . . . Sarnoff's answers to a questionnaire that American Home Products circulated in December 1981 to former employees who had received awards under the incentive plan, the committee concluded that [he] (along with 11 others out of a total of 400 recipients) had forfeited their awards, because Ensar's openers competed with housewares made by American Home Products. This determination was made in January 1982, before Sarnoff . . . had received the first installments of [his award]. [His] suit charges that the no-competition condition is invalid and in any event was misapplied; the district judge agreed with the first contention, so did not have to consider the second. . . .

[The court decided that New York law governed the dispute, because the contract states that any legal questions arising under the plan would be decided under the law of New York.]

So New York law governs the lawfulness of the non-competition condition, and the last question we need to decide is whether the New York courts would refuse to enforce such a condition if it was unreasonable, as they would do if instead of being a condition of receiving monetary benefits it was a covenant not to compete. *Kristt v. Whelan*, 4 A.D.2d 195 (1957), holds that such a condition is enforceable, apparently without regard to its scope and duration, and hence to its reasonableness. In defense of this result it can be pointed out that in the case of a covenant not to compete[1] the employee who quits and goes into competition with his former employer can be enjoined from competing; with the condition he cannot be, though if the forfeiture triggered by the condition's coming to pass is great enough, the inducement to avoid competing with his former employer may be as strong as the threat of a contempt judgment for violation of an injunction would be—or at least strong enough.

But against this distinction it can be argued that under either arrangement, which is to say whatever the initial assignment of rights—whether the employer has the right to prevent the employee from competing or the employee the right to compete but at some previously determined price—the parties, because there are only two of them (so that the costs of transacting should not be prohibitive), will be able to bargain their way to the position that maximizes their joint wealth. See Coase, *The Problem of Social Cost*, 3 J. Law & Econ. 1 (1960). Hence the amount of competition should not be affected. The only difference—but an important one given the paternalistic thinking that has been so prominent from the start in judicial thinking about covenants not to compete, is that at the moment when the employee must make the decision that will trigger the covenant or condition, he has a more limited set of choices under the former than under the latter. The covenant not to compete prevents him from competing unless he buys back the covenant from his former employer, whereas the condition gives him a choice between competing and receiving compensation for not competing—a choice, it might appear, between a cushion and a soft place. This distinction, however, is nowhere alluded to in *Kristt*, and ignores the fact that if the forfeiture is big enough it may prevent the employee from competing just as the covenant would do. And presumably the employee would have been compensated in advance for agreeing to a covenant that would restrict his freedom of future action. Moreover, the issue of reasonableness is barely discussed in *Kristt*; indeed, the entire discussion of the no-competition condition is perfunctory. And the decision is only that of an intermediate court, though it was affirmed by New York's highest court.

[After analyzing later New York decisions, the court decided that *Kristt* continued to govern the enforceability of non-competition conditions under New York law.]

The noncompetition condition was valid; there remains the question, not yet passed on by the district court, whether the incentive award committee acted unreasonably in finding that Sarnoff's company was competing with American Home Products. If not, American Home

[1] [In a covenant not to compete, the employee promises not to work for a competing employer. If the employee violates this promise, the former employer can get an injunction (court order) compelling the employee to honor her promise (contract) and stop working for the competitor. With a non-competition condition, the employee makes no promises about not working for a competing employer and the former employer has no right to an injunction to stop the employee from working for a competing employer. Nevertheless, if there is a non-competition condition and the employee works for a competing employer, the employee will not get something valuable in the future (such as stock in the company) that the employee would otherwise be entitled to. Prof. Klerman]

Products had no right under the plan (made binding by Sarnoff's acceptance of the letter offer) to forfeit Sarnoff's award. Judicial review of a committee, as of an arbitrator, is extremely limited. But Sarnoff has yet to receive such review of the committee's decision as he is entitled to, so the case must be remanded. . . .

Questions on *Sarnoff*

1. Is Posner correct in his application of the Coase Theorem? That is, is he right that "under either arrangement, which is to say whatever the initial assignment of rights—whether the employer has the right to prevent the employee from competing or the employee the right to compete but at some previously determined price—the parties, because there are only two of them (so that the costs of transacting should not be prohibitive), will be able to bargain their way to the position that maximizes their joint wealth." In answering that question, consider the following:

a. Suppose that Sarnoff anticipates that his new business, Ensar Corp., will generate $1,000,000 in profit, while American Home Products anticipates that Ensar will reduce American Home Products' profit by $500,000. What is the "position that maximizes their joint wealth"? Would their joint wealth be maximized by Sarnoff starting or not starting his new business? Does your answer depend on whether the non-competition condition is enforced? For the purposes of this and the following questions, assume that, on remand, the lower court holds that the incentive award committee acted reasonably in finding that Sarnoff's company would compete with American Home Products.

b. Suppose that the non-competition condition were valid and the stock that Sarnoff would get if he complied with the condition were worth $800,000. Would Sarnoff start his new business?

c. Same question as (b), but the stock was worth $1,200,000? In answering this question, consider carefully the possibility that Sarnoff and American Home Products might negotiate after Sarnoff left American Home Products but before Sarnoff started his new business.

d. Suppose the contract between Sarnoff and American Home products had included a covenant not to compete rather than a non-competition condition. The covenant not to compete forbade Sarnoff from starting or working for a competing business. A covenant not to compete, if valid, can be enforced by an injunction, so Sarnoff could be imprisoned if he persisted in violating it. Would Sarnoff start his new business? In answering this question, consider carefully the possibility that Sarnoff and American Home Products might negotiate. Is your answer affected by how much money Sarnoff has in his bank account at the time he starts his new business? By his ability to borrow money?

2. If Judge Posner is correct, that the parties will "bargain their way to a position that maximizes their joint wealth," whatever the applicable legal rule, why was it worthwhile for Sarnoff to incur the cost of litigating this lawsuit?

3. If Judge Posner is correct, that the parties will "bargain their way to a position that maximizes their joint wealth," whatever the applicable legal rule, why was it worthwhile for American Home Products to incur the cost of drafting the contract that included the non-competition condition?

4. Posner's opinion considers only the maximization of Sarnoff's and American Home Products' wealth. Are there any other persons whose wealth (or well-being) are affected? Should their interests be considered?

5. What does Posner mean when he writes, "presumably the employee would have been compensated in advance for agreeing to a covenant that would restrict his freedom of future action"?