Covenants Not To Compete

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In jurisdictions that allow private settlements, whereby individual plaintiffs settle out of court, such settlements are not res judicata as to other stockholders. A voluntary discontinuance of a derivative action in this manner would not bar a subsequent suit by other stockholders; however, once a derivative suit is voluntarily discontinued, the same suit may not be revived by a motion in the cause. This rule against revival was applied in Manufacturer's Mut. Fire Ins. Co. v. Hopson, where the New York court refused to reopen a stockholders' suit which had been privately settled by purchase of the complainant's stock at seven times the market value with funds of the corporation on whose behalf the suit had been brought. Although the court stated that the termination under these circumstances would not bar a new suit by the corporation, in such a case it may be that the statute of limitations has run.

Settlements, as a compromise to litigation, are generally encouraged in order to reduce the administrative burdens and expense to the courts and litigants. The requirement of court approval brings a proposed settlement out in the open where its fairness may be compared with the results that might be secured should the case proceed to trial. Generally court approval of these settlements is given by way of a final decree or judgment; however, the effect of an approved settlement when not rendered in this official form, e.g., the mere notation of the court's approval upon the record, is uncertain. A recommended method of clearly resolving questions of law in this area is the enactment of legislation similar to federal rule 23 but broader in scope. Such legislation should prohibit discontinuance, settlement, or compromise without court approval, and provide for the finality of court approved settlements, as well as specify the form in which such approval is to be rendered.

ROBERT N. RANDALL

Covenants Not To Compete

Covenants not to compete are most commonly found in contracts for the sale of a business or in contracts of employment and have as their


See generally Stevens, Private Corporations § 173 (1949).


object protection of the convenantee. It is the purpose of this Note to examine the limitations on the validity of such covenants and to consider what constitutes a breach or interference with rights thereunder.

In addition to the requirements that such covenants be supported by consideration and be in writing, our court seems to look only at the reasonableness of the provisions in determining their validity. The court in almost every instance when it sets forth the factors it will consider in determining the reasonableness of a covenant includes the time period as a vital factor. Yet the fact is that in no decision has a covenant been found to be unreasonable because of too extensive a duration. Of the eight cases found where the covenant was not upheld, always for other reasons, the limitation on the duration of the covenants was a certain number of months, two years, three years, five years, or ten years, and in three cases no time period was specified. A similar range in the length of time the covenants were to last may be found in those cases where the covenants have been upheld. In cases where the restriction was either “as long as the convenantee lives” or “as long as the convenantee continues in business” the court indicated it would interpret the length of time of the covenant to be co-extensive with the cov-

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1 "There are several reasons for the growing popularity of such covenants: 1. The raiding of employee talent by some employers. 2. The increasing business need to develop technical innovations and keep them secret. 3. Increased spending for research and development." Nation’s Business, Oct. 1959, p. 14.
2 Kadis v. Britt, 224 N.C. 154, 29 S.E.2d 543 (1944); Teague v. Schaub, 133 N.C. 467, 45 S.E. 765 (1903); see generally 17 C.J.S. Contracts § 260 (1939); 5 Williston, Contracts § 1636 (1937).
4 Beam v. Rutledge, 217 N.C. 670, 9 S.E.2d 473 (1939); Cowan v. Fairbrother, 118 N.C. 406, 24 S.E. 813 (1895); 17 C.J.S. Contracts § 240 (1939); 5 Williston, Contracts § 1636 (1937).
8 Noe v. McDevitt, 228 N.C. 242, 45 S.E.2d 121 (1947).
11 Covenant Upheld (cases) Time Period (years)
6. No time period.
2. Lives of the parties.
1. 1
2. 2
3. 3
4. 5
5. 10
6. 15
7. 20
enantor's life span.\textsuperscript{12} In \textit{Shute v. Heath}\textsuperscript{13} no time limitation was set out in the contract and the court said, "An indefinite restriction as to duration will not make such contracts void."\textsuperscript{14} 

As to a second area of reasonableness, the territorial extent of the restriction, there is a precedent question. Our court has said, "[T]here must be a definite limitation as to space; and the reasonableness of such limitation will depend upon the nature of the business and goodwill sold."\textsuperscript{15} This raises the questions what standard will be applied to determine if the limitation is definite enough and, if sufficiently definite, when is the criterion of reasonableness met.

In \textit{Shute v. Heath} there was a contract for the sale of a manufacturing business which included a restrictive covenant containing a limitation as to "any territory now occupied by them [covenantees] or from which they [covenantees] secure their patronage." The court held that this was not a sufficient limitation on the area. The court reasoned that where the covenantor could not secure patronage in the future is not something that could be determined at the time the contract was entered into. It should be noted that the decision rested not on the unreasonableness of the limitation, but on its indefiniteness.

