

# BUYING AND SELLING PRIVATELY HELD BUSINESSES

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**RESTRICTIVE COVENANTS AND THE SALE OF A BUSINESS**

By C. Andrew Head, Esq.

**I. RESTRICTIVE COVENANTS**

There are essentially three types of restrictive covenants: (i) non-competition agreements prohibiting competition in a certain business within a territory; (ii) non-solicitation agreements prohibiting solicitation of certain customers or employees, and (iii) non-disclosure agreements prohibiting disclosure of confidential information or trade secrets.

**II. GEORGIA LAW DISTINCTIONS**

- **Disfavored as a restraint on trade**

Georgia courts consider restrictive covenants of employment to be in partial restraint of trade, and such covenants will only be upheld if the restraint imposed is not unreasonable, is founded upon a valuable consideration, and is reasonably necessary to protect the interest of the party in whose favor it is imposed, and does not unduly prejudice the interests of the public. *W.R. Grace & Co. v. Mouyal*, 262 Ga. 464, 465, 422 S.E.2d 529 (1992).

- **Severability clauses – all or nothing**

Regardless of any severability clause, if any portion of a non-competition or non-solicitation provision is unenforceable, the entire portion of all non-competition or non-solicitation provisions in that agreement must also fail. *E.g.*, *Ward v. Process Control Corp.*, 247 Ga. 583, 584, 277 S.E.2d 671, 673 (1981); *McNease v. National Motor Club of America, Inc.*, 238 Ga. 53, 55-56, 231 S.E.2d 58, 60-61 (1976); *see also American Gen. Life & Accident Ins. Co. v. Fisher*, 208 Ga. App. 282, 283-84, 430 S.E.2d 166, 167 (1993) (holding that if any portion of non-competition or non-solicitation agreement fails, remaining non-competition or non-solicitation provisions in agreement also fail).

- **Choice of law provisions**

Georgia law will not apply the law of the jurisdiction selected by the parties where application of the chosen law contravenes the public policy of the State of Georgia; thus, if the chosen law of another state in an employment agreement is not as restrictive as Georgia law on restrictive covenants, Georgia courts will not enforce the choice of law provision. *See Nasco*,

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*Inc. v. Gimbert*, 239 Ga. 765, 238 S.E.2d 368 (1977); *Enron Capital & Trade Resources v. Pokalsky*, 227 Ga. App. 727, 730, 490 S.E.2d 136, 139 (1997).

- **Forum selection clauses**

Georgia courts will enforce a forum selection clause in a restrictive covenant agreement, although the Georgia Court of Appeals indicated in dicta that may have refused to enforce the forum selection clause if appellant had established that the chosen forum would apply a foreign state's law that will allow enforcement of a restrictive covenant affecting Georgia that violates Georgia's public policy against restraints on trade. *Iero v. Mohawk Finishing Products, Inc.*, 243 Ga. App. 670, 2000 WL 424238 (April 20, 2000).

- **Payment of royalties vs. forfeiture of severance ("clawbacks")**

Where a restrictive covenant requires the competing employee to pay a contractually determined royalty to the employer if he engages in the competitive conduct defined in the restrictive covenant, it will receive the same level of scrutiny as any other covenant not to compete. *Smith Adcock & Co. v. Rosenbohm*, 238 Ga. App. 281, 518 S.E.2d 708 (1999). On the other hand, where the restrictive covenant imposes as a condition precedent to recovering benefits not otherwise owed to the employee (i.e. a deferred compensation plan) that the employee refrain from competing with the employer, resulting only in forfeiture of such compensation in the event of competition, the restrictive covenant is not violative of public policy as being in restraint of trade and thus not subject to the same scrutiny as restrictive covenants ancillary to employment. *Sheppard v. Columbus Packaging Co., Inc.*, 146 Ga. App. 202, 245 S.E.2d 887 (1978).

- **Tolling provisions**

A tolling provision which purports to toll the duration of a restrictive covenant during the former employee's breach is unenforceable per se because it indefinitely extends the durational limitation. *ALW Marketing Corp. v. McKinney*, 205 Ga. App. 184, 421 S.E.2d 565 (1992). A tolling provision purporting to extend the durational limitation during the former employee's breach is not severable and renders the entire covenant unenforceable. *Gynecologic Oncology, P.C. v. Weiser*, 212 Ga. App. 858, 443 S.E.2d 526 (1994). On the other hand, a tolling provision that applies during the pendency of litigation to enforce the agreement, including appeals, is enforceable under Georgia law. *Paul Robinson, Inc. v. Haege*, 218 Ga. App. 578, 462 S.E.2d 396 (1995).

