

JEFFREY N. BERMAN
BENJAMIN I. FINK (GA & NJ)
CHARLES H. VAN HORN
KENNETH N. WINKLER
ANDRÉA MULLER KAUFFMAN
AARON B. CHAUSMER
WILLIAM J. PIERCY
STEVEN A. WAGNER
THOMAS E. SOWERS

NEAL F. WEINRICH
MAGGIE FOX REARDEN
KRISTIN N. ZIELMANSKI
BRAD J. EVANS
SHAWN G. SHELTON *

OF COUNSEL:
HENRY M. FEINSTEIN
DIANA S. BARBER
LISA S. MORCHOWER (GA & FL)

* NOT YET LICENSED IN GEORGIA

Selling or Buying a Business with Restrictive Covenants: What You Can (Or Cannot) Expect After the Sale Is Completed

*Aaron B. Chausmer, Esq.*¹

This article is not intended to constitute legal advice and should not be relied upon in lieu of consultation with an appropriate legal advisor.

One of the seminal moments in a business owner's professional life is when his/her business is founded or acquired. Another such moment is when the business is sold. Agreements that limit the seller's conduct or actions after the sale are typically a critical part of the sale or acquisition. Many buyers and sellers, however, do not fully appreciate the importance that these covenants can have. The use of restrictive covenants as part of the sale of a business can have significantly varied and long-term impacts on both sides. A meaningful understanding of the use of restrictive covenants in the sales transaction can be a powerful tool.

A restrictive covenant is a contractual provision that prohibits, or at least limits, one party's *future* business endeavors in favor of another. There are four common restrictive covenants. A covenant against competition primarily limits the seller's ability to compete with the buyer. A covenant against solicitation restricts the seller's ability to capitalize on the existing relationships with its former customers or clients, as these relationships become essential components of the buyer's acquired business. A covenant against disclosure enables the buyer to restrict the seller's ability to use the information and knowledge that were acquired by the buyer. Finally, a covenant against recruitment (or piracy) can stop the seller from capitalizing on its past relationships by limiting the seller's ability to recruit the business's employees, agents and representatives. None of these covenants are intended to stifle competition; rather, these covenants help ensure that the business continues for the buyer just as it was for the seller, with

¹ Aaron B. Chausmer, Esq. is a principal with Berman Fink Van Horn P.C., where he focuses on restrictive covenant-related matters and general commercial litigation. Mr. Chausmer is a featured speaker for an annual continuing legal education seminar in Georgia on the topic of restrictive covenants ancillary to the sale of business. Mr. Chausmer can be contacted at achausmer@bflaw.com or 404-261-7711.

Selling or Buying a Business with Restrictive Covenants: What You Can (Or Cannot) Expect After the Sale Is Completed

By Aaron B. Chausmer, Esq., of Berman Fink Van Horn P.C., Atlanta, Georgia

Summer, 2008

Page 2

the buyer merely replacing the seller. In the absence of such contractual covenants, a seller would generally be free to immediately compete against the buyer, thereby diminishing the value of the business acquired by the buyer.

This article addresses three important issues regarding the use of restrictive covenants ancillary to the sale of a business. In any situation where such restrictive covenants are being utilized, there are certain considerations that both the buyer and the seller should be aware of:

- What rules govern the enforceability of the restrictive covenants?
- What will likely happen if the restrictive covenants are overbroad or unenforceable?
- What are some of the special considerations when the seller stays involved with the business after the sale?

What Rules Govern the Enforceability of the Restrictive Covenants?

To be enforceable, a restrictive covenant must be reasonable in scope (what action is being restricted), duration (for how long), and territory (where actions cannot take place). Courts will frequently measure the reasonableness of a covenant ancillary to the sale of a business based on whether the restricted activity protects the buyer's legitimate business interests, i.e., the value of the acquired business and its good will. This means that the restrictions must be drafted to protect a specified business interest based on the transaction at issue.

For instance, while a buyer of a gas station may have a legitimate business interest in stopping the seller from opening another gas station directly across the street, the buyer will likely not have a legitimate interest in stopping the seller from operating either a restaurant across the street or a gas station in a different city.

One of the key benefits with the use of restrictive covenants as part of the sale of a business is that courts will generally afford the buyer significant latitude in terms of what is considered to be acceptable and reasonable. For instance, a covenant against competition that lacks a stated duration may be enforceable if the duration is determined by how long the buyer continues to operate the acquired business. There are a variety of reasons why such restrictive covenants related to the sale of a business are scrutinized less strictly than restrictive covenants in other contexts.