The standard of measurement that has been applied by the court to determine if the territorial limitation is sufficiently definite is whether the rules that apply to the description of real estate in deeds have been satisfied.\textsuperscript{16} However, the court seems to use two means other than the actual words of the contract to decide what actually is the extent of the limitation—namely, implied restrictions and restrictions established by parol testimony. In \textit{Hauser v. Harding}\textsuperscript{17} the restricting words in the contract were "the territory surrounding Yadkinville." Though the territory outside the town could not be identified, the town limits could be and the court held the contract was not uncertain to this extent and should be interpreted by implication to mean "within the town limits of Yadkinville."\textsuperscript{18} In \textit{Teague v. Schaub}\textsuperscript{19} the limitation, "If the field [of

\textsuperscript{12}This raises a problem as to what the court would decide if the covenantee either died before the covenantor or went out of business. It seems unlikely that the covenantor would be bound for life in either situation. It is submitted that the court would probably find that the covenantor would be bound for life, if either of these two events did not transpire during the covenantor's life span.

\textsuperscript{13}131 N.C. 281, 42 S.E. 704 (1902).

\textsuperscript{14}\textit{Id.} at 282, 42 S.E. at 704.

\textsuperscript{15}\textit{Id.} at 282, 42 S.E. at 704.

\textsuperscript{16}Shute v. Heath, 131 N.C. 281, 42 S.E. 704 (1902) ; Hauser v. Harding, 126 N.C. 295, 35 S.E. 586 (1900). \textit{But see} 17 C.J.S. \textit{Contracts} § 256 (1939), stating that by the majority view the criterion is that the contract must be sufficiently specific to allow a determination of its reasonableness.

\textsuperscript{17}\textit{Supra} note 16.

\textsuperscript{18}See also \textit{Wooten v. Harris}, 153 N.C. 43, 68 S.E. 898 (1910), where the court, expressly following \textit{Hauser}, said that the territorial limitation "in the town of Falkland or near enough thereto to interfere with the plaintiff's business," though
a 'medical practice' is not larger than now,' was too indefinite and the court refused to imply a restriction. The court reasoned that this limitation could relate to receipts from the practice, the number of patients, or the extent of the territory.20

The court in a recent case21 allowed parol testimony to determine the territorial limits of the restriction "in Lenoir or the territory now covered by him [covenantor]," finding it to cover ten counties. The court looked to what territory came within the confines of the restrictive covenant at the time the covenant was made, not at the time of the litigation. The covenant specified the territory "now covered" by the vendor's business and the court found this was not void for indefiniteness of description because the territory could be specifically located by parol evidence.

Once the territory is found definite enough, the proper conclusion would seem to be that the primary consideration of the court in determining whether there is a reasonable restraint on territory is whether the territory is greater than that required to protect the covenantee's business.22 In Noe v. McDevitt23 the covenant included North and South Carolina, but the covenantee's business only covered eastern North Carolina. The court held that the covenant covered too extensive a territory to be a reasonable protection of the covenantee's business and was thus void as against public policy. It has been suggested that a more appropriate remedy could have been reached in the Noe case if the court had enforced the contract only as far as the actual needs of the covenantee's business extended in eastern North Carolina instead of declaring the whole contract of no effect.24

The third area in which the test of reasonableness must be met concerns the hardship that may be imposed on the covenantor. Although the court does not seem to pay particular attention to this factor in contracts other than contracts of employment, it appears that employment contracts will be carefully scrutinized to ascertain whether there is any undue oppression resulting to the covenantor-employee.25 It should be

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19 133 N.C. 458, 45 S.E. 762 (1903).
20 The dissent reasoned that "field" should mean "Roxboro and the adjacent area" and that the Hauser case should control, so that this should be interpreted to mean the city limits of Roxboro. The dissent also favored the admission of parol testimony to determine the extent of the restraint.
23 228 N.C. 242, 45 S.E.2d 121 (1947).
24 See Note, 26 N.C.L. Rev. 402 (1948).
25 ['T]he English and American courts make a substantial distinction between the two in administrative practice. . . . The distinction rests on a substantial basis, since, in the former class of contracts we deal with the sale of commodities, and in
noted that when this issue is to be determined the burden of proof is on the covenantee-employer to establish its reasonableness.\textsuperscript{26}

There is a difference between the standard of reasonableness applied to a restrictive covenant in the case of a person in a professional or executive type job and that applied in the case of an employee.\textsuperscript{27} The reason for the difference is that an employee only has his labor to sell. If in urgent need of selling he will more probably accede to an unreasonable restriction at the time of his employment without proper thought for the future than will a person in a professional or executive type job who is in a better position to guard his own interests and is more capable of comprehending the after-effects. Consequently, the court seems to scrutinize less carefully the professional or executive contracts than common employment contracts in determining whether any undue hardship is placed on the covenantor.