### III. LEVEL OF SCRUTINY

- **Sale of a Business**

Restrictive covenants ancillary to the sale of a business receive the least scrutiny and will be broadly construed by Georgia courts. *White v. Fletcher Mayo Assocs., Inc.*, 251 Ga. 203, 303 S.E.2d 746 (1983).

- **Professional partnership agreements**

Restrictive covenants ancillary to professional partnership agreements receive mid-level scrutiny. *Habif, Arogeti & Wymne, P.C. v. Baggett*, 231 Ga. App. 289, 498 S.E.2d 346 (1998).

- **Employment agreements**

Restrictive covenants ancillary to employment agreements receive strict scrutiny based on the perceived inequality of bargaining power between the employee and his or her employer. *White, supra*.

#### IV. EMERGING TRENDS

- **New York case: one year is "a lifetime" in dynamic internet industry**

New York courts are reluctant to enforce restrictive covenant agreements which apply a durational limitation of one year or more to the dynamic internet industry, because "[g]iven the speed with which the Internet advertising industry apparently changes, defendants' knowledge of [employer's] operation will likely lose value to such a degree that the purpose of a preliminary injunction will have evaporated before the year is up." *Doubleclick, Inc. v. Henderson*, 1997 WL 731413, \*8 (N.Y. Sup. 1997); *Earthweb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 313 (S.D.N.Y. 1999)(holding one year duration was unreasonable given the dynamic nature of the internet industry).

- **California statute prohibits non-competes**

Sec. 16600 of California's Business and Professions Code states: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."

- **Texas requires mutual obligations**

Texas courts are generally reluctant to enforce restrictive covenants that are not part of an agreement containing mutually binding promises obligating both employer and employee. *E.g., CRC-Evans Pipeline International, Inc. v. Myers*, 927 S.W.2d 259 (Tex. Ct. App.—Houston [1st Dist.] 1996, no writ). If the agreement merely promises at-will employment, there is no obligation owed to the employee that the employee could sue to enforce upon execution of this at-will employment agreement. *See Evan's World Travel Inc. v. Adams*, 978 S.W.2d 225, 232 (Tex. Ct. App.—Texarkana 1998)("An employment at will relationship is not an otherwise enforceable agreement.") Texas courts apparently view an employer's promise to provide the employee with confidential information and trade secrets as illusory because the employee cannot sue to enforce that promise. *See, e.g., CRC-Evans, supra*, 927 S.W.2d at 265 (holding a promise to provide at-will employees with specialized training at some time during their employment is illusory because the employer could fire the employee and escape the obligation

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to perform); *but see Curtis v. Ziff Energy Group, Ltd.*, No. 14-98-01257-CV, 1999 Tex. App. LEXIS 9125 (Tex. Ct. App.—Houston [14<sup>th</sup> Dist.], Dec. 9, 1999)(holding promise to provide at-will employee with confidential information and trade secrets and return promise not to disclose such information constitutes mutually enforceable agreement).

## V. SALE OF A BUSINESS VS. EMPLOYMENT

- **Seller's goodwill is element of sale**

An employer may protect its interests in “property, confidential information and relationships, good will and economic advantage.” *Durham v. Stand-by Labor of Ga.*, 230 Ga. 558, 198 S.E.2d 145 (1973). In the sale of a business context, legitimate interests properly subject to protection by a non-competition covenant include the value of the business purchased and the good will of the customer base. *Carroll v. Ralston & Assocs., P.C.*, 481 S.E.2d 900, 902 (Ga. App. 1997).

- **Equal bargaining power**

Although Georgia courts have yet to establish a uniform test for determining whether a restrictive covenant is ancillary to the sale of a business or merely ancillary to employment that arises out of the sale of a business, some Georgia courts have considered the following factors in determining whether the covenant is ancillary to the sale of a business: (i) whether the selling company was reliant on the employee's skills; (ii) whether the employee was represented by counsel in negotiating the deal; (iii) whether the restrictive covenants were executed contemporaneously with documents related to the sale of a business and whether the various documents reference each other; (iv) whether the employee was aware of the consequences of the sale of his ownership interest (including stock); (v) whether the employee initiated the negotiations for the sale of the business, or whether there was any pressure or duress on the employee; (vi) whether the employee profited from the sale of his ownership interest; and (vii) whether the employee received indemnity from any personal liability for the debts of the acquired company. *Drumheller v. Drumheller Bag & Supply, Inc.*, 204 Ga. App. 623, 420 S.E.2d 331 (1992); *Annis v. Tomberlin & Shelnett Assoc., Inc.*, 195 Ga. App. 27, 392 S.E.2d 717 (1990)(implying that covenant was ancillary to sale of business where employee retained ownership interest in merged company and covenant was stated in both the employment agreement and the purchase agreement).

