ESSAY QUESTION NO. 3

Answer this question in booklet No. 3

Auklet Adventures, Inc. ("Auklet") is an Alaska company that specializes in guided bird watching tours on Attu, a remote island in western Alaska that is a stop for several rare species of migrating birds. Many of these birds cannot be viewed anywhere else in the world. Auklet's tours generally sell out every season based largely on the company's use of a specialized bird tracking technique developed by the company's owner and used by all Auklet guides. This technique is hugely successful, and allows Auklet to maintain its position as the top-rated birding company in Alaska, despite its many competitors throughout the state.

Auklet's employee guides are required to sign an employment agreement. The agreement contains the following provisions:

> A. In the event [employee] voluntarily ends [his/her] employment with Auklet Adventures, Inc. or is terminated for cause, [he/she] agrees to forgo employment in the birding industry, in any capacity, within the State of Alaska for a period of 2 years following [his/her] departure.
>
> B. In recognition of the indeterminate nature of damages for breaching this provision, Auklet Adventures, Inc. and [employee] agree that for each day [employee] acts in violation of this provision, [employee] will pay Auklet Adventures, Inc. one thousand five-hundred dollars ($1500) or the cost of an Auklet Adventures, Inc. tour, whichever is less. [Employee] and Auklet Adventures, Inc. agree that these amounts constitute reasonable compensation for a breach of this provision of the Agreement.

In December, 2010 Auklet hired Owen, a promising young Alaskan ornithologist seeking a career in guided bird watching, to lead its 2011 spring tours. Sitting in Auklet's offices, Owen read and signed the employment agreement. In the field Owen realized that his own bird tracking techniques were more effective than the Auklet technique, and he quickly reverted to using his own method. Owen was hugely popular with clients and his reputation spread in the birding community. At the end of the birding season in June, after six months of employment, Owen was ready for a change of scenery and he left Attu to try commercial fishing.

After a lucrative but brutal month of crab fishing, Owen realized that he missed birding. He moved to Kodiak, an island hundreds of miles from Attu and another migration stop for some of the same rare birds who visit Attu. There

Owen established his own guided bird watching business and contacted many of his former birding clientele he met while working for Auklet to alert them to his tours.

Auklet soon learned of Owen's business. Auklet sued Owen for breach of the non-competition provision and sought damages under the terms of the parties' agreement. Owen argued that the non-competition provision was unenforceable and that the liquidated damages provision was invalid and unenforceable under Alaska law.

1. What factors will the court consider in assessing Owen's claim that the non-competition provision in his employment agreement (paragraph A) is unenforceable? Discuss.

2. How will the court determine whether the liquidated damages provision in Owen's employment agreement (paragraph B) is valid and enforceable? Discuss.

GRADERS' GUIDE
*** * * QUESTION NO. 3 * * ***
CONTRACTS

(100 points)

I. Is the non-competition provision between Auklet Adventures, Inc. and Owen enforceable under Alaska law? Explain. (60 points)

This question is intended to allow examinees to demonstrate their knowledge of Alaska law concerning non-competition clauses in contracts.

A covenant not to compete will generally be upheld in Alaska so long as it is narrowly tailored to reasonably protect the interests of the employer and employee. *Metcalfe Investments, Inc. v. Garrison*, 919 P.2d 1356, 1362 (Alaska 1996). Here, Owen violated the terms of the covenant not to compete when he started his own birding tour company within two years of his voluntary departure from Auklet Adventures, Inc. In evaluating the enforceability of the covenant in this case, a court would first examine whether the covenant was reasonable.

If the court finds the provision reasonable under the test set forth below, the provision will likely be enforced as drafted. However, if the court determines that the agreement is unreasonable, it may alter its terms and enforce the modified covenant as long as the contract was drafted in good faith.

The Alaska Supreme Court has held that the courts have the power to alter overbroad non-compete covenants to render them enforceable, so long as the covenant was written in good faith. *Wirum & Cash, Architects v. Cash*, 837 P.2d 692, 709 n.25 (Alaska 1992) ("A predicate to the court altering an overbroad covenant not to compete to render it enforceable (based on what restrictions would be reasonable between the parties) is that the overbroad covenant was drafted in good faith.") (citing *Data Management, Inc. v. Greene*, 757 P.2d 62, 64 (Alaska 1988)). If court determines that the agreement was not drafted in good faith, the agreement will not be enforced.