The final factor in determining the reasonableness of a restrictive covenant is whether the dominant intent of the parties was, in effect, to oppress the public. In \textit{Shute v. Shute}\textsuperscript{28} the court held the covenant invalid because there was no intent to protect good will, but only an attempt to divide the territory in order to keep out all competitors, an object which was said to be against the interests of the public.\textsuperscript{29} It should be noted that as the court seems to have decided that the attempt to divide the area was present on the face of the contract, it speaks in terms of the intent present at the time the contract was made as opposed
to that at the time of litigation. The court has indicated that it is not necessary that the effect be a division of land which causes all competitors to keep out as long as this is the present intent.

In looking to the intent of a restrictive covenant, the court has two basic considerations, the needs of the public and the nature of the business. In *Shute v. Shute* the court found the object of the contract was to divide the territory between the covenantor and the covenantee in putting up ginning plants. The court said there should be a multiplication of plants according to the needs of the public, and that the public would be burdened if a competing ginning mill was too distant to make patronizing it economically feasible; consequently, the number of gins to be erected should not be restricted by an agreement between the parties in that line of business.\(^8\) In *Morehead Sea Food Co. v. Way & Co.*,\(^3\) where the covenantor sold his business to a corporation composed of all the major buyers of fish in a particular area, the court said there was nothing on the face of the contract showing an intent to prevent others from engaging in the same business. The court noted the fact that there were more competitors at the time of the suit than at the time the contract was made and that the public was getting the benefit from the ensuing competition.\(^3\) In *Cowan v. Fairbrother*\(^8\) the court upheld an agreement not to publish a competing newspaper in North Carolina. This seems to have been justified on the ground that "in its very nature this [agreement] could not seriously affect the public, because there is free opportunity to establish newspapers, which are largely the product of the individual ability of the editors."\(^8\)

In addition to the discussion of the primary question of what factors are considered by the court in determining the reasonableness of a restrictive covenant, it is appropriate to consider how or when the question arises. The question usually arises when the covenantee finds the covenantor, either alone or in association with a third party, competing with him in spite of the covenant.

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\(^3\) 169 N.C. 679, 86 S.E. 603 (1915).

\(^8\) The dissent reasoned the contract on its face was designed to monopolize the entire market. The basic question for the dissent was whether it is possible to injure the public, not whether the public is actually being injured. See also Wooten v. Harris, 153 N.C. 43, 68 S.E. 898 (1910), where the court said an agreement might be invalid "if it were shown that this was one of many similar contracts tending to engross or monopolize any given business, or the sale of any article, within the territory named." *Id.* at 46, 68 S.E. at 899.

\(^8\) 118 N.C. 406, 24 S.E. 813 (1896).

In *Reeves v. Sprague*, where the action was against a third party and the covenantor, the third party had bought the inventory of the covenantor, giving a purchase money mortgage to secure the payment of the purchase price. The court held it "would not restrain the covenantor from selling of leasing his premises to others to engage in the business which he has agreed to abstain from carrying on or from selling to them machinery or supplies needed in embarking in it." The holding of a mortgage by the covenantor was not deemed a sufficient interest to violate the covenant. The court seemed to look at whether the covenantor had divested himself of all interest in the subject matter of the covenant, and, if not, to how to direct his interest and control were in the competing activities of the third party. The court seemed to look at the third party to see whether his activities evidenced an alliance with the covenantor to avoid the effect of the covenant or whether the third party had intentionally induced the covenantor to breach the covenant.

In *Kramer v. Old*, where the action was against the covenantor, the court held "[A] different rule [from that in the Reeves case] must prevail when it appears that the prohibited party attempts, not to sell outright to others, but to furnish the machinery or capital, or a portion of either ... in a corporation organized with a view to competition with the person protected by his contract against such injury." In *Finch v. Michael*, the covenantor loaned money to the third party who competed directly with the covenantee, but the court held the covenantor did not have sufficient interest in the third party's business to violate his contract with the covenantee. The holding in the *Finch* case as to the furnishing of capital seems to disregard the language of the court in the *Kramer* case forbidding it. However, in *Finch* the court seems to be looking at the actual effect of the furnishing of capital to the third party and not at the motive of the covenantor. The court in *Finch* seemed to admit there was a breach of the covenant, but it did not feel there was a substantial breach present. The court admitted that the covenantor "might not be acting with due propriety nor with good faith" but it could not see how he had committed any legal wrong.