If the restrictive covenants arise out of the sale of a business between parties having equal bargaining power, Georgia courts will apply low-level scrutiny to the covenants as ancillary to the sale of a business. In *Drumheller, supra*, a father with a 5% interest in the company and his two sons with 13.5% and 5% interests respectively sold their stock in exchange for substantial payment and relief from indebtedness. The stock purchase agreement including employment contracts containing restrictive covenants. The court held that the covenants were ancillary to the sale of a business because the company was a close knit operation, dependent on the three employees' service and manufacturing skills; the covenants were part of a stock sales agreement; the three employees were represented by counsel during the sales negotiations and were aware of

the consequences of their sale; and there was no evidence that the three employees were pressured by the purchaser to sell their shares—rather, the father played a major role in initiating negotiations for the sale of the company, and his two sons joined in their father's efforts. *Id.* at 626-27, 420 S.E.2d at 334, 335. Similarly, in *Annis, supra*, the court implied that the restrictive covenants were ancillary to the sale of a business where an employee with a 15.2% interest in the company initiated the sale negotiations and was "totally involved in the negotiations for the sale." *Annis, supra*, 195 Ga. App. at 28-31, 392 S.E.2d at 720-22 (1990).

If the restrictive covenants are part of an agreement with an employee/owner having no greater bargaining power than a mere employee, Georgia courts will apply strict scrutiny to the restrictive covenants as ancillary to employment arising out of the sale of a business, rather than ancillary to the sale of the business interests. See *White v. Fletcher Mayo Assocs., Inc.*, 251 Ga. 203, 303 S.E.2d 746 (1983)(holding covenant was merely ancillary to employment where the bargaining capacity of a former vice-president of the merged company was not significantly greater than that of a mere employee, because the vice-president received the same for his shares of the company as other shareholders and did not control the overall management of the company); *Arnall Ins. Agency, Inc. v. Arnall*, 196 Ga. App. 414, 396 S.E.2d 257 (1990)(holding covenants executed in employment contract contemporaneous with sale of general partner and manager of insurance agency's interest in company were not ancillary to sale of the business because (i) employee did not retain any ownership interest in merged company; (ii) employee was hired as agent and was not "heart and soul" of the business; and (iii) the employment agreement and the purchase agreement had separate covenants and each document stood on its own); *Carroll v. Ralston & Assocs., P.C.*, 481 S.E.2d 900, 902 (Ga. App. 1997)(upholding preliminary injunction enforcing covenant in sale of accountant's business where accountant was "the key man in the operation of the accounting and bookkeeping business he sold" to purchaser); *S. Hammond Story Agency, Inc. v. Baer*, 202 Ga. App. 281, 281-82, 414 S.E.2d 287 (1991) (holding minority shareholder had no greater bargaining power than a mere employee notwithstanding the argument that the minority shareholder increased his bargaining power by delegating it to the controlling shareholders); *Russell Daniel Irrigation Co., Ltd. v. Coram*, 237 Ga. App. 758, 516 S.E.2d 804 (1999)("Even though he became part owner of the business as a result of the transaction (owning ten percent), he had the bargaining power of only a mere employee at the time he negotiated the transaction.").

- "Blue-penciling"

Under Georgia law, covenants ancillary to an employment contract receive strict scrutiny and are not blue-penciled, and covenants ancillary to a sale of a business receive much lesser scrutiny and may be blue-penciled. *Habif, Arogeti & Wynnie, P.C. v. Baggett*, 231 Ga. App. 289, 289-90, 498 S.E.2d 346, 349 (1998).

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## VI. NON-COMPETE COVENANTS

- **Rationally related to business activities to be performed during employment**

The restricted business activities must be expressed with sufficient particularity and must be rationally related to that which the employee did for the employer during employment. *Howard Schultz & Assocs., Inc. v. Broniec*, 239 Ga. 181, 236 S.E.2d 265 (1977).

