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Enforceability of Covenants Not to Compete Containing Unreasonable Indivisible Restrictions As to Geographical Area

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LAW NOTES

ENFORCEABILITY OF COVENANTS NOT TO COMPETE CONTAINING UNREASONABLE, INDIVISIBLE RESTRICTIONS AS TO GEOGRAPHICAL AREA

Contracts by which a business, a professional practice, or some other property is sold or otherwise transferred are frequently accompanied by ancillary covenants, either incorporated in the original agreements or made separately, which have for their purpose a complete or partial elimination of the vendor as a competitor of the purchaser.

The purpose of this note is to discuss the enforceability of such agreements wherein the restriction upon the vendor not to compete in a like business in competition with the purchaser has been found to include an unreasonably large geographical area and is drawn in indivisible form with the remainder of the covenant.

Agreements not to compete were generally regarded as unenforceable restraints of trade at early common law and void as against public policy.[1] However, the leading English case of *Mitchel v. Reynolds*[2] qualified the doctrine by distinguishing between general and partial restraints of trade, holding the latter enforceable if reasonably limited as to the time and area restricted. Following this case fixed rules[3] as to the conditions under which restraints were valid were followed by both English and American courts until the evolution of the modern rule: that in order to be valid a promise imposing a restraint in trade or occupation ancillary to the sale of a business or practice and its goodwill must be reasonable as to the territorial extent of the restraint and the period for which it is to be imposed.[4]

It should here be pointed out that although this note deals pri-

1. Colgate v. Bacheler, Cro. Eliz. 872, 78 Eng. Rep. 1097 (1596); The Blacksmith's Case, 3 Leon 217, 74 Eng. Rep. 643 (1587); Carpenter, *Validity of Contracts Not to Compete*, 76 U. PA. L. REV. 244 (1927); Comment, 31 IOWA L. REV. 249 (1946).

2. 1 P. Wms. 181, 24 Eng. Rep. 347 (1711); Carpenter, *Validity of Contracts Not to Compete*, *ibid.*; 5 WILLISTON, CONTRACTS §§ 1634, 1635 (Rev. ed. 1937).

3. 17 C. J. S., *Contracts* § 241-245a, pp. 624-627 (1939).

4. Oregon Steam Navigation Co. v. Winsor, 20 Wall. 64, 66-69 (U. S. 1873); Mattis v. Lally, 138 Conn. 51, 82 A. 2d 155 (1951); Delmar Studios of the Carolinas v. Kinsey, 233 S. C. 313, 104 S. E. 2d 338 (1958); Somerset v. Reyner, 233 S. C. 324, 104 S. E. 2d 344 (1958); Reeves v. Sargeant, 200 S. C. 494, 21 S. E. 2d 184 (1942); Metts v. Wenberg, 158 S. C. 411, 155 S. E. 734 (1930); Wood Mowing & Reaping Co. v. Greenwood Hardware Co., 75 S. C. 378, 55 S. E. 973, 9 L. R. A. (N. S.) 501, 9 Ann. Cas. 902 (1906); Carroll v. Giles, 30 S. C. 412, 9 S. E. 422, 4 L. R. A. 154 (1888); ANNOT., 46 A. L. R. 2d 119, 187 (1956); 17 C. J. S., *Contracts* § 246a, p. 627 (1939); RESTATEMENT, CONTRACTS §§ 515, 516 (1932); 5 WILLISTON, CONTRACTS § 1636 (Rev. ed. 1937).

marily with covenants accompanying the sale of a business and its goodwill, it is not necessary to the validity of a restrictive covenant that it be ancillary to a sale of a business only: it may be valid if ancillary to a sale[5] or lease[6] of property, to a contract of employment,[7] to a pledge of corporate stock,[8] to a license agreement and transfer of patents, machinery, and equipment,[9] or to any other lawful contract.[10]

It is essential that the covenant or contract by which the restraint is imposed be incidental to and in support of another lawful contract or sale by which the covenantee acquires some interest needing protection.[11] Contracts which have for their object merely the removal of a rival and competitor in a business are unlawful under all circumstances.[12]

