

RESTRICTIVE COVENANTS

When you buy an existing business, the last thing you want to see after handing over the purchase money is the vendor setting up his new business across the street from you. To guard against this the purchaser usually requires the vendor, as part of the deal, to agree not to do that.

Such a promise from a vendor not to directly compete against the purchaser of his former business is known as a restrictive covenant. Its purpose is to ensure that the purchaser gets the benefit of the goodwill that was purchased.

A restrictive covenant is a promise or an agreement by the vendor that restrains him from competing in specified areas of business in a specified geographical area for a specified period of time. Such a covenant can be enforced by way of a court injunction. Breaches may be remedied and the victim (purchaser) compensated by an award of money as damages for the harm suffered as a result of the vendor failing to keep his promise.

The problem with restrictive covenants is that they are not always easy to enforce. The general rule is that people should be free to earn their living in whatever manner they wish. Restrictive covenants are exceptions to this general rule but they will not be allowed if they are unreasonable. As is the case with so many legal rules, what is reasonable depends upon the particular facts of the case.

When it comes to restrictive covenants it is probably a good idea not to get too greedy because, if you do, the covenant may not be enforceable as being unreasonably in restraint of trade. There are, of course, ways in which a well drafted agreement can circumvent these problems.

For example, let's assume you are buying a dry cleaning business. Is it fair to require that the vendor not establish or purchase another dry-cleaning business within five miles of his old one? How about ten miles, twenty miles or fifty miles? Who would travel fifty miles just to get their shirts laundered? Is it fair or reasonable to prohibit the vendor from doing that for a year,

or five years or ten? What if you pay \$20,000.00 for the business, or \$50,000.00 or one million? Obviously, there is no right answer and every case is different.

Usually the courts determine whether the restrictive covenant in question goes beyond what is necessary to protect the business being sold. If it does then they next check to see if the agreement contains a “blue pencil” clause that allows the court to do the equivalent of a line-by-line veto, taking out the offending parts until what is left is reasonable.

The three main areas of concern are the scope of the area of trade being restrained, the area and the time limit. If someone is selling a car wash it is not reasonable to restrict them from selling used cars, for example, even if the cars happen to get washed regularly before being offered for sale. The general rule with respect to the area restrained is that it should not be more extensive than the trading area of the business. As far as time goes, if the scope and the area are held to be reasonable then the time is usually held to be reasonable, too.

However, these are general rules and must be viewed in the context of the actual facts under consideration. If you want a reasonable predetermination of what is likely to “fly” in your case if it ever goes to court, talk to a lawyer. Of course, the best your lawyer can do is to give you an educated guess as to what is likely to fly but an educated guess is usually better than an uneducated one or no clue at all.

Lawyers do this sort of thing regularly. Not only do they have a pretty good idea what is allowed, they also know what is required. Most are more than happy to assist you in the negotiations leading up to the sale of the business because that is where they can really do something for you that will allow them to earn their fees. Remember, it is always cheaper and more effective to use the lawyer to keep you out of trouble than to use the lawyer to get you out of trouble.

Once the deal is signed, it is usually too late. There is virtually no room left for the lawyer to wiggle. If he tries to get the other side to agree on new terms, they are probably going to have a few demands of their own to make, like more money. After the deal is signed, you

don't need a lawyer so much as you need his secretary to type it up.