A Look at the Law

By John K. Larkins Jr.

Considering the Consideration Approach to Classifying Georgia Contracts In Partial Restraint of Trade

In *Rakestraw v. Lanier*,[1] decided in 1898, the Georgia Supreme Court complained about the law governing contracts made in restraint of trade:

> We cannot, within reasonable limits, undertake to reconcile conflicting opinions in treating of contracts in restraint of trade, nor cite the authorities which bear upon the different constituent elements which render such contracts valid, or the want of which make them void, for the reason that the first are irreconcilable, and the latter inharmonious.[2]

If only they could see us now. Over a century later, Georgia law governing covenants in partial restraint of trade (including non-competition, non-disclosure, non-solicitation, and non-piracy covenants—collectively referred to herein as "Covenants")[3] is an ever-changing labyrinth from which few agreements escape.[4] Even a sophisticated commercial agreement, negotiated at arm's length by parties represented by counsel, may be deemed by a court to be "analogous" to an employment contract and thereby subjected to the strictest of scrutiny.

But the stage has perhaps been set for a modest but important change. Two recent decisions of the Georgia Court of Appeals have discarded the traditional "type of contract" method of categorizing Covenants for review, relying instead on an analysis based on the relative bargaining power of the parties and the existence of consideration for the Covenant. This article suggests that the "consideration" prong of this new test should be jettisoned,

and that "bargaining power" should be the sole criterion for determining which level of scrutiny a court uses to analyze a Covenant.

THE TRADITIONAL CLASSIFICATIONS OF AGREEMENTS CONTAINING COVENANTS

Under current Georgia law, the threshold task for a court considering the enforceability of a Covenant is to examine the nature of the agreement containing the Covenant. Based on the type of contract, the court then determines whether the Covenant receives strict, mid-level or low-level judicial scrutiny.[5] Traditionally, Covenants ancillary to employment contracts receive strict scrutiny, those ancillary to professional partnership agreements receive mid-level scrutiny, and those ancillary to the sale of a business receive lower scrutiny.[6]

Significant distinctions exist among the levels of scrutiny that dramatically affect the survival of the Covenant at issue. Although Covenants of *all* types are theoretically evaluated under a "rule of reason,"[7] a Covenant subject to strict review is subject to numerous sub-rules defining reasonableness, and the violation of any one of these sub-rules will toll the death knell for the Covenant (and possibly others associated with it). Perhaps most importantly, a Covenant receiving strict review cannot be "blue-penciled" and will fail for even the most minor transgression, whereas a Covenant receiving low-level review can be judicially modified to make it enforceable, if necessary.[8]

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Although strict scrutiny is typically and nominally associated with employment contracts, as a practical matter it is the default category; if the contract is not a professional partnership agreement or a contract for the sale of a business, it will be deemed "analogous" to an employment contract and thus subject to strict scrutiny.[9] Indeed, *Richard P. Rita Personnel Services International, Inc. v. Kot*[10]—the case in which the Georgia Supreme Court adopted the "no blue-pencil" rule on the basis of the "in terrorem effect on employees ... and on competitors who fear legal complications if they employ a covenantor"—involved a *franchise* agreement, not an employment contract.

Consequently, even commercial transactions between sophisticated parties bargaining at arm's length have been deemed to be analogous to employment contracts and have fallen prey to the strict scrutiny rules. For example, in *Amstell, Inc. v. Bunge Corp.*,[11] a non-competition covenant contained within an agreement between two corporations regarding the distribution of a product was considered under strict scrutiny/no-blue-pencil principles, because the covenant was "ancillary to an independent contractor manufacturing and distributorship, which is treated as an employment rather than a sales contract."[12] In some cases, the court has even engaged in a two-step analogy to arrive at strict scrutiny, holding that an agreement was like a franchise agreement and therefore like an employment agreement.[13]