- First, and often most importantly, it is generally understood that the seller who signs, or agrees to a, restrictive covenant when the business is sold receives additional consideration (usually an increased price paid) in exchange for the seller's partial abstention from that business in the future. Courts routinely may be less concerned about the seller's ability to earn income, given that the seller has already received financial consideration in exchange for agreeing to the covenant

Selling or Buying a Business with Restrictive Covenants: What You Can (Or Cannot) Expect After the Sale Is Completed

By Aaron B. Chausmer, Esq., of Berman Fink Van Horn P.C., Atlanta, Georgia

Summer, 2008

Page 3

against competition. Also, the buyer cannot then fully realize the value of what was purchased unless the seller agrees not to work to later diminish the value of the acquired business. Thus, one issue to be considered during the negotiation process is how much the seller is willing to accept, or the buyer is willing to pay, in exchange for the restrictive covenants. This amount may be itemized as a separate line item in the transaction or it may be included in the intangible “good will” being sold to the buyer.

- Additionally, while other restrictive covenants (such as those ancillary to employment) are contained in contracts between parties presumed to have disparate bargaining positions, a seller and a buyer are presumed to have equal bargaining power. The seller has the same ability to negotiate a limited restrictive covenant as the buyer has to demand a broader restrictive covenant. In practical terms, if the seller does not want to agree to the proposed restrictions, the seller is not required to sell the business; similarly, if the buyer is not satisfied with the seller’s proposed restrictions, the buyer is not required to buy the business. Both the seller and the buyer are in equal positions to negotiate, control or otherwise influence the final restriction.

Given these considerations, courts frequently allow restrictive covenants ancillary to the sale of a business to be drafted more broadly, so as to protect what is reasonably necessary, than those that might otherwise be agreed to in a different context, such as employment, lease, or franchise agreements.

What Will Likely Happen If the Restrictive Covenants Are Overbroad or Unenforceable?

Even with the flexibility provided to restrictive covenants ancillary to the sale of a business, courts may still find that a restrictive covenant exceeds the reasonable limitation necessary to protect the legitimate business interests of the buyer. The restrictive covenant may then be declared overbroad and unenforceable. The seller will, however, likely still be entitled to some protection through the use of the restrictive covenant.

Another fundamental benefit of the lesser lever of judicial scrutiny is that courts can “blue pencil,” or modify, a restrictive covenant to a more limited scope. The buyer can still be protected because it may still be able to receive some level of protection from a court. Had the restrictive covenant been related to an agreement for employment, a lease, or a franchise, the entire covenant would likely be stricken because covenants in those contexts cannot be “blue penciled.” Unlike these “all or nothing” situations, when the restrictive covenants are related to the sale of a business, the seller can still receive some value from the restrictive covenant, albeit in a reduced and more limited form.

If this step is necessary, however, the “blue penciled” restrictive covenant will be *more*

Selling or Buying a Business with Restrictive Covenants: What You Can (Or Cannot) Expect After the Sale Is Completed

By Aaron B. Chausmer, Esq., of Berman Fink Van Horn P.C., Atlanta, Georgia

Summer, 2008

Page 4

limited than if the parties had contractually agreed upon a reasonable territory themselves. Courts generally do this to deter the agreement's drafters from preparing an excessive restrictive covenant simply because a court may pare, or limit, the restrictive covenant down at a later date. To establish the more narrowly limited restrictive covenants, courts often require that the enforcing party (most likely the buyer) demonstrate what is essential (as opposed to reasonably necessary) for the protection of the buyer's acquired business interests. This heightened standard will likely result in a more limited restrictive covenant. It may, therefore, be in the buyer's best interests to agree to a reasonable restrictive covenant with the seller to avoid the risk of having a court blue pencil an otherwise overbroad restrictive covenant and ultimately receive less protection than was initially expected or negotiated. This uncertainty still affects both the buyer and the seller, as neither can have a solid understanding of the restrictions until after a court is involved.

What Are Some of the Special Considerations When the Seller Stays Involved with the Business after the Sale?

It is not uncommon for a seller to remain involved in the business after it is sold, either as an employee or consultant. The seller's continued involvement may be a requirement of the buyer, as it helps the buyer maintain continuity while he/she "learns" the particulars of the acquired business. Frequently, the terms and conditions of the seller's continued involvement are governed by a separate employment or consultant agreement.

This arrangement raises the significant issue of whether the seller's restrictive covenants are part of the sale of the business (and subject to the flexibility and blue penciling discussed above) or are related to employment, which are strictly construed by many courts and cannot be blue penciled. There are a number of factors that impact this analysis, such as whether the agreement governing the sale of the business has its own separate restrictive covenants, whether the parties to the agreements are the same (for instance, the buyer may actually buy the business from the seller's company, while retaining the seller individually), and whether the agreements for the sale of the business and the seller's subsequent involvement were executed contemporaneously. Unfortunately, there are no hard and fast rules that govern this analysis.

It goes without saying that every sale or transaction is different and has its own particular dynamics. Whether a transaction involves restrictive covenants and, if so, what the intended effects of the restrictive covenants are, should be evaluated for each transaction. A solid understanding of the fundamentals underlying the use of restrictive covenants as part of the sale of a business can help maximize the overall benefits of the transaction and manage expectations.