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CONTRACTS

# Protecting the Business Purchaser

## Restrictive covenants accompanying the sale of a business

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Though more often discussed in the context of employment contracts, restrictive covenants are also extremely important in contracts for the sale of a business. A restrictive covenant provides an important protection to the purchaser by ensuring that he receives the full benefit of the goodwill of the business. In essence, it protects the business purchaser's expectations. A carefully tailored restrictive covenant will protect the purchaser from unwanted competition for years after the business sale takes place.

Generally, a restrictive covenant must serve a legitimate protectable interest and be reasonable in scope and duration, but must not impose an undue hardship on the restricted party or be injurious to the public. Notwithstanding greater deference accorded covenants in connection with the sale of a business, New Jersey subscribes to the "blue pencil" doctrine; covenants that are too overreaching are subject to being reformed on equitable grounds or held unenforceable. As such, it is important to know the factors used by New Jersey's courts to test restrictive covenants for validity.

The sale of a business as a going concern is a unique transaction. Ideally, the purchaser expects to keep the business running as if no change in ownership had taken place. He expects to buy not only the seller's stock in trade, buildings and equipment, but also the intangible asset of the business's intrinsic goodwill. In the abstract, the purchaser hopes to obtain the benefit of the seller's reputation. More concretely, the purchaser expects to "buy" the seller's existing customers. Colloquially, it is said that the purchaser seeks to "step into the seller's shoes."

To protect this investment, a purchaser should require a seller to agree to a restrictive covenant. This agreement may prohibit the seller from soliciting the business's existing customers, competing directly with the buyer, trading on information purchased by the buyer and/or recruiting employees from the business sold. Whatever the protected business interest, a restrictive covenant generally ensures that the seller will do nothing to usurp the goodwill transferred to the purchaser.

If reasonable in scope, duration and geographic area, courts will generally uphold restrictive covenants in a business-sale contract. However, there are no bright-line rules as to when or to what extent these restrictive covenants will be enforced. That determination hinges on a fact-sensitive inquiry as to the business interest being protected and the particular circumstances of each case.

For drafters, a standard of "reasonableness" offers little direction. As a general rule, a restrictive covenant should only be as broad in scope, duration and geographic area as affords fair protection to the interests of the party in whose favor it is written. In addition, it should not be so broad as to create a monopoly or otherwise interfere with the public interest. For further guidance, drafters must be aware of the factor test used by New Jersey's courts to scrutinize covenants for validity.

In *Davidson Bros. v. D. Katz & Sons, Inc.*, 121 N.J. 196 (1990), the New Jersey Supreme Court held that, for making a determination about a covenant's validity, future courts should consider whether the covenant (1) had an impact on the purchase price of the business sold; (2) is clear and express in its restrictions; (3) is in writing and recorded; (4) is reasonable in terms of geographic scope and duration; (5) imposes an unreasonable restraint on trade or secures a monopoly for the covenantor; (6) interferes with the public interest; and (7) the intention of the parties when the covenant was executed. Courts may also decide whether "changed circumstances" make the covenant unreasonable. Since *Davidson*, New Jersey's courts have consistently returned to this list. Of all the factors, courts care most whether the covenant is reasonable in terms of geographic scope and duration.

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Restrictive covenants in a business-sale contract will not be enforced if they extend beyond the existing territory of the business or the territory into which the buyer and seller contemplated the business might expand. New Jersey's courts have upheld restrictive covenants that extend 10 blocks, others that extend a specified number of miles, and even found that a nationwide restrictive covenant may be appropriate so long as there is evidence that the business is national in scope. *Voices, Inc. v. Metal Tone Mfg. Co.*, 119 N.J. Eq. 324, 330 (Ch. 1936).

It is crucial for a purchaser to conduct research on the business's geographic market area. A purchaser should identify not only current customers, but potential customers that share attributes with the current customers. Additionally, a purchaser should identify how far current customers typically commute to obtain the business's services. Both pieces of information are invaluable to drafting a restrictive covenant that is broad enough to protect the purchaser's potential market.

In terms of duration, the standard is less clear. New Jersey courts have found various durations to be reasonable — in some unique circumstances, even as long as 20 years. *Davidson*, *supra*. In practice, a restrictive covenant should last only as long as necessary to protect the goodwill obtained by the purchaser. The covenant should give the buyer time to establish himself as the owner and develop relationships with the existing customers. It should not last so long that it collides with the public interest of free market competition.

In some states, all restrictive covenants, even those accompanying the sale of a business, are void as against public policy. In others, courts have the ability to strike only the offensive language. In New Jersey, as noted above, courts have authority to equitably reform restrictive covenants. Courts may choose not to enforce unreasonable provisions or invalidate a covenant in its entirety. After considering the facts of a particular case, New Jersey's courts may choose to alter the express terms of a covenant.

Still, noncompete clauses ancillary to the sale of a business will be construed more liberally than those entered in the employment context. *Coskey's Television & Radio Sales & Service, Inc. v. Foti,* 253 N.J. Super. 626, 633 (App. Div. 1992). There are various reasons for this differing treatment. Primarily, a seller who agrees to a restrictive covenant generally receives a premium for the business. Courts are not as concerned with the well-being of the seller or his ability to make a living since he has already received extra consideration. Additionally, parties to the sale of a business are generally on the same footing in terms of negotiating power, or, at least, there is not the disparity observed between employer and employee. If the parties cannot agree on a restrictive covenant, the seller need not sell and the purchaser need not buy. Both seller and purchaser are capable of negotiating the final restriction. Moreover, the covenant typically is consideration for the goodwill associated with the sale. The purchaser will not receive the full benefit of the transaction if the seller is allowed to diminish the value of the business by competing with it at the first opportunity.

However, consider franchise agreements. These typically require that the franchisee not compete with the franchisor for the duration of the agreement. Throughout most of the country, courts view these restrictive covenants as more akin to those found in employment contracts and analyze them with heightened judicial scrutiny. This is due to concern that franchisees lack the same level of sophistication and business acumen as franchisors, and the franchisee may typically be on unequal footing with respect to bargaining power. Thus, most courts treat these transactions more like agreements between employees and employers than purchasers and sellers.

New Jersey state courts largely have been silent on restrictive covenants accompanying franchise agreements. In 1993, the U.S. District Court for the District of New Jersey found that the New Jersey Supreme Court would *likely* treat these agreements with the same level of deference afforded to restrictive covenants accompanying the sale of a business. *Jiffy Lube Int'l v. Weiss Bros.*, 834 F. Supp. 683 (D.N.J. 1993). This would place New Jersey firmly in the national minority. New Jersey courts have yet to address the issue squarely.

Whenever the sale of a business is being negotiated, one issue that must be considered is how much the seller is willing to accept, or the purchaser willing to pay, in exchange for a restrictive covenant. A properly crafted restrictive covenant will add a significant amount of value to a purchased business by preventing competition from a competitor who already knows the business model. Attorneys, business owners and prospective purchasers should all take note of New Jersey's treatment of these agreements in order to draft a properly tailored covenant and to defend or challenge a covenant should the situation arise.■