- **Scope of duties limited (e.g., managing, physical therapy, etc.), not "in any capacity" or "engaging"**

A restrictive covenant that attempts to prohibit an employee from working in a capacity which is substantially beyond the capacity in which he or she worked for her employer is likely to be unenforceable. *E.g., Harville v. Gunter*, 230 Ga. App. 198, 200, 495 S.E.2d 862, 864 (1998). Georgia courts will not enforce non-competition provision including the language "in any capacity" or "engaging" after the list of prohibited activities because the scope of prohibited duties is indefinite and exceeds the duties the employee provided to his former employer. *See, e.g., Fleury v. AFAB, Inc.*, 205 Ga. App. 642, 423 S.E.2d 49 (1992)(holding the phrase "in any capacity" following a list of proscribed activities is indefinite and unenforceable); *Orkin Exterminating Co. v. Walker*, 251 Ga. 536, 539, 307 S.E.2d 914, 917 (1983)(holding contract language which prohibits an employee from "engaging" in a competitive business is overbroad and unreasonable under Georgia law).

- **"Heart and soul" of the business if scope of duties unlimited**

Only if the employee is the "heart and soul" of the business and has been involved in every facet of the business may a restrictive covenant prevent the employee from working in a specified business, and then only in a very restricted territory and for a short period of time. *Russell Daniel Irrigation Co., Ltd. v. Coram*, 237 Ga. App. 758, 516 S.E.2d 804 (1999)(citing *Watson v. Waffle House*, 253 Ga. 671, 673, 324 S.E.2d 175 (1985)).

- **Reasonable duration (one to two years)**

Georgia courts have not established a maximum durational limitation, and restrictive covenants of one or two years have been upheld in certain cases and rejected in others depending on the facts of the case.

- **Territory limited to geographic area where employee will actually work for employer**

A non-competition provision which does not contain a territorial restriction is unenforceable per se under Georgia law. *See, e.g., Wiley v. Royal Cup, Inc.*, 258 Ga. 357, 370 S.E.2d 744 (1988)(holding specific territorial restriction required to give employee notice of restricted conduct). A non-competition provision that does not contain a geographical limitation tied to where the employee actually will perform business for the employer will not be enforced in Georgia. *See Specialized Alarm Services, Inc. v. Kauska*, 189 Ga. App. 863, 377 S.E.2d 703

(1989)(holding non-competition covenant that applies wherever employer does business was unenforceable).

- **Geographic restriction must be ascertainable at signing – restriction does not follow employee**

The prohibited territory must be ascertainable at the time of executing the contract. *See Koger Properties, Inc. v. Adams-Cates, Co.*, 247 Ga. 68, 69, 274 S.E.2d 329, 331 (1981)(holding covenant not to compete which cannot be determined until date of employee's termination is too indefinite to be enforced). A non-competition or non-solicitation of customers provision containing a territorial limitation which purports to follow the employee wherever he or she may be transferred in the future is unenforceable. *Orkin Exterminating Co. v. Pelfrey*, 237 Ga. 284, 227 S.E.2d 251 (1976).

- **Agreement must be in writing**

Covenants prohibiting competition must be in writing. *Pope v. Kem Manufacturing Corp.*, 249 Ga. 868, 295 S.E.2d 290 (1982).

## VII. NON-SOLICITATION COVENANTS

- **Geographical limitation unnecessary if limited to soliciting customers or clients whom employee actually contacted while employed**

Georgia courts will enforce an otherwise reasonable non-solicitation provision without a geographical limitation if it is limited to those customers with whom the employee had material contact during a reasonable time prior to his termination. *E.g., W.R. Grace & Co. v. Mouyal*, 262 Ga. 464, 422 S.E.2d 529 (1992).

- **Two years prior to termination**

The limitation on a reasonable time before customer relationships go "stagnant" appears to be the two years prior to the termination of employment. *W.R. Grace & Co., supra*; *see also Gill v. Poe & Brown of Ga., Inc.*, 241 Ga. App. 580, 524 S.E.2d 328 (1999)(holding non-solicitation agreement that applied to customers on a list created over four years before employee's termination, some of whom were not customers within the last two years of employee's employment, was unreasonable and unenforceable)

- **If territorial limit is reasonable, can prohibit soliciting any customer or client**

Alternatively, an employer can prohibit an employee from soliciting any customer or client of the employer, including those with whom employee did not have material contact, provided that the territorial limitation is reasonably narrow. *E.g., W.R. Grace & Co., supra*.

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- **Territory defines customer, not source**

An effective non-solicitation provision containing a territorial limitation should protect the territory containing the customers, rather than protecting the territory from which the employee can make his solicitations. "The key in covenant not to compete cases is that the forbidden services or activities cannot be performed in a certain territory; it is not relevant who the clients are or what activities, whether soliciting or otherwise, occur outside the territory." *Habif, Arogeti & Wynne, P.C. v. Baggett*, 231 Ga. App. 289, 295-97, 498 S.E.2d 346, 353-54 (1998). In dicta, the Georgia Court of Appeals stated:

A covenant not to compete by definition may preclude the employee from accepting related business (whether solicited or not) from any clients (whether previously contacted by him or not) if the employee is officed in, or is to perform the restricted activities in, the forbidden territory. A covenant not to solicit, on the other hand, may preclude the employee from soliciting the employer's clients (possibly just those clients located in a limited territory if the covenant does not restrict the forbidden clients to those whom the employee had encountered while at the employer), but it may not preclude the employee from accepting unsolicited business from those clients.

