ESSAY QUESTION NO. 7

Answer this question in booklet No. 7

The ACME Engineering Company of Alaska (ACME) recently began selling a unique test that can predict what the stability of soil will be during an earthquake. This test is of great benefit to property owners because it allows them to determine whether their building will be structurally stable during an earthquake. No one else performs this test in Alaska. ACME did not invent the test, but instead purchased the test and equipment from a vendor.

ACME hired and trained Dan, a young engineer, to perform this test. ACME drafted an employment contract for Dan to sign. The contract contained the following non-competition clause:

> In the event Dan leaves the employ of ACME, he agrees not to perform or provide similar testing services within the State of Alaska for six years.

Dan read and signed the agreement. After one year, Dan quit work at ACME and opened up his own engineering company. Dan's company provided engineering services, including a test very similar to ACME's. The test performed by Dan's company was not developed from any information gained during Dan's employment at ACME. ACME's test sales declined after Dan's company began performing the similar test.

When ACME found out that Dan had opened his own engineering firm and was performing a similar test, it sued Dan in Superior Court for breach of the non-competition clause.

1. Is the non-competition provision between ACME and Dan enforceable under Alaska law? Explain.

2. Assuming the non-competition provision is enforceable and was breached by Dan, what types of damages might ACME be entitled to?

GRADER'S GUIDE

***** QUESTION NO. 7 *****

SUBJECT: CONTRACTS

1. Enforcement of Non-Competition Clauses (70 points)

This question tests the examinee's knowledge of the law concerning enforcement of non-competition agreements.

The Alaska Supreme Court addressed the enforcement of non-competition agreements in *Metcalfe Investments, Inc. v. Garrison, 919 P.2d 1356 (Alaska 1996)* and *Data Management, Inc. v. Greene*, 757 P.2d 62 (Alaska 1988). A non-competition provision will generally be upheld if it is narrowly tailored to reasonably protect the interests of the employer and employee. *See Metcalfe*, 919 P.2d at 1362. The Alaska Supreme Court has also held that if an overbroad non-compete covenant can be reasonably altered to render it enforceable, then the court should do so -- unless it determines the covenant was not drafted in good faith. *See Data Management*, 757 P.2d at 64. The burden of proving that the covenant was drafted in good faith is on the employer. *Id.* *See also* Restatement (Second) of Contracts § 184(2) (1981) (A court may treat only part of a term as unenforceable … if the party who seeks to enforce the term obtained it in good faith and in accordance with reasonable standards of fair dealing."). *See also* UCC § 2-302, codified under Alaska Statute 45.02.302 (unconscionable contract or clause).

This "reasonableness" approach permits the courts to fashion an agreement between the parties, in accordance with their intention at the time of contracting, and enables the court to evaluate all the factors comprising "reasonableness" in the context of employee covenants. 757 P.2d at 65. The factors considered by the court are:

- The absence or presence of limitations as to time and geography;
- Whether the employee represents the sole contact with the customer;
- Whether the employee is possessed with confidential information or trade secrets;
- Whether the covenant seeks to eliminate competition which would be unfair to the employer or merely seeks to eliminate ordinary competition;
- Whether the covenant seeks to stifle the inherent skill and experience of the employee;
- Whether the benefit to the employer is disproportional to the detriment to the employee;
- Whether the covenant operates as a bar to the employee's sole means of support;

- Whether the employee's talent which the employer seeks to suppress was actually developed during the period of employment; and,
- Whether the forbidden employment is merely incidental to the main employment.

In this case, Dan clearly violated the non-competition provision. Whether the provision is enforceable as written under Alaska law depends on the "reasonableness" of its terms. Consistent with the rule described above, if the provision is deemed reasonable, the court will enforce it as written. If deemed unreasonable, a court may alter the terms to render it reasonable and enforce the modified provision. All this assumes the non-compete clause was drafted in good faith. Here, there are no facts to suggest the clause was drafted in bad faith.

A. ACME's Arguments that the Non-Competition Clause is Reasonable

- The geographic limitation – Alaska – is reasonable because of the State's relatively small population compared to its size, and the small number of cities and towns within the State. There is a smaller clientele base in Alaska than would normally be found in more highly populated states. Accordingly, restricting Dan's performance of similar testing services to outside of Alaska is reasonable. A less restrictive limitation would essentially put Dan in direct competition with ACME;
- The six-year restraint is a reasonable amount of time to protect ACME should Dan eventually decide to perform or engage in similar testing services;
- Dan was privy to ACME's confidential information with respect to its clientele base and teaching techniques;
- The provision does not prevent Dan from working in his field of education as an engineer, only from engaging in testing duties similar to those he learned and performed while working at ACME; and
- The benefit to ACME is measured and not disproportional. ACME is not granted a national monopoly.