A GLIMMER OF REFORM

There are indications that the Georgia Court of Appeals is seeking a new paradigm. Decided in 2001, *Swartz Investments, LLC v. Vion Pharmaceuticals, Inc.*[14] involved an agreement by Swartz to raise financing for Vion. Vion agreed to a "non-circumvention provision" prohibiting it for a period of five years from contacting or negotiating with named investors regarding an investment in Vion or another company without Swartz's permission. The covenant called for the payment of a commission to Swartz if investments were obtained in violation of the covenant.[15]

Finding that the provision was a covenant in partial restraint of trade, the *Swartz* court proceeded to determine the proper category of scrutiny. After identifying the traditional categories, the court made an extraordinary statement:

> Of course, not every contract falls directly into one of these three categories. *Nor do we believe that the type of contract should automatically determine the applicable level of scrutiny.*[16]

Examining the purposes under-

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lying the varying levels of scrutiny, the court then found that the analysis is governed by the "relative bargaining power of the parties" and "whether there is independent consideration for the restrictive covenant itself."[17] The court ruled that the two corporations had equal bargaining power (the parties were sophisticated corporations and advised by counsel), but that there was "no consideration for the covenant at issue," and therefore applied strict scrutiny.[18] Thus, the absence of independent consideration for the covenant was sufficient to trigger strict scrutiny, despite the parties' equal bargaining power.[19]

In 2003, the Court of Appeals followed the *Swartz* approach in *West Coast Cambridge, Inc. v. Rice*,[20] in which the court considered a non-competition provision in a convoluted agreement involving a physician, a corporation and a partnership. Citing *Swartz*, the court noted, "Recently, we found that the level of scrutiny is not directly tied to the type of contract under consideration."[21] After applying the *Swartz* bargaining power/consideration analysis, the court announced that it was "unpersuaded" that the physician lacked bargaining power and concluded that he had received "significant monetary consideration" as a passive investor.[22] Based on these findings, the court held that the transaction at issue was comparable to the sale of a business and applied low-level scrutiny.[23]

Swartz and *West Coast Cambridge* are certainly not unique in their use of consideration and/or bargaining power as a rationale to justify the level of scrutiny applicable to a Covenant.[24] Covenants in contracts for the sale of a business have been distinguished from those in employment contracts, in part, on the grounds that the seller of a business receives consideration for the Covenant in the form of the good will portion of the purchase price, while the terminated employee supposedly receives no additional remuneration for post-termination restrictions.[25] Additionally, Covenants in professional partnership agreements have been scrutinized less closely than those in employment agreements on the basis that each of the partners in the partnership is reciprocally bound by the Covenant, thus demonstrating a common consideration flowing to all.[26]

In *White v. Fletcher/Mayo/Associates, Inc.*,[27] the Georgia Supreme Court focused on relative bargaining power as the primary factor in determining the appropriate level of scrutiny for analyzing covenants. The issue in *White* was how to treat non-competition covenants that were simultaneously ancillary to both an employment contract and the sale of a business. The court could not determine whether the consideration for the covenants flowed from the profit from the sale or from White's continued employment, so it turned its attention to the parties' relative bargaining power:

> [W]e hold today that where a judge is asked to determine the enforceability of a noncompetition covenant which the buyer of a business contends was given ancillary to the covenantor's relinquishment of his interest in the business to the buyer, and not solely in return for the covenantor's continued employment, the judge must determine the covenantor's status. If it appears that his bargaining capacity was not significantly greater than that of a mere employee, then the covenant should be treated like a covenant ancillary to an employment contract....[28]

Likewise, in *Watson v. Waffle House, Inc.*,[29] which involved a non-competition covenant contained in a lease, the Georgia Supreme Court identified bargaining power as the determining factor in analyzing the covenant. In ruling that the covenant should receive strict scrutiny, the court posited that the lease arrangement was most closely analogous to an employment agreement because of the imbalance of bargaining power between the parties.[30] The *Watson* court did not even consider whether there was independent consideration for the covenant.

