

## POST-EMPLOYMENT COVENANTS IN UTAH: A UNIFIED FRAMEWORK USING LAW AND ECONOMICS

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### I. INTRODUCTION

Covenants not to compete in post-employment contracts are becoming an important area of litigation in Utah. Spawned by the advance of high tech industry, the skills and education of Utah's professionals have become a critical cornerstone of the U.S. economy. Employers regard post-employment restraints as a critical method of protecting their investments in their work forces, including protecting trade secrets and customer relationships. Many employees have the opposite view. After many years of expensive education, employees seeking a return on this investment wish not to be held captive by employers seeking to restrict their career opportunities.

While covenants not to compete have increasingly become a key part of employment relationships, Utah case law has typically lagged behind, failing to forge adequate tools to deal effectively with many of the difficult issues raised by post-employment restraints in a high tech economy. Practitioners in this area often complain that the outcome of a challenge to a post-employment restraint in Utah courts is virtually unpredictable. This paper will attempt to show that the discipline of law and economics can contribute to a sounder analysis of post-employment restraints by Utah courts. We begin by briefly reviewing the relevant Utah case law on post-employment covenants and identifying the loci of ambiguity therein.<sup>1</sup> We then review the underlying sources of current law in early common law and in the Sherman Act. Next we review briefly the fundamentals of the law and economics approach. Finally, we apply the law and economics approach to the area of post-employment covenants to develop a unified framework for analyzing post-employment restraints that can assist litigants and courts in evaluating issues raised by such covenants.

### II. UTAH LAW CONCERNING POST-EMPLOYMENT RESTRAINTS.

Utah, like most states, has adopted a common law test for the enforceability of post-employment restraints similar to the rule contained in the *Restatement of Contracts 2nd*:

- (1) A promise to refrain from competition that imposes a restraint that is ancillary to an otherwise valid transaction or relationship is unreasonably in restraint of trade if:
  - (a) the restraint is greater than is needed to protect the promisee's legitimate interest, or
  - (b) the promisee's need is outweighed by the hardship to the promisor and the likely injury to the public.<sup>2</sup>

Justice Stewart may have offered the clearest statement of Utah's law concerning the enforceability of post-employment restraints in Robbins v. Finlay:

Covenants not to compete are enforceable if carefully drawn to protect only the legitimate interests of the employer. The reasonableness of a covenant depends upon several factors, including its geographical extent; the duration of the limitation; the nature of the employee's duties; and the nature of the interest which the employer seeks to protect such as trade secrets, the goodwill of his business, or an extraordinary investment in the training or education of the employee.<sup>3</sup>

In Finlay, the Utah Supreme Court explained that "the law balances the nature of the interest of one seeking to enforce such a covenant. . . against the hardship imposed on the employee as the result of the restraint<sup>4</sup>." Moreover, but almost as an afterthought, the court commented that restraints "primarily designed to limit competition" are unenforceable.<sup>5</sup>

Finlay modified the earlier test found in Allen v. Rose Park Pharmacy<sup>6</sup>, where the Utah Supreme Court focused on protection of "goodwill" alone, as opposed to the employer's interest in the protection of trade secrets and investment in employee training. In Finlay the court held that a former employer must show not only a need to protect goodwill but also that the services rendered by the employee were special, unique or extraordinary.<sup>7</sup> Most Utah courts have followed the Finlay approach to analysis of post-employment restraints.<sup>8</sup>

The Utah test, like the *Restatement* test, is inherently ambiguous. The test requires a balancing of the employer's need to protect a trade secret or an investment in training against the resulting hardship to the employee. Yet why or how such a weighing process is to take place is left unspecified. Moreover, Finlay addresses the impact of a post-employment restraint on competition only in passing. Understandably, courts and practitioners in Utah have been left with an intractable task of analysis leading to unpredictable results.

In this paper we attempt to take a first step toward adding structure and precision to the analysis of post-employment restraints by adopting an economic approach. Before developing such an analysis it is important to understand the origins of the current test and why current law is in such a state of confusion.

### III. TWO SOURCES OF LEGAL PRECEDENT

In part, post-employment restraints are difficult to analyze because such covenants traverse two distinct areas of law: contract law and restraints of trade. Generally, state courts have relied on traditional principles of contract law to analyze covenants not to compete, only occasionally incorporating elements of the common law from restraints of trade. In contrast, federal courts have analyzed post-employment restraints under the Sherman Act. The Sherman Act originally codified the early common law of restraints of trade in the late nineteenth century, but jurisprudence under the Sherman Act has developed significantly over the last century. The Supreme Court recognized these common roots in National Society of Professional Engineers v. United States, where the Court explained that both the Sherman Act and state law regarding common law restraints of trade can be traced to a common origin.<sup>9</sup>

#### A. Early Common Law Treatment of Post-Employment Restraints.

The early common law essentially separated agreements in restraint of trade into three distinct categories: general restraints of trade, partial restraints of trade, and restraints on future employment<sup>10</sup>. General restraints of trade consisted of those agreements that always impeded trade in some way and had no clear benefit to competition. These agreements were void per se. Partial restraints of trade were those agreements ancillary to the sale or transfer of a business interest. Although these agreements certainly constituted a restraint of trade, the English courts generally upheld such agreements, so long as they were reasonably tailored to the scope of the connected transaction<sup>11</sup>. Finally, restraints on future employment were the same as modern day covenants not to compete, and were originally held invalid, irrespective of the scope of the restriction, because of their negative impact on economic freedom.

