Langdon T. Owen, Jr.[1]
Cohne Kinghorn, pc
801 363-4300
lowen@cohnekinghorn.com

COVENANTS NOT TO COMPETE

I. Covenants Not to Compete Background.

A. **Types of Covenants**. Managerial and technical employees are quite often faced with covenants restricting in various ways their ability to compete with the group for which they had been providing service prior to leaving it. Some of the more significant forms of these covenants include:

Covenants against soliciting other employed or affiliated employees or professionals.

Covenants against soliciting customers.

Covenants against soliciting third-party payor contracts (*e.g.*, insurance, HMO's, etc., in the health care industry).

Covenants against competition.

We will here be most concerned with the last category, direct covenants against competition, because it is the most widely used and has been the subject of the most case law, but our discussion will touch on issues that are also relevant to the other forms of covenants because they are all subject to many of the same policies.

B. **Circumstances of Use** . Such covenants usually arise in one of three main settings:

1. Employment or independent contractor agreements.

2. Affiliation agreements for a business. The covenants are often contained in a buy-sell agreement or in a partnership or limited liability company agreement, or in the corporate bylaws or other such documents creating the business organization.

[1] This article is provided for informational purposes only. It is not intended as, and does not constitute, legal advice. Further, access to or receipt of this article by anyone does not create an attorney-client relationship. Although this article was believed to be correct within the scope of its purposes when written, it may be incorrect or incomplete, was not intended to comprehensively cover any subject, does not cover a number of related matters, and does not cover anyone's particular situation. As such, it is not reasonable for anyone to rely upon this article with respect to any particular legal matter. Rather, readers are encouraged to retain a licensed attorney to provide individualized and current legal advice.

3. Business sale agreements by which a shareholder, partner, member, or other equity holder with board, officer, or managerial functions sells a business or a division of a business.

The policies relating to such covenants in each of these circumstances are similar but are not identical. For example, a provision that may be reasonable in connection with the sale of a business, including its good will, may not be reasonable in an employment situation.

C. **Reasons for Use** . The major reason for the use of such covenants is, of course, to restrict competition. This is not a favored purpose under American public policy which generally seeks to enhance economic competition. Particularly in employment contracts noncompete provisions tend to be strictly construed. *General Surgery, P.A. v. Suppes*, 953 P.2d 1055 (Kan. Ct. App. 1998). However, some offsetting purposes have been found to legitimately allow certain covenants against competition.

1. Protection of Good Will. A business may depend on its reputation and good will with its customers to obtain a return on its investment greater than a passive investment such as a bank account. This may take many years of development and many dollars of investment to create, and may be a very important, or even the single most important, asset of the enterprise. This is particularly true of professionals providing services. It may not be fair to allow a professional or employee to build a personal reputation in the industry using this important asset, only to take the benefit of it away from the business when the person leaves the business. Most of the other purposes for covenants against competition are variations on this theme.

2. Protecting Confidential Information. It may be unfair to allow an employee or professional to use certain information against the business that produced it. There may also be trade secret act protection available.

3. Protecting Investment in Employees. In order to encourage investment in employees, such as through unique training beyond a base level, it may be important to prevent an employee from using that training to the competitive disadvantage of the former employer.

4. Protecting Customer Relationships. If an employee develops a relationship with a customer on behalf of the business, it may be unfair to allow that employee to deprive the group of the benefit of that relationship.

D. **Limitations on Use**. Although there are circumstances where covenants against competition can legitimately be used, they should be restricted to protect the valid interests involved and not to go beyond this to restrict general competition of the sort a stranger could provide. The courts thus generally require such covenants to be reasonably limited. The limitations are as to:

1. Span of Time. The restriction should not last longer than reasonably necessary.

2. Space of Application. The geographical area to which the restriction applies should be reasonable.

3. Scope of Activities. The restriction should be limited as to the activities involved to those reasonably necessary to protect a legitimate interest of the person benefitting from the restriction.

4. Special Restrictions. Some states impose special restrictions on covenants affecting competition by statute or by case law. Some of these are to deny enforceability except in specific circumstances (*e.g.*, business sales), to require the covenants be in writing, or to require no unconscionability or unfair bargaining power in their creation. See T. Leigh Anenson, the "Role of Equity in Employment Noncompetition Cases," 42 Am. Bus. L. J. 1 (Spring 2005) (possible unclean hands defense where employer enforces its own covenants while challenging other's covenants, at least in context of competitor's suit for tortious interference with contract).