The fact that the general rule is one of reasonableness, and hence, relative in character, indicates that the result of each case must rest upon the particular facts and circumstances of that case[13] and that identical limitations as to territory may be found to be reasonable under one set of circumstances, but unreasonable under different facts. The question of reasonableness is for the court, not the jury,[14] and in considering what is reasonable several basic concepts are generally adhered to: the territorial restraint, in order to be reasonable, (1) must be necessary in its full extent for the protection of some legitimate interest of the promisee, (2) must not impose undue hardship upon the person restrained, and (3) must not be injurious to the public as a whole.[15]

A restraint which is unreasonable is illegal notwithstanding it is but a partial restraint.[16] Contracts containing promises found to

5. Tuzik v. Lukes, 293 Ill. App. 297, 12 N. E. 2d 233 (1938).
6. Vanover v. Justice, 180 Ky. 632, 203 S. W. 321 (1918).
7. Delmar Studios of the Carolinas v. Kinsey, 233 S. C. 313, 104 S. E. 2d 338 (1958).
8. John Lucas & Co. v. Evans, 141 Kan. 57, 40 P. 2d 359 (1935).
9. Voices, Inc. v. Metal Tone Mfg. Co., 119 N. J. Eq. 324, 182 Atl. 880 (1936).
10. John Lucas & Co. v. Evans, note 8 *supra.*
11. Stoneman v. Wilson, 169 Va. 239, 192 S. E. 816, 818 (1937).
12. 17 C. J. S., *Contracts* § 250, p. 633 (1939).
13. Henderson v. Jacobs, 73 Ariz. 195, 239 P. 2d 1082 (1952); Faust v. Rohr, 166 N. C. 187, 81 S. E. 1096 (1914); Reeves v. Sargeant, 200 S. C. 494, 21 S. E. 2d 184 (1942).
14. Hood v. Legg, 160 Ga. 620, 128 S. E. 891 (1925); Aero. Bocker Corp. v. Axelrod, 136 Misc. 521, 241 N. Y. S. 158 (1930); Norfolk Motor Exchange v. Grubb, 152 Va. 471, 147 S. E. 214, 63 A. L. R. 310 (1929).
15. *See* ANNOT., 46 A. L. R. 2d 119, 149-151 (1956); 5 WILLISTON, CONTRACTS § 1636 (Rev. ed. 1937); Reeves v. Sargeant, 200 S. C. 494, 21 S. E. 2d 184 (1942).
16. John T. Stanley Co. v. Lagomarsino, 53 F. 2d 112 (S. D. N. Y. 1931), 13 C. J. p. 475, note 476.

be unlawful because of too extended restrictive effect have not been held so unlawful in their general purpose as to invalidate the whole transaction of which they were a part.[17] It follows that a contract for the sale of a business which contains a covenant by which the vendor agrees not to compete with the purchaser in a certain geographical area, the enforcement of which is found to be in unreasonable restraint of trade, may be perfectly reasonable as to a part of the territory included in the restriction. Will the courts enforce such an agreement in part while holding the remainder invalid, or is the whole agreement to be voided, the parties to be left as though they had intended that no restriction accompany the sale?

ENFORCEMENT OF GEOGRAPHICAL RESTRICTIONS TODAY

A. Prevailing View

The prevailing view of the courts in this country today is that in sustaining the validity of noncompetition agreements, partial enforcement may be had of geographically divisible restrictive covenants, which are broader than necessary for the covenantee's protection, if the part of the area in which enforcement would be reasonable is, by the wording of the instrument, readily ascertainable.[18] However, the majority of the courts have held that the whole contract was illegal and void where the restraint imposed was in excess of what was reasonable and the terms of the agreement indicated no line of division.[19] Thus, under this rule it has been held that an agreement by the vendor not to compete in the same county with the buyer of his grocery business was unduly restrictive, and since it was indivisible, partial enforcement could not be had even as to the towns in which the buyer operated his stores.[20]

The traditional statement of the test of severability is the "blue penciling" test by which the English courts severed a covenant if it were so worded that the unreasonable elements might be lined out

17. Hall Manufacturing Co. v. Western Steel & Iron Works, 227 Fed. 588, L. R. A. 1916C 620 (7th Cir. 1915).

18. Athletic Tea Co. v. Cole, 16 S. W. 2d 735 (Mo. App. 1929) (covenant restricting competition in "Imperial, Missouri, and surrounding territory" held enforceable only as to named city); General Bronze Corp. v. Schmeling, 208 Wis. 565, 243 N. W. 469 (1932) (covenant restricting competition in all states but one, in Canada, and in Mexico held enforceable only as to the forty-seven states); Restatement, Contracts, § 518 (1932); 5 Williston, Contracts § 1659 (Rev. ed. 1937).