A line of cases, which we will refer to as "the Dyer cases", provides a good example of the typical view of restrictive covenants at the time. Dyer's case is the first known case dealing with restrictions on the

individual practice of a craft.<sup>12</sup> In Dyer, the plaintiff brought a writ of debt against the defendant, a dyer by trade. The dyer asserted that, according to his "indenture," or apprenticeship contract, the debt was to be forgiven so long as he did not practice his trade in the plaintiff's town for six months after his training. He further claimed that he had satisfied this requirement. Although the case was allowed to proceed, and no further proceedings are reported, the Lord of the English court hinted that the defendant might have demurred because the restriction was illegal at common law.

At the beginning of the transition from the apprenticeship system to an entrepreneurial system of capitalism, in 1717, the pivotal case regarding covenants not to compete, Mitchel v. Reynolds, was decided.<sup>13</sup> In Mitchel, the defendant assigned a bake-house to the plaintiff in the city of St. Andrews Holborn. As a condition on the sale, the defendant agreed not to participate in the baking business for five years. If the defendant breached the agreement, he was to pay the plaintiff a bond of fifty pounds. After the defendant breached the condition, the plaintiff brought suit for the fifty pounds. The defendant argued that, because he was a baker by trade, the agreement constituted a restraint on future employment and was therefore void in law. Lord Macclesfield, writing for the court, disagreed with the defendant and ruled for the plaintiff.

Macclesfield recognized the importance of the freedom of contract theory. The impact of this theory on Macclesfield's decision is evidenced by his statements that "a man may, upon a valuable consideration, by his own consent, and for his own profit, give over his trade, and part with it to another in a particular place," and that "the true distinction of this case is, not between promises and bonds, but between contracts with and without consideration."

Beyond recognizing the importance of contract theory, the part of the Mitchel decision which had the greatest impact on the future of antitrust and restraint of trade law, was the introduction of the "rule of reason" test<sup>15</sup>. In Mitchel, Macclesfield stated that "in all restraints of trade, where nothing more appears, the law presumes them bad; but if the circumstances are set forth, that presumption is excluded, and the court is to judge of those circumstances, and determine accordingly; and if upon them it appears to be a just and honest contract it ought to be maintained."<sup>16</sup>

After Mitchel, while the traditional rule remained that all restraints of trade were prima facie invalid, the court allowed the parties to prove the validity of covenants not to compete based on the circumstances involved. Under this test, in determining whether or not to uphold a contract which, on its face, restrained trade, the court was asked to determine whether or not there was some essential economic or business purpose behind the agreement, and whether or not the contract was supported by adequate consideration. If the contract was based on adequate consideration, and had economic and business purposes, then the court was to look at the surrounding circumstances and determine if, given the circumstances as they were at the time the agreement was made, the terms of the agreement were reasonable.

With Mitchel, the essential legal theory of employment covenants was largely completed.<sup>17</sup> As a result of long transition from a feudal to a capitalist economy, businesses in England faced an increase in competition, and employees began searching for new and improved ways of protecting their businesses. By the late eighteenth and early nineteenth centuries, as England fully abandoned the apprenticeship system, freedom of contract became an essential part of the ideology of the English market system.<sup>18</sup> The enforcement of contracts replaced the stability lost from the apprenticeship system. As the freedom to contract grew, the courts faced the challenge of having to reconcile previous opinions, such as Mitchel, based mostly on the old economic system, with the new, more common economic practices.

Even with a change in economic systems, and the need for legal adaptation in the area of restraints of trade, however, the courts did not completely abandon the basic premises of Lord Macclesfield's "rule

of reason" analysis<sup>19</sup>. What did change, however, was the focus of the "reasonableness" element of the analysis. As previously stated, Macclesfield relied partly on the existence of valid consideration as a threshold of inquiry to the "reasonableness" of the restraint. Without a showing of adequate consideration, the court would, theoretically, refuse to enforce the restraint. However, as the society became more capitalist, and legal scholars turned more towards contract principles, the courts began adopting less stringent, more flexible requirements. What became important was not the actual consideration for the contract itself, but whether the contract, in its entirety, was fair and reasonable.

Appropriately enough, the adaptation of the Mitchel "rule of reason" test to changing economic conditions began in cases regarding restraints on future employment. The first case to clarify and reformulate the "rule of reason" test, in 1831, was Horner v. Graves.<sup>20</sup> Horner involved a restraint on future employment which prohibited a dentist's assistant from practicing dentistry within 100 miles of his employer's town, so long as the employer remained in practice.<sup>21</sup> In declining to enforce the agreement, the court found that "the element of reasonableness was not limited to the consideration stated in the contract but extended to all facts relevant to 'whether the restraint is such only as to afford a fair protection to the interests of the party in favour of whom it is given, and not so large as to interfere with the interests of the public.'"<sup>22</sup>

Following Horner, the English courts further adapted the "rule of reason" test to fit the modern entrepreneurial, capitalist economic system and the promotion of freedom of contract principles, in Tallis v. Tallis.<sup>23</sup> In Tallis, the Court of Queen's Bench modified the traditional rule, announced by Mitchel, that all restraints of trade are prima facie invalid, and held instead that the burden was on the covenantor to show that the covenant was unreasonable and therefore invalid. Unless such a showing was made, the reasonableness of the agreement would be presumed and the agreement upheld as a contract freely entered into by the parties.