Beginning in 2016, Utah generally imposes a one year restriction on post-employment covenants not tied to the sale of a business. UCA § 34-51-201. The restriction does not apply to nonsolicitation, nondisclosure, or confidentiality provisions or to severance agreements entered into at or after discharge, or to covenants in connection with the sale of a business where the individual subject to the covenant receives value in the sale. There are special rules for broadcast employees (UCA § 34-51-201(2)).

E. **Factors in Determining Reasonableness** . These limitations (to the extent not imposed by a statute) are generally applied by use of a balancing process taking into account the relevant facts and circumstances. No particular easily definable weight can be given to any particular circumstance. How various factors are applied and weighted varies from jurisdiction to jurisdiction, and appears to vary over time, with the trend of the cases being to restrict such covenants more than they were restricted, say, 30 years ago. Some factors that may be important in a set of circumstances include:

1. Level of Responsibility. A harsher covenant (*e.g.*, longer term, broader geographical coverage) may be enforceable against an employee who is also the chief executive of the business than may be reasonable for a manager in the first year of employment without broader responsibilities.

2. Time and Space Relativity. Generally, the more space covered, the shorter the time element will need to be, and the longer the time, the narrower the space factor will need to be, but in either event there are certain (not very clear) outside limits beyond which neither element can go.

3. Scope Effects. If the covenant covers a narrower range of activities, such as being limited to not soliciting the particular customers with which the employee had personal contact, a somewhat longer time element may be found enforceable. Also, a covenant applying

to specialty areas not practiced by the employer, or to services not provided for the employer, may be found to be overbroad.

4. Community Need. The perceived reasonableness of a covenant may be influenced by the effect its enforcement may have on the community as a whole, for example by eliminating needed medical skills or resources in an area of scarcity. This may be a factor, for example, in the health care industry, at least in some states. See S. Elizabeth Wilborn Malloy, "Physician Restrictive Covenants: The Neglect of Incumbent Patient Interests," 41 Wake Forest L. Rev. 189 (Spring 2006). See also *Community Hospital v. More*, 869 A.2d 884 (N.J. 2008); *Valley Medical Specialists v. Farber*, 982 P.2d 1277 (Az. 1999); *Intermountain Eye & Laser Centers, PLLC v. Miller*, 127 P.3d 121 (Id. 2005); each of these cases found patient interests relevant as a factor against enforcing a covenant not to compete. Compare with these cases the statement in *Mohanty v. St. John Heart Clinic*, 866 N.E.2d 85, 95 (Ill. 2006) that where such covenants allow experienced practitioners to take on inexperienced practitioners, there can be a positive effect on patient care; the court there rejected infringement of the physician patient relationship as a basis for invalidating a noncompete covenant. Perpetuation of significant monopoly power may be another community factor in the enforcement of such covenants.

5. Consideration Paid. Some states require adequate consideration or some particular type of consideration for such covenants. In others the amount paid for the covenant is one factor (among others) that relate to the reasonableness of the covenant.

6. Freedom of Contract. Freedom of contract considerations also are a factor, and courts tend to try to enforce agreements freely entered into. This tendency may be of more influence in some states than in others, and can be over come by indications of unfairness or overreaching in the bargaining process. Take it or leave it contracts of adhesion may be more carefully scrutinized for reasonableness than openly negotiated agreements between equals.

7. Type of Agreement. The reasonableness of a covenant may also be influenced by the type of agreement containing it. Sales of a business with the good will of the business may support a more restrictive covenant than an at-will employment agreement, because it may be unfair to allow a person to sell good will and then reduce its value by competing against the buyer.

8. Hardship. Some courts take into account the hardship on the individual restricted by the covenant.

F. **"Blue Pencil" Interpretation** . Some courts will enforce an unreasonable restriction up to the point the court deems reasonable. This is done in two ways:

1. Interpretation. The court may under its law of contract interpretation seek to enforce a provision to the extent possible. *Cent. Ind. Podiatry, PC v. Krueger*, 882 N.E.2d 723 (Ind. 2008) (43 counties reduced to 3).

2. Specific Provisions. A court may be reluctant to enforce an otherwise excessive covenant without a specific contract provision allowing it to enforce the covenant to the maximum extent it finds reasonable, but will do so when such a provision exists.

3. Otherwise. If a court won't "blue pencil" a covenant deemed excessive, it will be unenforceable in full.

G. **Employer Breach**. The breach of an agreement by the employer or other person benefitting from the covenant may in some states prevent enforcement of the covenant, especially if the breach is directly related to the covenant, or if bad faith termination of employment is involved on the part of the employer. It is possible that an "unclean hands' equitable defense could be applied.

H. **Collateral Issues**. There may be some side issues raised by covenants not to compete, including:

1. Antitrust. State or federal antitrust or fair competition acts may apply to some circumstances where these covenants are used. This could create a cause of action for damages or criminal responsibility.

