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Non-Competes in the Employment Context Revisited

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In 2016 we wrote about a non-compete decision where special referee found that a seller of a business had breached a sales agreement by violating both a non-compete covenant and an exclusive sales provision contained in the agreement. The seller appealed, and the Court of Appeals reversed and remanded, holding the 150-mile territorial restriction in the non-compete covenant was unreasonable and unenforceable. The South Carolina Supreme Court reviewed that Court of Appeals decision and has now issued its decision. Read on to see what the Supreme Court did.

FACTUAL AND PROCEDURAL HISTORY

The factual and procedural history of this case is very instructive and bears repeating in this article. In the 1980's, Robert Knight (Knight") began operating a mortuary transport business, Knight Systems, Inc. ("KSI"). KSI eventually expanded to include the manufacturing and sale of body bags. In 2006, Knight decided to sell the mortuary transport portion of its business and approached a broker for assistance. In October 2006, Donald and Ellen Lintal (the CEO and CFO of Palmetto Mortuary Transport, Inc. ["Palmetto"]) met with a broker to discuss the purchase of Knight's mortuary transport business. From November 2006 to January 5, 2007, the parties and their agents-including brokers, accountants, and attorneys-negotiated the terms of an asset purchase agreement ("Agreement"). During negotiations, Mr. Knight expressed to Mr. Lintal his desire to get out of the mortuary transport business.

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On January 5, 2007, Knight and Palmetto executed the Agreement. Pursuant to the Agreement, Knight sold various tangible assets, goodwill, and customer accounts-including body removal service contracts with Richland County, Lexington County, and the University of South Carolina-to Palmetto in exchange for $590,000.The Agreement included a provision (Exclusivity Provision) requiring Palmetto to purchase body bags from Knight for ten years and requiring Knight to sell body bags to Palmetto for ten years. The Exclusivity Provision became a central issue in the dispute between the parties.

A ten-year, 150-mile non-compete covenant was also executed and was included as an exhibit to the Agreement. Although the non-compete covenant restricted Knight from providing mortuary transport services within a 150-mile radius of Lexington County, it placed no restrictions on Knight's ability to continue its body bag manufacturing business. The non-compete covenant also provided that a breach by Palmetto of the Agreement or such other documents ancillary to the sale, shall constitute a breach of the non-compete covenant and shall release Knight from any and all restrictions under the Agreement.

During the trial of the case, Mr. Lintal testified the 150-mile territorial restriction extending from Lexington County was included to ensure Knight would not compete with Palmetto in South Carolina for ten years. Mr. Lintal acknowledged that at the time Palmetto purchased the transport business, Knight provided services primarily in Richland and Lexington County. Mr. Lintal testified that at the time the Agreement was executed, "We didn't know where the business was actually going to -- what we were going to -- if we were going to try to expand it at different locations. We wanted to keep our options open if it was doable."

In 2011, Palmetto still held the mortuary transport services contract with Richland County pursuant to the Agreement. Since the original five-year term between Palmetto and Richland County was expiring, Richland County issued a Request for Proposal (RFP) seeking mortuary transport service for the succeeding five years. Palmetto timely submitted its response to the RFP.

As noted above, the Exclusivity Provision required Palmetto to purchase body bags exclusively from Knight for ten years. From 2007 through 2011, Palmetto purchased over $45,000 worth of body bags from Knight. Palmetto had also purchased body bags from manufacturers other than Knight in the amount of $884.97. These purchases consisted of thirty-one infant bags ($192.75), four extra-large body bags ($213.72), six heavy duty body bags ($208.50), and six water-retrieval bags ($270.00). Knight became aware of the purchase of infant bags in 2009 or 2010 and immediately considered the purchase to be a breach of the Agreement, but did not confront Palmetto about the supposed breach for almost two years. Mr. Knight testified he did not become aware of the other purchases until discovery was exchanged after litigation began.

Palmetto believed the Exclusivity Provision did not require Palmetto to purchase either infant or extra-large bags from Knight. Palmetto agreed it had breached the Exclusivity Provision in purchasing heavy duty and water-retrieval bags from other manufacturers but argued this breach was not material. It argued the remedy for this breach was not cancellation of the Agreement, but rather money damages in the amount of $478.50, the sum it paid other manufacturers for heavy duty and water-retrieval bags. Knight argued the Exclusivity Provision required Palmetto to purchase *all* of its body bags from Knight and claimed the breach was material and nullified all terms and conditions of the Agreement, including the non-compete covenant.

On June 16, 2011, one day prior to the deadline for responses to the RFP, Mr. Knight recorded a conversation he had with Mr. Lintal. During the conversation, Mr. Knight accused Palmetto of purchasing infant body bags from other manufacturers. Mr. Lintal replied he did not believe his purchase of these body bags from other manufacturers was "significant," and he noted he did not believe "it was anything to break [the Agreement]." As noted above, Mr. Knight was aware of Palmetto's supposedly illicit purchase of infant body bags for almost two years before he confronted Mr. Lintal.