The Supreme Court clearly indicated in *White* and *Watson* that bargaining power is the primary factor in the determination or rationale for the appropriate level of scrutiny.[31] But should it be the sole criterion?

BARGAINING POWER AS THE SOLE DISPOSITIVE CRITERION

In *Swartz* and *West Coast Cambridge*, the Court of Appeals took

a step in the right direction by eschewing the "type of contract" approach to analyzing Covenants. As evidenced by the Supreme Court's focus on bargaining power in *White* and *Watson*, however, perhaps the "consideration" prong of the analysis should be abandoned, leaving only an examination of the balance of bargaining power between the contracting parties as determinative of the level of scrutiny.

The idea, expressed in *Swartz* and adopted in *West Coast Cambridge*, that an analysis of the ultimate legality of a covenant in restraint of trade may depend on the existence of "independent consideration" for the promise has no mooring in the law.[32] Only slight consideration is required to support a valid contract, and a Covenant ancillary to a valid agreement is supported by the same consideration that necessarily must exist in the underlying agreement.[33] As a practical matter, unless separate, "independent" consideration is identified in the contract itself, it is impossible for a court to truly parcel out and accurately weigh the consideration of an agreement to find out what portion is associated with the Covenant, much less to determine whether that part is "substantial." As stated in *Rakestraw v. Lanier*, "The exact value of consideration the court ought not, and, in the nature of things cannot undertake to measure."[34] For example, who knows if the investment company in *Swartz* would have created a different financial arrangement, or not done the deal at all, without the client's promise not to circumvent their efforts? And it is no answer to say that consideration is *presumed* from the nature of the contract (for example, in a contract for the sale of a business), for then the analysis is circular (*i.e.*, consideration, not the type of contract, is dispositive, but consideration is determined by the type of contract).

Finally, using the absence of identifiable "independent consideration" as a criterion for determining the level of scrutiny is poor policy, for it frustrates reasonable commercial expectations of parties who engage in true arm's-length negotiations to arrive at a mutually agreeable contract.[35] This can be seen in *Swartz*, where two sophisticated corporations with equal bargaining power negotiated for a contract in an investment transaction with enormous financial consequences, only to have a significant part of it die under a strict scrutiny analysis merely because there was no discernable "independent consideration" for the Covenant.

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Adopting bargaining power as the sole criterion for determining the level of scrutiny would effect a small but important reform in Georgia law. Primarily, where the contract is in fact the product of true bargaining by parties on equal footing—and thus not an adhesion contract—the parties' contractual expectations would not be frustrated by the unforgiving technicalities of strict scrutiny. Under current Georgia law, if two sophisticated parties freely negotiate a business agreement containing a Covenant that is subject to strict scrutiny, the Covenant will fail utterly if a court finds it to be unreasonable even in one minor detail, probably resulting in a windfall for one party, perhaps a disaster for the other, and certainly a frustration of their contractual intent.[36] Adoption of the bargaining power approach would change a largely unpredictable commercial environment to one in which the parties to a negotiated agreement could be assured that if their contract were found to be unreasonable because it tripped one of Georgia's technical rules, or simply because a court considered it unreasonable in some respect, it could be judicially modified and the parties' general contractual intention enforced.

Under a pure bargaining power approach, even some employment contracts may be subject to low-level scrutiny. And why not? If a public company enters into an agreement with its new CEO that is the product of negotiation, where both sides are represented by counsel, that contract should not be subject to the same strict scrutiny applied to the typical adhesion employment contract.[37]

There also would be no use for the mysterious "mid-level" scrutiny. This concept was the product of the "type of contract" approach, where a professional partnership did not seem analogous to either an employment contract or a sale of business. Thus, its *raison d'être* would vanish under a method of analysis focusing only on bargaining power.[38] Any characteristics unique to professionals or partnerships would simply be accounted for by the court in its basic "reasonableness" analysis.