2. Regulatory Issues. There may be special regulatory matters affected by such covenants. For example, in the health care industry:

a. Antikickback and Stark Self Referral. The Antikickback law applicable to physicians and, in somewhat unusual circumstances the Stark Self Referral restrictions (*e.g.*, in some hospital physician recruiting contexts), may affect such a covenant. For example, excessive payments for a covenant may be a prohibited kickback or may violate Stark. See *U.S. ex rel. Singh v. Bradford Reg'l Med. Ctr.*, 752 F. Supp. 2d 602 (W.D. Pa. 2010) (non-compete agreement supported finding of indirect financial relationship under Stark Act). A violation could make the covenant unenforceable (see generally *Polk County, Tex. v. Peters*, 800 F.Supp. 1451 (E.D.Tex.1992) (unenforceable illegal recruitment agreement), or impose sanctions on the parties to it, or both. This can be a risky defense to a covenant because both parties are liable for any Anti- Kickback law violations.

b. Tax Exemption. Also, excessive payments for a covenant may be an inurement to private benefit that may adversely affect the tax exemption of a not-for-profit hospital or clinic.

c. Medical Practice Act. A state's general medical practice act may be read to imply some restrictions on certain covenants, even in the absence of specific provisions relating directly to such covenants.

d. Patient Rights. The patient does not have a cause of action against the former employer for the enforcement of a covenant that requires a change of physicians.

3. Employment and Tax Law. The existence of a covenant not to compete may be a factor which may result (with other factors) in reclassifying a purported independent contractor as an employee for various purposes, including employment tax purposes, sometimes with expensive consequences (tax, interest, penalties, employee benefit qualification, etc.). Covenants acquired with the acquisition of a business are a "section 197 intangible" under IRC § 197, amortizable over 15 years.

4. Choice of Law. The rules on covenants not to compete vary considerably state by state, either by statute or by case law. Multistate employers may try select by contract the law of a state favorable to the use of covenants not to compete. Some states which are not favorable to the covenant may not enforce such a choice of law provision where it conflicts with state policy against such covenants, at least where the interests of the other state do not predominate. See *Beilfuss v. Huffy Corp*., 685 N.W.2d 373 (Wis. Ct. App. 2004). This often results in each of the parties racing to the courthouse in the state most favorable to it in an attempt to preclude action in the other state.

5. Professional Ethics. Some professions may have ethical rules prohibiting the use of such covenants. This is true for lawyers, except in connection with benefits provided on retirement. See Ut. Rul. Prof. Conduct 5.6. The American Medical Association has opined that they may be unethical for physicians if they fail to make reasonable accommodations for a patient's choice of physician. AMA Opinion 9.02, "Restrictive Covenants and the Practice of Medicine," at www.ama-assn.org/ama/pub/physician-resources/medical-ethics/code-medical-ethics/opinion902.shtml.

II. **Utah Law on Covenants Not to Compete**.

A. **Types of Cases** . There are some reported Utah cases dealing with covenants not to compete. The reported cases involve particular industries, but the basic standards set forth in them would generally apply to most other industries as well, although there may be special considerations in certain cases (*e.g.*, health care) that might be used in addition to those so far discussed in the reported cases.

B. **Protectable Interests** . The Utah cases support protecting at least the following interests of the person benefitting from the covenant:

1. Good Will. The goodwill of the business can be protected against the likelihood that customers will be drawn away. A covenant against soliciting customers may provide sufficient protection that an additional general covenant against competition may become excessive and of questionable enforceability.

2. Trade Secrets and Confidential Information Can be Protected. This includes customer lists not easily reproducible.

3. Extraordinary Investment. Investments in employee training or education beyond the general knowledge and experience of a common calling or the efficiency and skills generally developed through working.

C. **Requirements for Covenant** . At least if a covenant against competition is to be enforced by preliminary injunction, and perhaps if at all, the covenant:

1. Must be supported by consideration, but initial employment is sufficient and a change in the terms of employment, at least in an at-will context, is sufficient.

2. Must not be the subject of any bad faith in its negotiation; such matters as procurement by fraud, mistake, overreaching, or oppression or the effect of disparate bargaining positions, lack of access to relevant information, monopoly, duress, or contracts of adhesion will be relevant as to the enforceability of a liquidated damages provision associated with a covenant not to compete and may likewise affect the covenant itself.