Not surprisingly, it was not long until the English courts adopted contract principles in all restraint of trade cases, including those regarding "general restraints." In 1897, in Nordfelt v. Maxim Nordenfelt Guns and Ammunition Company, for example, the English court upheld the sale of a vast munitions business and a world-wide covenant not to compete.<sup>25</sup> In deciding the case, the Lords resolved any lingering doubts about the validity of "general" restraints by holding "that a restraint [which was] no wider than reasonably necessary to protect the interests of the covenant and not against the public interest should be upheld."

## **B. The Sherman Act.**

The common law of restraints of trade was imported largely intact from England to the United States. However, the dramatic transformation of the American economy during the Industrial Revolution led to dissatisfaction with common-law remedies. Massive mergers and growth of industry led to tremendous rivalry between large efficient firms with homogeneous products previously protected by local markets. The rise of large firms and more advanced communication and transportation resulted in the breakdown of local boundaries. The period after the Civil War was characterized by severe price competition and deflation. The natural reaction of firms engaged in what was perceived as destructive competition was to develop cartels in the form of trusts and stock pools to curtail price competition.

The public perception of the "trust problem" led to irresistible pressure for congressional action. The primary flaw of the common law of restraints in controlling the trusts was that contractual privity was required for standing (possessed only by the cartel members themselves) when the primary anticompetitive effect was borne by third parties (consumers and small businesses)<sup>27</sup>. The Sherman Act<sup>28</sup> essentially codified the common law of restraints by stating "every contract, combination in the form of trust, or otherwise, or conspiracy, in restraint of trade ..." is illegal,<sup>29</sup> while at the same time

extended standing to the government and affected private parties.

When Congress enacted the Sherman Act on July 2, 1890, the result from the competing economic and political forces was a compromise between those who feared big business, primarily because of its impact on political and economic freedom, and those who supported big business, which promoted efficiency and higher levels of production resulting in lower costs. Rather than create a law which required ultimately "free competition," leaving no room for any trust activity, as the original proponents of the Act suggested, Congress adopted the more ambiguous common law concepts which prohibited restraints of trade and monopolies. This less stringent law provided some protection for traditional business without completely sacrificing the advantages of the corporate revolution. Thus, though the original goal and purpose of the Sherman Act was to protect traditional small firms, in reality, the final version would become more of a compromise between the two competing views on big business.<sup>34</sup>

This compromise is evidenced by the language of section 1 itself: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is hereby declared illegal." Rather than clearly define what was meant by a restraint of trade, Congress left the term purposefully ambiguous in order to avoid limiting the protections afforded to traditional firms by the Act. The courts quickly developed a body of jurisprudence under the Sherman Act to deal with a wide variety of competition issues.

Interestingly, post-employment restraints remained one of the few areas that continued to fall within the domain of common law restraints of trade. At the state level courts developed and applied the common law of restraints to post-employment restraints primarily by incorporation of the law of contract. Thus, today one finds in state post-employment restraint cases many citations to Corbin, Williston and the Restatement, but little reference to the development of antitrust jurisprudence by the federal courts.

It was not until Harvey Goldsmid's influential paper on post-employment restraints that federal courts began to subject covenants not to compete to Sherman Act scrutiny. <sup>36 37</sup> Thus, today there are two disparate sources of legal precedent concerning covenants not to compete: federal law under the Sherman Act and the common law of restraints of trade as developed by the states.

#### **IV. THE LAW AND ECONOMICS APPROACH**

Law and economics analysis can help to reconcile the state and federal law approaches to post-employment restraints by providing a logical, predictable method for analyzing post-employment restraints. Before turning to the final analysis we briefly introduce the basic concepts of law and economics for the uninitiated.

Law and economics analysis developed primarily in the 1960s and 1970s.<sup>38</sup> Fundamental to law and economics analysis is the assumption that microeconomics principles explain the rationale behind existing legal rules, as well as aid legal scholars in fashioning rules to achieve defined ends.<sup>39</sup> Microeconomics is theory that describes how markets operate/function. More specifically, the principal working hypotheses among law and economics proponents are: (1) the proper goal of the common law is the advancement of economic efficiency, and (2) the common law tends to evolve toward efficient rules even if it is not conscious of that process.<sup>40</sup> The goal of economic efficiency may appear to some to be overly narrow.<sup>41</sup> However, one need not accept the efficiency goal to find useful the analysis we develop. This article argues that economics can help clarify our thinking about post-employment restraints because such restraints directly concern the functioning of the market.

##### **A. The Efficiency Goal**