A. Good Faith.

The covenant of good faith and fair dealing is implied in all contracts as a matter of law. *Alaska Pacific Assurance Co. v. Collins*, 794 P.2d 936, 947 (Alaska 1990). The purpose of the implied covenant is to give effect to the reasonable expectations of the parties, preventing each party from interfering with another party's right to receive the benefits of the agreement. *Hawken Northwest, Inc. v. State, Dep't of Admin.*, 76 P.3d 371, 381 (Alaska 2003). The implied covenant has both a subjective and an objective component. The subjective component prohibits one party from acting to deprive the other of

the benefits of the contract. The objective component requires both parties to act in a way that a reasonable person would consider fair. *Id.*

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."); UCC § 2-302, codified at AS 45.02.302 (regarding unconscionable contracts or clauses).

Here, the facts do not indicate that Auklet drafted the non-compete clause in bad faith. There is no evidence Auklet targeted Owen as the facts state that all Auklet employees are required to sign an employment agreement with the same provision.

B. Reasonableness.

The "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 of the factors comprising "reasonableness" in the context of employee covenants. *Data Management*, 757 P.2d at 65. Nine factors are considered by the court. *Id.* at 65 (citations omitted).

1. The absence or presence of limitations as to time and geography.

Time. Auklet Adventures, Inc. will argue that the two year prohibition on Owen's participation in the birding industry is a reasonable length of time to protect Auklet's interests in its birding business.

Owen will likely respond that the two year limitation is an unreasonable amount of time to prevent him from pursuing his chosen career. Owen might argue that many other birding competitors already exist, none of which has so far limited Auklet's successes, and therefore his fledgling start-up should not be prohibited.

Geography. Auklet will point out that the limitation on participating in a birding operation is reasonable because the birds clients travel to see make migration stops exclusively in Alaska. Accordingly two companies would likely be in direct competition with one another.

Owen will argue that Auklet's demand that he not work in the birding industry in Alaska is unnecessary and over-broad. Auklet's operations are based solely on Attu, and he has set up his business on another island hundreds of miles away. Owen might point also out that the birds tourists travel to see only migrate through these areas, and therefore he could not effectively operate in the same way outside of Alaska.

2. Whether the employee represents the sole contact with the customer.
The facts do not specifically address whether Owen was the sole contact with clients at Auklet. But there is a suggestion that he was particularly popular and that his reputation and abilities as a guide might have impacted both Auklet's (as well as his own) business success.

3. Whether the employee possesses confidential information or trade secrets.
Auklet will likely argue that its specialized tracking technique is a tremendous and valuable trade secret – confidential information to which only Auklet employees are privy.

Owen might respond that he used his own tracking techniques, and that he began doing so while working for Auklet. He will argue that Auklet's tracking strategy is not specialized or unique among high-level birders. Finally Owen could argue that although he possesses the confidential information, he demonstrated that he has no intent of using it.

4. Whether the covenant seeks to eliminate competition which would be unfair to the employer or merely seeks to eliminate ordinary competition.
Auklet will tell the court that the covenant not to compete is intended to limit or eliminate unfair competition. The unique nature of the services provided by the two companies, along with their small target market (birders who want to view rare migratory species), suggest that Auklet and Owen would be competing for the same customers. Auklet might argue that Owen's access to Auklet clientele, along with his use of Auklet's specialized tracking technique, results in an unfair advantage.

Owen will respond that the clause is unenforceable because it would result in an elimination of ordinary and reasonable business competition. In light of the fact that another bird tour guide would be free to set up a business next to Auklet or to Owen, the clause does nothing but eliminate ordinary competition.

5. Whether the covenant seeks to stifle the inherent skill and experience of the employee.
Auklet will argue that the non-compete clause is reasonable because Owen is young and has a bright future ahead of him, with many other career options. Additionally, Auklet will remind the court that the covenant only remains in effect for two years.

Owen will argue that the covenant is wholly unreasonable because being a bird guide is his chosen profession – one in which he is extraordinarily skilled. He will submit that to deprive him of the chance to pursue his dreams for two years is unreasonable. Owen will remind the court that he declined to use

Auklet's specialized tracking technique and suggest that the covenant not to compete could easily be narrowed to require employees to agree to forgo use of Auklet's tracking technique after leaving the company.

6. Whether the benefit to the employer is disproportional to the detriment of the employee.

Auklet will argue that the court's decision to enforce the covenant as written will achieve a balanced result between the benefit to the company and Owen's detriment. Auklet will point out that the provision is limited in that it only bars Owen from working in the Alaska birding industry for two years.