3. Must be necessary to protect the good will of the business as shown by a likelihood that customers may be taken.

4. Must be reasonable in terms of time and geographical area. This analysis takes into account, among other things,

a. The location and nature of the employers clientele;

b. The time necessary to consolidate the goodwill of the business in order to withstand competition;

c. The nature of the employee's duties, and whether they are special, unique, or extraordinary;

d. The interests the enforcing party seeks to protect. For example, trade secrets might be more widely protected than customer goodwill;

e. Whether activity restrictions could as well protect the interest as a general geographic non-competition restriction.

5. The burden appears to be on the party seeking to enforce the covenant.

6. As long as the time and space restrictions are reasonably necessary, claimed hardship by the restricted person will not create equitable grounds for relief against the covenant.

7. If it is to be in effect beyond one year, it must be in writing.

8. Must not be a post-employment covenant with a term over a year, or an exception to the statute must apply. UCA § 34-51-201.

D. **Provisions Upheld**. Utah courts have upheld a 5 year 2 mile covenant not to compete by a pharmacy against a former employee, and have upheld a restriction in favor of a nationwide business where no geographic limitation was specified. It is undecided in Utah whether a court should enforce an otherwise unreasonable restriction to the maximum reasonable extent whether with or without a specific contractual "blue pencil" provision.

E. **Authorities**. The main cases and secondary authorities applicable in Utah are:

1. Utah Cases. *Robbins v. Finlay*, 645 P.2d 623 (Utah 1982) (hearing aids); *Allen v. Rose Park Pharmacy*, 237 P.2d 823 (Utah 1951) (pharmacy); *Kasco Servs. Corp. v. Benson*, 831 P.2d 86 (Utah 1992); *System Concepts v. Dixon*, 669 P.2d 421 (Utah 1983); *Regan Outdoor Advertising v. Lundgren*, 692 P.2d 776 (Utah 1984); *Regional Sales Agency v. Reichert*, 784 P.2d 1210 (Ut. Ct. App. 1989). See also, *Pratt v. Prodata, Inc*., 885 P.2d 786 (Utah 1994); *Foster v. Montgomery*, 82 P.3d 191 (Ut. App. 2003); *Orlob v. Wasatch Mgmt*., 33 P.3d 1078 (Ut. App. 2001); *Melrose v. Low*, 15 P.2d 319 (Ut. 1931). See also *Microbiological Research Corp. v. Muna*, 625 P.2d 690 (Ut. 1981) (customer list not protectable where publicly available).

2. Tenth Circuit and Utah Related Federal Cases. *Lundgrin v. Clayton*, 619 F.2d 61 (10th Cir. 1980); *Heaps v. Mitchell*, 166 F.3d 1074 (10th Cir. 1999) (appeal from U. S. Dist. Ct. for Utah, applying Utah and Colorado law). *Whole Living, Inc. v. Tolman*, 344 F. Supp. 2d 739 (D. Utah 2004) (employer's business illegal not a defense); *Ross, Bovins & Oehmke, PC, v Lexis/Nexis*, 348 F. Supp. 2d 845 (ED Mich. 2004) (applying Utah law). See also, *Electrical Distributors, Inc. v. SFR, Inc*., 166 F.3d 1074 (10th Cir. 1999) (applying Colorado law to restriction covering Utah, finding no violation of fundamental Utah public policy); *Dorr, Bentley & Pecha, CPAs, PC, v. Pasek (in re Pasek)*, 983 F.2d 1524 (10th Cir. 1993) (dischargeable in bankruptcy); *Tahitian Noni Int'l v. Dean*, 2009 U.S. Dist. LEXIS 5671 (D. Utah 2009); *Bad Ass Coffee of Hawaii, Inc. v. JH Nterprises, LLC*, 636 F. Supp. 2d 1237 (D. Utah 2009); *Systemic Formulas, Inc. v. Kim*, 2009 U.S. Dist. LEXIS 116038 (D. Utah 2009). 2016 WL 4734589; *Novus Franchising, Inc. v. Brockbank*, No. 1:16-CV-00078, 2016 WL 4734589 (D. Utah 2016) (preliminary injunction denied).

3. Secondary Sources. Burton, Janove & Whitsett, "Covenants not to Compete", 6 Utah B. J. 9 (Feb.1993); "Recent Developments in Utah Law, Contracts: Enjoining Third Parties from Assisting a Covenantor in Violating a Covenant not to Compete", 1993 Utah L. Rev. 214 (1993) (discussing the *Kasco* case, supra.); "Covenants not to Compete", a State by State Survey, Tenth Ed., ABA 2012, BNA Books, Utah article, at p. 4727 with 2016 Supp. at p. 653 (contributed by H. Dickson Burton of the Utah Bar). The ABA State by State Survey is a very useful resource which is well organized and indexed and allows locating cases from around the country based on issues raised, type of industry, and various other factors.