19. Consumer's Oil Co. v. Nunnemaker, 142 Ind. 560, 41 N. E. 1048, 51 Am. St. Rep. 193 (1895).

20. Beit v. Beit, 135 Conn. 195, 63 A. 2d 161 (1948), but see 23 Conn. Bar Jour. 40, 43 for criticisms by Professors Williston and Corbin.

with a "blue pencil", and the remaining elements might be treated as a separable enforceable covenant.[21] Even though the covenants are not separately stated, some courts supposedly following the prevailing view have held a severance in the thought expressed in the covenant to justify striking out or ignoring so much of the promise in unreasonable restraint of trade, leaving the remainder of the covenant valid and enforceable.[22]

B. MODERN TREND VIEW

The minority view has been that the legality of contracts in restraint of trade should not turn upon the mere form in wording but rather upon the reasonableness of giving effect to the indivisible promise to the extent that would be lawful.[23] The trend of the more recent cases on the subject has been said to follow this minority view whereby courts seek to impose reasonable restrictions consistent with the intention of the parties, even though the expressed terms of the agreement imposed a much greater restraint.[24] Thus, under this view, where a defendant sold his ice business to the plaintiff agreeing not to compete with the plaintiff in the area then covered by that business or in four other cities for a certain period of time but did re-enter the business in two of the cities covered in the agreement during the restricted period, the court, although finding the covenant to be unreasonable and unnecessary for the protection of the purchaser as to time and territory, enforced the contract as to those two cities in which the defendant engaged in competition with the plaintiff.[25]

The modern view, which would allow partial enforcement even though covenants are not divisible in form, is based on the logical contention that "questions involving legality of contracts should not depend on form,"[26] but rather on "whether partial enforcement is possible without injury to the public and without injustice to the parties themselves."[27]

21. Attwood v. Lamont, [1920] 2 K. B. 146, 155; 5 WILLISTON, CONTRACTS § 1659 (Rev. ed. 1937).
22. Edgecomb v. Edmonston, 257 Mass. 12, 153 N. E. 99 (1926).
23. 5 WILLISTON, CONTRACTS § 1660 (Rev. ed. 1937); 6 CORBIN, CONTRACTS § 1390 (1951).
24. Hill v. Central West Publishing Co., 37 F. 2d 451 (5th Cir. 1930); Yost v. Patrick, 245 Ala. 275, 17 So. 2d 240 (1944); Edwards v. Mullin, 220 Cal. 379, 30 P. 2d 997 (1934); Ceresia v. Mitchell, 242 S. W. 2d 359 (Ky. App. 1951); Metropolitan Ice Co. v. Ducas, 291 Mass. 403, 196 N. E. 856 (1935); Hartman v. Everett, 158 Okla. 29, 12 P. 2d 543 (1932).
25. Metropolitan Ice Co. v. Ducas, *ibid.*
26. 5 WILLISTON, CONTRACTS § 1660, p. 4683 (Rev. ed. 1937).
27. 6 CORBIN, CONTRACTS § 1390, p. 499 (1951).

C. CRITICISMS OF SUCH VIEWS

One of the major objections raised by the majority of the courts to the adoption of the view of partially enforcing a contract containing unreasonable terms which are indivisible is that purchasers possessing superior bargaining power would insist upon including the most unreasonable restrictions in the contract, knowing that the court will in any event enforce the covenant in part, if not in full.[28] It is urged, however, that this can be avoided at least in part by the adoption of a rule which completely invalidates covenants deliberately unreasonable and oppressive whether severable or not.[29] Another strong objection given by the courts to the adoption of such a view is that a court cannot, where a promise is not clearly divisible, take out so much as is objectionable since that would be making a new contract to which the parties did not agree.[30] Those supporting the modern trend take the view that the requirement of severance imposes no intolerable burden on the courts and that as a matter of contract law such a rule better effectuates the intentions of the parties.[31] A further objection made to the so-called modern trend is that where the contract is indivisible and partially unlawful, it is void since it is impossible for the court to determine which part of the restraint induced the consideration.[32]