Following his conversation with Mr. Knight, Mr. Lintal suspected Knight was going to bid against Palmetto on the Richland County contract. Mr. Lintal's suspicion was correct-Mr. Knight submitted his own RFP the very next day. Even though Knight had received $590,000 for the sale of the business and an extra $45,000 in body bag purchases from Palmetto, Mr. Knight testified, "I didn't want to get back in the business. I was forced to. . . . I felt like if I didn't take action at that time, I was going to be left out in the cold." After the RFP deadline passed, Mr. Knight contacted the Richland County Procurement Office and told a Richland County official that Knight should be awarded the contract because it was the sole provider of odor-proof body bags-a requisite of the RFP. Although Palmetto's response to the RFP contained the lowest price for services and received the highest total points from the Richland County Procurement Office, Richland County awarded the contract to Knight the next month.

Palmetto sued Knight for breach of the Agreement, alleging Knight violated: (1) the non-compete covenant prohibiting Knight from providing mortuary transport services for ten years within the 150-mile territorial restriction and (2) the Exclusivity Provision, based upon Knight's refusal to supply Palmetto with body bags. Knight answered and counterclaimed, alleging the non-compete covenant was unenforceable because it contained an unreasonable territorial restraint, contained an unreasonable time restriction, and was not supported by adequate consideration. Knight also alleged any breach of the non-compete covenant was excused because Palmetto first materially breached the Exclusivity Provision by purchasing body bags from other manufacturers.

The case was tried before a special referee. The special referee found the non-compete covenant was reasonably limited in time and territorial scope and was supported by valuable consideration. The special referee found Knight breached the Agreement by violating the non-compete covenant and by refusing to sell body bags to Palmetto. The special referee determined Palmetto's purchase of heavy duty and water-retrieval body bags from other manufacturers, although a breach, did not constitute a material breach of the Agreement such that Knight was excused from performance of its contractual obligations. The special referee ordered Knight to pay (1) attorneys' fees and (2) damages of $373,264.54 in lost profits resulting from the wrongful competition with Palmetto. The special referee issued a permanent injunction requiring Knight to comply with the terms of the non-compete covenant for a term of five years and seven months following the date of his order, but allowing Knight to complete its performance of the 2011 mortuary transport contract with Richland County. Finally, the special referee awarded Knight $478.50 in damages for Palmetto's breach of the Agreement.

Non-Competes in the Employment Context Revisited

Knight appealed the special referee's order to the Court of Appeals, arguing the special referee erred in finding (1) the territorial restriction in the non-compete covenant was reasonable and enforceable, (2) the territorial restriction was supported by independent and valuable consideration, (3) the non-compete covenant was not void as against public policy, and (4) the non-compete covenant was not voided by Palmetto's breach of the Exclusivity Provision. The Court of Appeals reversed the Special Referee and remanded (sent the case back to the Referee), holding the non-compete covenant's 150 mile territorial restriction was unreasonable and unenforceable. Because South Carolina does not follow the "blue pencil rule" ('i.e., rewriting an agreement for the parties) and because the non-compete covenant did not include a "step-down provision (language eliminating grammatically unreasonable provisions, but not adding or rewriting provisions)," the Court of Appeals found it would be impermissible to redraw the Agreement to include a smaller territorial restriction. The Supreme Court granted Palmetto's petition to review the Court of Appeals' decision.

THE COURT'S OPINION

Palmetto's argument was that the Court of Appeals erred in holding the territorial restriction in the non-compete covenant was unreasonable.

The Court first set forth the standards for non-competes - A covenant not to compete is enforceable if it is not detrimental to the public interest, is ancillary to the sale of a business or profession, is reasonably limited as to time and territory, and is supported by a valuable consideration. The Court further stated that the reason why such covenants are held to be unenforceable is that unless they meet certain criteria, they constitute a restraint upon trade which is against public policy. Against this standard the Court then looked at the facts and prior law in the non-compete area.

Relying on a 1942 decision, the Court wrote that in determining whether a contract in partial restraint of trade is reasonable, the court will look to the whole subject matter of the contract, the kind and character of business, its location, the purpose to be accomplished by the restriction, and all circumstances which show the intention of the parties and which must have entered into the making of the contract. In determining whether a contract is reasonable in respect to the restraint being challenged the prior case observed that it would seem that the fair and full protection of the business, good will and trade name which the vendee has purchased and paid for, may well be accepted as the test. *It follows naturally that each case must be governed in the main by its own facts*. The 1942 case had a lifetime restriction for the seller to not re-enter the business.

Disagreeing with the Court of Appeals analysis the Supreme Court wrote that an analysis of the reasonableness of a territorial restriction in a non-compete covenant must take into account relevant facts surrounding the making of the agreement.; specifically noting that whether a non-compete covenant is reasonable, the following should be considered: (1) the whole subject matter of the contract; (2) the kind and character of the business; (3) location; (4) the purpose to be accomplished by the restriction; and (5) all circumstances which show the intention of the parties and which must have entered into the making of the contract.