Determining the level of scrutiny solely based on bargaining power is also perfectly consistent with the policy underlying the "no-blue-pencil" doctrine. The doctrine was adopted to intimidate or punish employers who might be tempted to fashion onerous Covenants, knowing that the few Covenants that made it to court would simply be pared down and enforced.[39] But this rationale obviously does not apply where the parties have relatively equal bargaining power and thus negotiate the terms of the restriction in a commercial agreement. Moreover, even where blue-penciling is allowed, Georgia law establishes that the court strictly limits the covenant to what has been shown by clear and convincing evidence to be *necessary*, instead of what is merely reasonable, thus imposing a brake on a party's overreaching.[40]

Adopting bargaining power as the sole criterion for classifying covenants would result in more agreements being analyzed under low-level scrutiny, but it would not involve any disruption in the basic principles of current law. Indeed, as shown above, the "bargaining power" analysis was largely the approach adopted by the Supreme Court in *White*. As the Court of Appeals has already held in *Swartz*, the mere type of contract would no longer be determinative of the level of scrutiny. The courts could reasonably adopt a rebuttable presumption that employment contracts are not the product of bargaining, and the opposite presumption for contracts for the sale of a business and contracts between persons entering into business associations. Such rebuttable presumptions would recognize that employment contracts typically involve parties of unequal bargaining power, whereas contracts for the sale of business and agreements among persons forming a business association are usually made by parties having relatively equal bargaining power.[40] Agreements not plainly falling into these categories, however, would no longer be "analogized" based on a resemblance derived from an analysis of consideration or other factors.

Adoption of a bargaining power test would not mean that parties are free to craft a Covenant beyond judicial review—once the appropriate level of scrutiny is determined, the customary rules of "reasonableness," informed by public policy, would apply in assessing the enforceability of the Covenant. Under this model, the nature of the consideration reflected in the agreement would, at best, merely be evidence of the parties' bargaining power.

CONCLUSION

The recent decisions of the Court of Appeals in essence go halfway towards a small but potentially meaningful reform in Georgia's Covenant law. Determining the level of scrutiny under which Covenants are analyzed by examining only the parties' bargaining power would cure some complications and uncertainties in current law, as well as strike an appropriate balance between the freedom of parties to freely negotiate their contracts and the public policy against covenants unreasonably restraining trade.