The view represented by the modern trend is stated as the proper rule by Professor Corbin[33] and is now sanctioned by Professor Williston,[34] although the opposite rule was adopted by the Restatement of Contracts.[35] Professor Williston criticized the prevailing view by reasoning that if the lawful parts of a divisible contract can be enforced, there is no reason why a contract indivisible in its terms cannot be enforced to the extent that is legal.[36] Professor Corbin agrees, and further contends that partial enforcement of an indivisible agreement would involve much less variation from the effect intended by the parties than would total non-enforcement.[37]

28. 5 WILLISTON, CONTRACTS § 1660 (Rev. ed. 1937); Notes, 22 CORN. L. Q. 246, 248 (1948); 26 N. C. L. REV. 402 (1948).
29. 5 WILLISTON, CONTRACTS § 1660 (Rev. ed. 1937).
30. Interstate Finance Corp. v. Wood, 69 F. Supp. 278 (E. D. Ill. 1946); Automobile Club of N. J. v. Zubrin, 127 N. J. Eq. 202, 12 A. 2d 369 (1940); Somerset v. Reyner, 233 S. C. 324, 104 S. E. 2d 344 (1958).
31. Note, 7 N. C. L. REV. 249, 258 (1929).
32. Johnson v. McMillion, 178 Ky. 707, 199 S. W. 1070 (1918).
33. 6 CORBIN, CONTRACTS § 1390, p. 500 (1951).
34. See 23 CONN. BAR JOUR. 40 (1948).
35. RESTATEMENT, CONTRACTS, § 518 (1932).
36. 5 WILLISTON, CONTRACTS § 1660 (Rev. ed. 1937).
37. 6 CORBIN, CONTRACTS § 1390 (1951).

SOUTH CAROLINA VIEW

The South Carolina Supreme Court has held that "a restrictive covenant not to compete, ancillary to the sale of a business and its good will, will be upheld and enforced if (1) supported by valuable consideration, (2) if reasonably limited as to time, and (3) if reasonably restricted as to the place of territory, that is, where the time is not more extended or the territory more enlarged than for a reasonable protection of the rights of the purchasing party."[38]

Although our courts have made it clear that they will not enforce a claim based upon an illegal contract,[39] the plaintiff has been allowed to recover in a case where the contract sought to be enforced is separable from the illegal or unreasonable agreement.[40]

The Supreme Court of South Carolina, in the recent case of *Somerset v. Reyner*,[41] came face to face with the question of whether or not a covenant found to be unreasonable in its geographical restrictions, but indivisible in its terms, should be partially enforced within such an area as necessary for the protection of the business sold. In this case, the seller of a jewelry business located in the city of Columbia agreed not to engage in a similar business within the state of South Carolina for a period of twenty years, but later did re-enter the business within Columbia long before the expiration of that period. In a suit by the seller for a declaratory judgment declaring the covenant signed by him to be void, the Court found that the covenant was unreasonably broad in including a greater area than necessary for the protection of the business sold, and that it was clearly indivisible as it covered the entire state of South Carolina and furnished no basis for dividing the territory. The Court therefore reasoned that the whole agreement must be void and unenforceable and that the Court could not render partial enforcement as to a reasonable area necessary for the protection of the covenantee, since it would be exceeding its power in that it would be making a new agreement for the parties into which they did not voluntarily enter. In so holding, the Court expressly followed the prevailing view in this country today.

38. Metts v. Wenberg, 158 S. C. 411, 155 S. E. 734 (1930) (contract whereby the seller of a barber shop agreed not to compete within the city of Orangeburg during the next five years upheld as reasonable, though in partial restraint of trade); Reeves v. Sargeant, 200 S. C. 494, 21 S. E. 2d 184 (1942) (covenant held enforceable under which seller of photographic business, its tradename, and goodwill agreed never again to engage in the same business within that county).

39. McConnell v. Kitchens, 20 S. C. 430; Gist v. Telegraph Co., 45 S. C. 363, 23 S. E. 143 (1895).

40. Packard v. Byrd, 73 S. C. 1, 51 S. E. 678, 6 L. R. A. 547 (1905).

41. 233 S. C. 324, 104 S. E. 2d 344 (1958).

A similar result was reached by the South Carolina Court during the same term in the case of *Delmar Studios of the Carolinas v. Kinsey*,[42] decided on North Carolina contract law since the contract was entered into there, where the covenant not to compete was ancillary to a contract of employment. The Court held the entire covenant to be void and unenforceable since the terms were found to be unreasonably broad.