B. Dan's Arguments That the Non-Competition Clause is Unreasonable

- Preventing Dan from working within the entire State of Alaska is excessive, and unnecessary. ACME is currently the only company performing the test, and the State is large enough for two competitors to provide this testing service. Further, this geographical restriction would effectively force Dan to move out of State if he wanted to continue performing this test;

- Six years is an unreasonable amount of time to prevent Dan from practicing in an area of his trade. By that time, there will likely be many companies performing the test – which is not proprietary to ACME – in earthquake-prone Alaska;
- As the test and equipment could be purchased from a vendor, Dan did not possess any confidential or proprietary information of ACME's;
- The provision seeks to eliminate ordinary competition through its durational and geographic restrictions. Since ACME did not invent the test and the testing equipment may be freely purchased, another company can begin selling the test in Alaska tomorrow and compete against ACME. The benefit gained by ACME is disproportional to the detriment of Dan; and
- The test is of public benefit because it identifies homes that would be unsafe during an earthquake and so Dan should not be restricted from competing as a matter of public policy.

A court will likely find the geographical and time restrictions unreasonable. However, a court will probably find the scope of the employment limitation to be reasonably restricted because it limits Dan's employment with respect to his prior testing duties at ACME, only. To the extent a court might find certain parts of the provision unreasonable, it can tailor these terms to create a reasonable provision and enforce it as modified. In some form or another, the non-competition provision will be enforceable.

2. Damages (30 points)

This question tests the examinee's knowledge of the law concerning breach of contract damages.

ACME could seek its expectation damages caused by Dan's breach of the covenant not to compete. "The purpose of awarding expectation damages for a breach of contract is to put the injured party in as good a position as that party would have been had the contract been fully performed." *Guard v. P & R Enterprises, Inc.*, 631 P.2d 1068, 1071 (Alaska 1981). The damages available in a breach of contract case are limited, however, to those damages that are the natural consequence of the breach. *See Arctic Contractors, Inc. v. State*, 564 P.2d 30, 44-45 (Alaska 1977).

Here, ACME was the sole provider of the test until Dan began performing the similar service. Thus, it is foreseeable that Dan's failure to comply with the non-compete provision would cause ACME to lose business and therefore profits. The facts indicate that ACME's sales did decline after Dan's company began performing the similar test. Accordingly, ACME will likely seek its lost profits as the measure of damages. *See National Bank of Alaska v. J.B.L. & K.*

of Alaska, Inc., 546 P.2d 579, 590 (Alaska 1976) (the measure of damages for breach of a covenant not to compete is generally the lost profits of the party asserting the breach).

In a breach of contract action, damages must be proved with reasonable certainty, and there must be a reasonable basis for computing the award. *See Power Constructors, Inc. v. Taylor & Hintze*, 960 P.2d 20, 41 (Alaska 1998). With this in mind, Dan will likely argue that since ACME's testing business is relatively new, there will be insufficient financial data to support a reasonable estimation of its lost profits. Consequently, Dan will argue that an award of ACME's lost profits is inappropriate because the amount would be too speculative. *See Dowling Supply & Equipment, Inc. v. City of Anchorage*, 490 P.2d 907, 909-910 (Alaska 1971) (Award of lost profits not proper if the result of speculation).

In response, ACME will argue that it is not required to compute its damages with mathematical precision, and one year's worth of financial data is adequate to compute its lost profits with reasonable certainty. *See Johnson v. Alaska State Dept. of Fish & Game*, 836 P.2d 896, 910 (Alaska 1991).

If the court is persuaded that computing ACME's lost profits would be too speculative, ACME may alternatively argue that its damages can be measured by the profit realized by Dan's company from the testing. *See Wirum & Cash, Architects v. Cash*, 837 P.2d 692, 709 (Alaska 1992) (in calculating damages for breach of non-competition provision, profits of the breaching party can be used to approximate the profits lost by the party asserting the breach when it would otherwise be too difficult to estimate the non-breaching party's lost profits.)

ACME should be able to recover damages in the amount of lost profits – either its own or Dan's company's.