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Endnotes

1. 104 Ga. 188, 30 S.E. 735 (1898).
2. *Id.* at 192, 30 S.E. at 737.
3. *See* J. Larkins, GEORGIA CONTRACTS: LAW & LITIGATION, Ch. 8 (Thomson West 2002) (hereinafter, *Georgia Contracts*).
4. "There is no area of Georgia law of more intricate subtlety than the law governing covenants not to compete.... Despite decades of appellate decisions, covenants not to compete continue to be struck down with great frequency, and the rules continue to develop." *Georgia Contracts, supra* note 2, at § 8-2.
5. White v. Fletcher/Mayo/Assoc., Inc., 251 Ga. 203, 303 S.E.2d 746 (1983); Advance Technology Consultants, Inc. v. Roadtrac, LLC, 250 Ga. App. 317, 551 S.E.2d 735 (2001).
6. For a general discussion of the categories, see, *e.g.*, Habif, Arogeti & Wynne, P.C. v. Baggett, 231 Ga. App. 289, 498 S.E.2d 346 (1998); *Georgia Contracts, supra* note 2, at § 8.3.
7. *See, e.g.*, Durham v. Stand-By Labor of Ga., Inc., 230 Ga. 558, 198 S.E.2d 145 (1973).
8. Whether a covenant under mid-level scrutiny can be blue-penciled is undecided. *Habif, Arogeti & Wynne, P.C.*, 231 Ga. App. at 291, 498 S.E.2d at 350; *but see* Physician Specialists in Anesthesia, P.C. v. MacNeill, 246 Ga. App. 398, 539 S.E.2d 216 (2000) (striking covenant subject to mid-level scrutiny without addressing blue pencil issue). There seems to be a tendency to conflate the level of scrutiny with the blue pencil rules. *See* Hicks v. Doors By Mike, Inc., 260 Ga. App. 407, 579 S.E.2d 833 (2003) (quoting blue pencil rule during scrutiny phase of review).
9. *See generally* Jenkins v. Jenkins Irrigation, Inc., 244 Ga. 95, 259 S.E.2d 47 (1979).
10. 229 Ga. 314, 317, 191 S.E.2d 79, 81 (1972).
11. 213 Ga. App. 115, 443 S.E.2d 706 (1994); *see also* Advance Technology Consultants, Inc. v. Roadtrac, LLC, 250 Ga. App. 317, 551 S.E.2d 735 (2001) (agreement between manufacturer and distributor); Northside Hospital, Inc. v. McCord, 245 Ga. App. 245, 537 S.E.2d 697 (2000) (covenant in sublease); PCS Jt. Venture Ltd. v. Davis, 219 Ga. App. 519, 465 S.E.2d 713 (1995) (exclusive distributor agreement between fertilizer manufacturer and customer).
12. *Amstell*, 213 Ga. App. at 116, 443 S.E.2d at 707.
13. Watson v. Waffle House, Inc., 253 Ga. 671, 324 S.E.2d 175 (1985); Owens v. RMA Sales, Inc., 183 Ga. App. 340, 358 S.E.2d 897 (1987).
14. 252 Ga. App. 365, 556 S.E.2d 460 (2001).
15. *Id.* at 366, 556 S.E.2d at 461.
16. *Id.* at 369, 556 S.E.2d at 463 (emphasis added).
17. *Id.* The *Swartz* court cited *W.R. Grace & Co. v. Mouyal*, 262 Ga. 484, 422 S.E.2d 529 (1992), for its reliance on the consideration factor. An examination of *W.R. Grace* reveals, however, that the Supreme Court merely quoted *Rakestraw v. Lanier*, 104 Ga. 188, 30 S.E. 735 (1898), for the proposition that a valid covenant must be supported by consideration, not that the covenant had to be supported by *independent* consideration.
18. The Court of Appeals' reference here and in other places to *no* consideration would seem to be a mistake, since the covenant would have been entirely unenforceable if it was not supported by any consideration. Evidently, what the court was referring to was the absence of *independent* consideration for the covenant.
19. *See also* Herndon v. Waller, 241 Ga. App. 494, 525 S.E.2d 159 (1999); Northside Hosp. Inc. v. McCord, 245 Ga. App. 245, 537 S.E.2d 697 (2000).
20. 262 Ga. App. 106, 584 S.E.2d 696 (2003).
21. *Id.* at 108, 584 S.E.2d at 698 (citing *Swartz*, 252 Ga. App. at 368-69, 556 S.E.2d at 463).
22. *West Coast Cambridge, Inc.*, 262 Ga. App. at 109-10, 584 S.E.2d at 699. Note that the term "comparable" is indicative of the "analogy" methodology.
23. *Id.* at 110, 584 S.E.2d at 699.
24. Rash v. Toccoa Clinic Med. Ass'n, 253 Ga. 322, 320 S.E.2d 170 (1984); White v. Fletcher/Mayo/Assoc., Inc., 251 Ga. 203, 303 S.E.2d 746 (1983). Note, however, that *White* went on to hold that bargaining power was dispositive.
25. *See, e.g.*, Rakestraw v. Lanier, 104 Ga. 188, 30 S.E. 735 (1898). The effect on the person restrained appears to be the primary "public policy" concern.
26. *Rash v. Toccoa Clinic Med. Ass'n*, 253 Ga. at 325, 320 S.E.2d at 173.
27. 251 Ga. 203, 303 S.E.2d 746 (1983).
28. *Id.* at 208, 303 S.E.2d at 751; *but cf.* Lyle v, Memar, 259 Ga. 209, 378 S.E.2d 465 (1989) (possibly citing different rule, but not overruling or citing *White*).
29. 253 Ga. 671, 324 S.E.2d 175 (1985).
30. *Id.* at 672, 324 S.E.2d at 177 ("The rationale behind the distinction in analyzing covenants not to compete is that a contract of employment inherently involves parties of unequal bargaining power to the extent that the result is often a contract of adhesion. On the other hand, a contract for the sale of a business interest is far more likely to have been entered into by parties on equal footing.").
31. *See also* Johnstone v. Tom's Amusement Co., 228 Ga. App. 296, 491 S.E.2d 394 (1997) ("The focus in such cases is on the relative bargaining power of the parties."); Kem Mfg. Corp. v. Sant, 182 Ga. App. 135, 355 S.E.2d 437 (1987)