*Id.* A territorial limitation in a non-solicitation agreement that merely defines the originating point of the employee's solicitation merely encourages the employee to make his phone calls or send his correspondence from a point outside the region.

- **Scope of work protected from solicitation**

Unless the employee was involved in every facet of the business, the non-solicitation agreement should be limited to prohibiting solicitation of the same or similar business in which the employee was involved while working for the employer.

- **Cannot prohibit acceptance of unsolicited business or employment application**

A non-solicitation agreement may not prevent a former employee from accepting unsolicited business from his former customers unless it contains a reasonable territorial restriction prohibiting competition. *E.g., Habif, Arogeti & Wynne, P.C. v. Baggett*, 231 Ga. App. 289, 498 S.E.2d 346 (1998).

- **Non-solicitation of employees not limited to material contact**

Covenants against solicitation of employees do not require material contact or a territorial limitation. *E.g., Sunstates Refrigerated Services, Inc. v. Griffin*, 215 Ga. 61, 449 S.E.2d 858 (1994).

## VIII. NON-DISCLOSURE COVENANTS

- *Georgia Trade Secrets Act*

The Georgia Trade Secrets Act protects "trade secrets" indefinitely and regardless of contract, provided that the information meets the following definition of "trade secrets": (1) information not commonly known by or available to the public; (2) which has actual or potential economic value to its possessor because others who can obtain economic value by using or disclosing it (a) generally do not know it and b) cannot readily ascertain it by proper means; and (3) the possessor has made reasonable efforts to keep the information secret. O.C.G.A. §§ 10-1-761(4), 10-1-762(d), and 10-1-763(c).

- *Confidentiality Agreements*

Under Georgia law, a non-disclosure agreement that does not contain a time limitation is unenforceable as a matter of law. *E.g., Howard Schultz & Assocs. of the Southeast, Inc. v. Broniec*, 239 Ga. 181, 236 S.E.2d 265, 270 (1977). A valid non-disclosure restraint may cover "confidential information relating to the business, such as trade secrets, methods of operation, names of customers, personnel data, and so on – even though the information does not rise to the level of a trade secret." *Durham v. Stand-by Labor of Ga., Inc.*, 230 Ga. 558, 563-64 198 S.E.2d 145, 149-50 (1973). Unlike general non-competition provisions, non-disclosure agreements bear no relation to territorial limitations and their reasonableness turns on factors of time and the nature of the business interest sought to be protected. *Id.*

## IX. ENFORCEMENT

- *Prospect of employment or continuing employment is sufficient consideration*

The prospect of employment or continued employment is adequate consideration for restrictive covenants in Georgia. *Thomas v. Coastal Indus. Services*, 214 Ga. 832, 108 S.E.2d 328 (1959).

- *Did employee actually work in restricted territory?*

An employer must prove that the employee actually worked in substantially all of the restricted territory before a Georgia court will enforce the restrictive covenant at issue. *See Reardigan v. Shaw Industries, Inc.*, 238 Ga. App. 142, 518 S.E.2d 144 (1999) (upholding enforcement of 18-county restrictive covenant where employee was employed in most or all of the 18-county area described in the contract).

- *Was territory sufficiently defined? "Metro Atlanta" vs. "within 50-mile radius of Atlanta"*

Georgia courts have held that "Metro Atlanta, Georgia" is not a sufficiently definite area upon which to base a non-competition agreement. *Hamrick v. Kelley*, 260 Ga. 307, 392 S.E.2d

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518 (1990). Where a non-competition agreement defines the restricted territory as a certain radius from the "City of Atlanta," however, the territorial definition is sufficiently definite. *Keeley v. Cardiovascular Surgical Assoc., P.C.*, 236 Ga. 26, 29-30, 510 S.E.2d 880, 884-85 (1999).

- **Prior breach by employer? If so, severability clause?**

If the employment agreement does not contain a severability clause, and the employer breaches a provision in the agreement (i.e. by terminating the employee in breach of a contract of employment for a specified period), the employer's breach may preclude the employer from enforcing a covenant not to compete in that agreement. *E.g., Marcre Sales Corp. v. Jetter*, 223 Ga. App. 70, 476 S.E.2d 840 (1996).