In applying these criteria the Court was careful to note that as for the subject matter of the contract, the non-compete covenant between Knight and Palmetto arose out of the sale of a business between two sophisticated parties. Non-compete covenants executed in conjunction with the sale of a business should be scrutinized at a more relaxed level than non-compete covenants executed in conjunction with employment contracts. The Court explained as follows: Non-compete covenants executed in the context of an employment contract are generally disfavored and are strictly construed against an employer. The probability of unequal bargaining power that may exist between an employer and employee is significantly reduced when the restriction arises in the context of a sale of a business between two sophisticated parties. Also, a non-compete covenant executed pursuant to the sale of a business allows the opportunity for a seller to capitalize on the disposition of the business's goodwill and bargain for a higher price.

In the context of examining each case on its own facts the Court noted the following facts - the Agreement involved the somewhat complex sale of Knight's mortuary transport business to Palmetto for $590,000. Both Palmetto and Knight are sophisticated parties and were represented by legal counsel throughout the negotiation and execution of the Agreement. Knight necessarily considered the restrictions in the non-compete covenant in making his decision to enter into the Agreement. The non-compete covenant was integral to Palmetto's decision to enter into the Agreement. Mr. Lintal testified about Mr. Knight's "strong reputation" in the business and stated, "[The non-compete covenant] was very important to us because without the non-compete, we wouldn't have bought the business." Further, the non-compete covenant specifically provided, "[Knight] has agreed to provide such covenants as set forth herein as *a material inducement to [Palmetto]* to enter into and close the Purchase Agreement." (emphasis added). It is clear the non-compete covenant was a centerpiece of the Agreement and that both Palmetto and Knight bargained for and intended to benefit from its terms.

While the non-compete covenant effected a partial restraint of trade by limiting Knight's ability to provide mortuary transport services, this restraint was offset by Knight's continuation of its body bag manufacturing business and the Exclusivity Provision requiring Palmetto to purchase body bags from Knight throughout the term of the non-compete covenant. Indeed, Palmetto purchased approximately $45,000 worth of body bags from Knight before the current controversy arose. The Agreement did not prohibit Knight from continuing to sell bags to other customers. It is clear that both Knight and Palmetto carefully considered and calibrated their options and best interests in striking their bargain.

The Court then considered the kind and character of the business and the location of the business. The territorial restriction in this case consisted of a 150 mile radius surrounding Lexington County. At the time Palmetto purchased Knight's business, the business predominantly serviced Richland and Lexington counties. However, focusing only upon the existing territory of Knight's business and Palmetto's lack of concrete plans for geographical expansion ignores the kind and character of the business. A mortuary transport business necessarily involves mobility of services, and expansion into other areas of South Carolina is certainly foreseeable. This is not a brick and mortar 1950's local retail business. Palmetto, a sophisticated buyer, saw the opportunity for expansion outside Knight's existing business area and thus negotiated the Agreement with Knight, a sophisticated seller, to protect its interests by implementing the 150-mile territorial restriction. At his deposition, Mr. Lintal testified that since the execution of the Agreement, Palmetto has added new customers and "on occasion" provides services for customers outside of the Columbia and Lexington area.

After considering the Agreement as a whole, and after giving the non-compete covenant the more relaxed scrutiny it requires, the Court found that the territorial restriction was not greater than what was essential for a reasonable protection of the rights purchased by Palmetto.

Further in looking at any potential invalidity on public policy grounds, the Court found that although there may be situations in which this Court may find a restriction of competition between potential competitors for public contracts to be void as against public policy, this case does not rise to such a level. Based on all of the facts in the case including Knight's desire to get out of the mortuary transport business the Court declined to create a blanket rule that a non-compete covenant that restricts competition between potential competitors for public contracts is invalid and void as against public policy.

Further, agreeing with the Special Referee, The Court held that while Palmetto breached the Exclusivity Provision by purchasing $478.50 worth of body bags from manufacturers other than Knight this breach was not material and did not nullify Knight's obligation to honor the non-compete covenant.

The Court reversed the Court of Appeals and reinstated the Special Referee's Order.

LESSONS FOR EMPLOYERS

A first take-away is that the rigorous application of what is going to be required for an employer/ employee non-compete remains. Non-competes in the employment context will still be disfavored and very specific restrictions with limited times and places signed with adequate consideration will still be the norm. Overbroad non-competes in the employment context will likely be struck down by the Courts. The second take-away is that in the business context, the standards will not be as rigorous. The Courts instead, on a case by case basis, will look at the following: (1) the whole subject matter of the contract; (2) the kind and character of the business; (3) location; (4) the purpose to be accomplished by the restriction; and (5) all circumstances which show the intention of the parties and which must have entered into the making of the contract. Be careful not to conflate the standards for the sale of a business in a single stand-alone employer/former employee non-compete issue.