("In order to classify an agreement containing a non-competition covenant, we consider certain factors to be determinative. Of these factors, we give primary importance to the relative bargaining power of the parties.").

32. *See* S. Harbour, "Restrictions on Post-Employment Competition by an Executive Under Georgia Law," 54 Mercer L. Rev. 1133, 1176 (2003). This article severely criticizes *Swartz, Northside Hospital*, and *Herndon v. Waller*: "In these three cases, the court could not have meant that the noncompete covenant was not supported by consideration. Lack of consideration means the covenant is not enforceable at all, not that it is subject to a higher level of scrutiny." As indicated, *supra* note 18, the "no consideration" language in *Swartz* in fact seems to refer to the absence of separate consideration for the covenant.
33. *See, e.g.*, Mike Bajalia, Inc. v. Pike, 226 Ga. 131, 172 S.E.2d 676 (1970). Indeed, the contention that a valid covenant must be supported by independent consideration was expressly rejected in *Rider v. Orkin Exterminating Co.*, 224 Ga. 145, 160 S.E.2d 381 (1968).
34. Rakestraw v. Lanier, 104 Ga. 188, 196, 30 S.E. 735, 739 (1898).
35. Arguably, the concept of consideration underlying *Swartz* and similar cases is flawed, for it seems to contemplate the discarded "injury or benefit" formula. In 1981, Georgia adopted the "bargain" theory of consideration. O.C.G.A. §§ 13-3-42; 13-3-43; *see also Georgia Contracts, supra* note 2, at § 4-1.
36. This is true notwithstanding that the parties also agreed on a severability clause. *See, e.g.*, McNease v. Nat'l Motor Club of Am., Inc., 238 Ga. 53, 231 S.E.2d 58 (1976).
37. *See* Harbour, *supra* note 33 (suggesting that such agreements could be subject to mid-level scrutiny).
38. "Middle scrutiny," as a term, originated with the Court of Appeals in *Habif, Arogeti & Wynn* as an explanation for the Supreme Court's holding in *Rash*. It is now a settled, if somewhat vague, principle in Court of Appeals precedent, however.
39. Richard P. Rita Pers. Svcs. Int'l, Inc. v. Kot, 229 Ga. 314, 317, 191 S.E.2d 79, 81 (1972).
40. Jenkins v. Jenkins Irrigation, Inc., 244 Ga. 95, 259 S.E.2d 47 (1979).
41. Such a presumption may be important because so many Covenants are the subject of TRO proceedings. Another practical consideration is the fact that many contracts will be drafted to include statements regarding bargaining power. Of course, under the bargaining power/consideration test, contracts may contain recitations concerning independent consideration as well. In either case, the rule seems to be that such recitations are not necessarily dispositive. *See* Griffin v. Vandegriff, 205 Ga. 288, 53 S.E.2d 345 (1949) (recitals must be supported by evidence); ALW Mktg. Corp. v. Hill, 205 Ga. App. 194, 422 S.E.2d 9 (1991) (recital that covenant is reasonable not binding); but see Rash v. Toccoa Clinic Med. Ass'n, 253 Ga. 322, 320 S.E.2d 170 (1984) (noting that parties agreed covenant was reasonable and its breach would cause harm).