Such holdings establish a rule in which enforceability depends on form alone. Given two restrictive contracts containing identical provisions, one may be enforceable and the other void, depending entirely on the wording of the contract as a whole. The view under which unreasonable, indivisible contracts are partially enforced to the extent necessary for the protection of the parties results in much less a variation from the effects intended by the parties than would total nonenforcement. The very fact that the contract, to which they mutually assented, calls for an unreasonable restraint clearly shows that the parties intended for some restraint upon the participants and usually implies their assent to the lesser degree being imposed by a court.

South Carolina courts have found no insurmountable difficulty in giving partial enforcement to contracts too broad in their terms in other areas. Thus, where an agent acted in excess of his authority in making a contract broader in its terms than he was authorized to make, the court held the principal bound under the contract to the extent of the agent's authority.[43] It found that only that part in excess of his authority was void and not the whole contract. Likewise, the South Carolina Supreme Court has held that if a vendor is unable to perform the entire agreement, and can convey only part of or a lesser interest in the property, he may be compelled, at the election of the vendee, to convey that interest.[44] It is impossible for this writer to see such a distinction between the above mentioned instances and those where the indivisible contract contains too broad a geographical limitation that the courts can partially enforce the contract in one instance and not in the other.

CONCLUSION

Where the parties involved in the sale of a business enter into a covenant whereby the seller agrees not to compete in a like business with the purchaser within a certain geographical area and for a certain period of time, it is to be assumed that such an agreement

42. 233 S. C. 313, 104 S. E. 2d 338 (1958).
43. Walker v. Peake, 153 S. C. 257, 150 S. E. 757 (1929).
44. Moore v. Maes, 214 S. C. 275, 52 S. E. 2d 204 (1949).

was entered into for the protection of the goodwill of the business purchased. Where the area contained in the agreement is found to be wider than necessary to afford a reasonable protection to the interests of the purchasing party and therefore injurious to the interests of the public as a whole, and the covenant furnishes no basis for dividing this territory, in many cases the refusal of a court to enforce the agreement even to the extent necessary for the purchaser's protection of his business interest has resulted in injustice to him and reward to the defaulting covenantor, a consequence certainly against public policy, upon which ground these very covenants are ruled void.[45] A prime example of this injustice is found in the recent case of *Somerset v. Reyner*,[46] where the whole covenant was declared void because its terms were found to contain unreasonably broad restrictions, thus permitting the seller to resume his former business within a close proximity to the business sold in the same city and to thereby deprive the vendee of the goodwill that he had purchased. The precise question presented in this case was a novel one in South Carolina, and the court presumably could have adopted and applied either of the existing views. If it had adopted the minority view, the Court would in effect be saying that the interpretation and effect of a covenant embracing an unreasonably large area would be that the covenant could not operate beyond reasonable limits. This would not be making a contract for the parties: it would be reading into the contract the unexpressed principle of law so adopted. When an attorney draws up a contract containing restrictive provisions as to the territory covered, he does so with the belief that such terms are reasonable. Since the determination of what is a reasonable restriction varies with the particular factual situation of each case, it may be asked how are attorneys to know what is reasonable and unreasonable when drawing these contracts? With the South Carolina Court having adopted a view which declares the entire covenant void when its terms are indivisible and are found to be unreasonably broad, it becomes a gamble when, in drawing up the contract, any territorial restrictions whatsoever are placed upon the seller. The adoption of the view of partially enforcing an unreasonably broad covenant, indivisible in its terms, to the extent necessary to the protection of the goodwill purchased would have provided a more just solution to the *Somerset v. Reyner* case,[47] as well as to cases that may arise in the future.

45. Beit v. Beit, 135 Conn. 195, 63 A. 2d 161 (1948); Consumer's Oil Co. v. Nunnemaker, 142 Ind. 560, 41 N. E. 1048, 51 Am. St. Rep. 193 (1895).
46. 233 S. C. 324, 104 S. E. 2d 344 (1958).
47. *Ibid.*

The view that is the foundation of the modern trend has the merit of protecting the purchaser's interests without placing an undue burden on the vendor. This is not the making of a new contract by the court, but is an equitable limitation on the extent to which the court will enforce the contract as written. The trend towards this view is grounded in more just and reasonable interpretation and operation of partially illegal contracts in restraint of trade.

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