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35 114 N.C. 647, 19 S.E. 707 (1894).
36 Finch v. Michael, 167 N.C. 322, 324, 83 S.E. 459, 460 (1914).
37 119 N.C. 1, 25 S.E. 813 (1896).
38 Id. at 12, 25 S.E. at 815; cf. King v. Fountain, 126 N.C. 196, 35 S.E. 428 (1900), where the covenantor got his wife to set up a business in competition with the covenantee and the court said: "[I]t requires but little scrutiny to look through these facts and discover who controls the business and enjoys the profits."
39 167 N.C. 322, 83 S.E. 458 (1914).
40 Id. at 325, 83 S.E. at 460. But see Baker v. Cordon, 86 N.C. 119 (1882), where the court said the covenantor had to maintain his "personal separation" from the business the covenantee was engaged in and could not be "instrumental in inducing others to embark in it." See also Kramer v. Old, 119 N.C. 1, 25 S.E. 813 (1913).
In *Sineath v. Katzis* the vendor corporation sold all its assets to the covenantee. The covenantor was president of the vendor corporation and owned ninety-eight percent of its stock. The court said that the covenantor did not need to have a direct interest in the business sold to be subject to a validly binding restrictive covenant; he needs only to be prominent in the business sold. The court seemed to feel that this would satisfy the requirement that the covenant be incidental to or in support of another lawful contract, a requirement necessary because the covenantor must receive a valuable consideration in return for his agreeing to the restraint. The court uses language to the effect that if the parties intended that the covenant should be incidental to the main transaction, though there was no express agreement present, this would be satisfactory.

As stated in *Sineath*, the general rule is that a third party cannot be enjoined from engaging in the business covered by the covenant or be otherwise held liable except when he, knowing of the covenant, aids the covenantor in violating his covenant or receives some benefit from the violation. In *Sineath*, after the vendor corporation had sold to the vendees all its real and personal property, the third party organized a corporation which competed with the covenantees. The covenantor participated indirectly in its management and in the profits the new corporation made. As a consequence, the court found that the third party as well as the covenantor had participated in a breach of the contract.

In *Sineath* the court seems to take the position that the corporation is not to be enjoined from competing with the covenantee, though the corporation was organized and supported by the covenantor, unless the corporation is found to be the alter ego of the covenantor. The court mentioned the fact that the covenantees failed to show who the stockholders were or what interest any particular party had in the new corpo-

41 218 N.C. 740, 12 S.E.2d 611 (1940).

42 In order to hold an outsider liable for compensatory damages for causing a breach of contract, the following elements are required: (1) that there existed a valid contract between the third party and the plaintiff; (2) that the outsider had knowledge of the existence of such a contract; (3) that the outsider intentionally induced the third party not to perform his contract; (4) that the outsider acted without justification; and (5) that the outsider's action caused the plaintiff actual damage. The outsider has knowledge of the contract if he knows the facts which give rise to the plaintiff's contractual right against the third party. He is subject to liability even though mistaken as to the legal sufficiency of the contract and the significance thereof and believes there is no contract or that the contract means something other than what it is judicially held to mean. If the outsider acts without a sufficient lawful reason then he has acted without justification. *Childress v. Abeles*, 240 N.C. 667, 84 S.E.2d 176 (1954).


44 See generally LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 64-65 (1936).
ration. For this reason the court seemed to feel that the new corporation had not been brought within the exception to the general rule.

In summary, the court thus far in its decisions does not seem to give any substantial weight to the duration of the covenant. However, the covenantee would seem well advised to avoid a covenant that lasts forever, and to limit the covenant to the lives of the parties involved, since the court has used language in its decisions which would give it an adequate peg on which to hang any future finding of unreasonable duration.

In respect to the extent of the territory the covenant is to include, any restriction on the covenantor which is all-encompassing should be avoided. The covenantee, of course, will want to draw up a contract that will include the territory presently covered by the covenantee’s business and, at the same time, will include the territory the covenantee will reasonably need protected in the future. Perhaps one means to accomplish this is to separate the territory into various segments so that the court, if it feels the outer limits are unreasonable, can easily enforce the covenant as to a portion without destroying the entire contract.

The covenantee will have no guide as to whether the contract will be in violation of public policy. To say the court looks to the nature of the business and the needs of the public is nebulous and of little help outside fact situations like those ruled on in prior cases. Thus, the matter is largely one of prediction. As a further difficulty, the court does not always make clear in its decisions whether it looks at the reasonableness of the covenant at the time the contract was made or at the time the contract is being litigated. Finally, it should be noted that the court does not seem to consider any one factor of reasonableness alone in arriving at its decisions.

W. Thomas Ray

Landlord and Tenant—Liability of Landlord for Personal Injuries Caused by His Failure To Repair

In a recent case from the Third Circuit, plaintiff, a social guest in the home of a tenant, was injured as she left the premises. She sued the landlord, alleging that, in performing his covenant to make repairs, he negligently installed a light fixture and that as a consequence of this improper installation she was injured. The district court gave summary judgment for the defendant. The circuit court reversed, saying that under New Jersey law, when the landlord undertakes to make repairs, he is bound to perform the work in a reasonably careful manner, and for failure to do so he will be liable in tort to one injured because of his negligence.