Owen will respond that, if the clause is enforced as drafted, Auklet will receive a disproportionate benefit and advantage because its top competitor will be forced out of business.

7. Whether the covenant operates as a bar to the employee's sole means of support.

Auklet will point out that Owen left birding to pursue another career that provided ample support. Owen will respond that his only current support is his birding operation.

8. Whether the employee's talent which the employer seeks to suppress was actually developed during the period of employment.

The facts state that Owen was seeking a career in guided bird watching when Auklet hired him. Auklet will argue Owen's training and work at Auklet Adventures greatly advanced his general guiding skills. Auklet will also argue that Owen's success as a birding guide came about through his use of the company's specialized tracking technique.

In response, Owen will remind the court that he abstained from using Auklet's special technique, instead opting to make use of his own skills and talents that were developed through his education and innate ability to find birds.

9. Whether the forbidden employment is merely incidental to the main employment.

The clause prohibits Owen from working in the birding industry, seemingly without exception. Working in the birding industry is not incidental to working as a birding guide. Auklet does not have a persuasive argument under this factor.

Owen will argue that it is unreasonable to prevent him from doing business in the birding industry when his main employment with Auklet was as a birding guide.

The facts of this question are close, and a court could easily find that some elements of the non-competition provision are reasonable (*i.e.* the limitation on

the time period), but that other elements are unreasonable (*i.e.* the scope of the limitation). To the extent that a court might find certain parts of the provision unreasonable, it can tailor those terms to the reasonable expectations of the parties at the time of contracting and enforce it as modified.

II. Is the liquidated damages provision from the employment agreement valid? Discuss. (40 points)

The Alaska Supreme Court has held that, "[g]enerally, parties to a contract are free to stipulate in advance" to an amount that would be paid as compensation for a loss or injury flowing from a breach of the contract. *Carr-Gottstein Properties, Ltd. Partnership v. Benedict*, 72 P.3d 308, 310 (Alaska 2003) (citations omitted). The crucial question regarding enforcement of a liquidated damages clause is whether the stipulated amount is a reasonable pre-contract estimate of actual damages or is an illegal penalty. "A valid liquidated damages clause is an agreement to set in advance the damages for breach which would otherwise be difficult to determine. However, the clause may not set damages so as to penalize the breaching party for the breach, without regard to the harm caused by the breach." *Helstrom v. North Slope Borough*, 797 P.2d 1192, 1200 (Alaska 1990) (citations omitted).

Alaska has adopted a two-step test for liquidated damage clause enforceability. Liquidated damages are proper (1) where it would be difficult to ascertain actual damages, and (2) where the liquidated amount is a reasonable forecast of the damages likely to occur in the event of a breach. *Carr-Gottstein*, 72 P.3d at 311 (citing Restatement (Second) of Contracts § 356(1) (1981); *Southeast Alaska Constr. Co., Inc. v. State*, 791 P.2d 339, 343 (Alaska 1990).

The liquidated damages provision at issue here likely meets the first part of the test, as it would be difficult for a court to ascertain Auklet's actual damages due to Owen's breach of the non-competition provision. Owen might argue that the court could simply conduct a straight-forward lost profits analysis in order to determine Auklet's damages. Auklet would respond that if the damages provision is not enforced, the court would be tasked with determining an appropriate measure of Auklet's past and future damages, which could be difficult to determine in a bird guiding business that is impacted by reputation, weather, and other conditions. *See National Bank of Alaska v. J.B.L. & K. of Alaska, Inc.*, 546 P.2d 579, 590 (Alaska 1976) ("The measure for breach of a covenant not to compete is generally not the profits earned by the breaching party, but rather the lost profits of the party asserting the breach.") (citations omitted).

Whether the liquidated damages provision meets the second part of the test is a close question. Auklet will argue that, when determining the amount of liquidated damages, the parties attempted to ascertain the approximate damages for a breach of the agreement. Owen will argue that the provision is a

penalty provision because it does not realistically approximate damages, and because he will be forced to pay for each day he is in breach of the agreement by operating his birding business, regardless of whether or not customers patronize his business, or the success or failure of his business. *Compare Kalenka v. Taylor*, 896 P.2d 222, 229 (Alaska 1995) *with Carr-Gottstein*, 72 P.3d at 312-13 *and Aviation Associates, Ltd. v. TEMSCO Helicopters, Inc.*, 881 P.2d 1127 (Alaska 1994).

Conclusion.
Because these are close questions, the examinees' ultimate conclusions are not as important as the analysis they perform in reaching those conclusions.