COVENANTS NOT TO COMPETE IN THE TRANSFER OF A BUSINESS—SELECTED PROBLEMS

I. INTRODUCTION

The inclusion of a covenant not to compete in a contract for the transfer of a business[1] is a protective device to insure to the transferee the value of his acquired goodwill.[2] Although there is an implied covenant where goodwill is transferred which prohibits the transferor from derogating from the value of what he has sold,[3] such implied protection is often inadequate.[4] The incorporation of an anticompetitive covenant into a general contract of transfer will impose definite restraints upon a covenantor's conduct and will thereby afford the promisee full protection.

The purpose of this Note is to provide a basic understanding of the law of these covenants and to highlight specific practical problems of drafting and enforcement. As there has been much recent comment on covenants not to compete in connection with employment contracts,[5] discussion of these agreements is largely excluded.

II. HISTORICAL BACKGROUND

Although some of the oldest English decisions indicated that all promises to refrain from pursuing a trade or business were invalid,[6] at a very early date these courts were upholding those agreements where they were part of a transfer of property and were only partially restrictive.[7] These latter cases were the ones followed by the American courts when they first considered questions of restraint of trade in the nineteenth century.[8]

The much-cited English case of *Mitchell v. Reynolds*[9] was the first to ex-

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1. For purposes of this Note, the meaning of the phrase "transfer of a business" will include a lease, a dissolution of partnership and a sale of an individual interest in a business as well as a sale of a business in toto, unless otherwise indicated or implied.

2. *See* Carpenter, *Validity of Contracts Not to Compete*, 76 U. PA. L. REV. 244, 255 (1928) [hereinafter cited as Carpenter].

3. See Note, *The Sale of a Business—Restraints Upon the Vendor's Right to Compete*, 13 CASE W. RES. L. REV. 161 (1961) for a complete discussion of the majority rule on implied convenants.

4. *Id.* at 169.

5. *See, e.g.*, Koehn & Ptacek, *Employer Protection Against Loss of the Key Employee*, 57 IOWA L. REV. 75 (1971); Newman, *Restrictive Covenants in Employment Contracts*, 35 TEX. B.J. 225 (1972); Note, *An Employer's Competitive Restraints on Former Employees*, 17 DRAKE L. REV. 69 (1967); 21 DRAKE L. REV. 641 (1972).

6. *See* Carpenter, *supra* note 2, at 244.

7. *See* Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 629-46 (1960).

8. See *Swigert & Howard v. Tilden*, 121 Iowa 650, 97 N.W. 82 (1903) for an early Iowa discussion of the development of acceptable convenants not to compete.

9. 24 Eng. Rep. 347 (Q.B. 1711). *See* Baum, *Lessors' Covenants Restricting Competition*, 1965 U. ILL. L. FORUM 228, 233-34 and Note, *The Sale of a Business—Restraints Upon the Vendor's Right to Compete*, 13 CASE W. RES. L. REV. 161, 170-71 (1961) for discussions of this case.

plicate the rationale for judicial acceptance of partial restraints incidental to the transfer of a business. Although voluntary restraints upon employment may work mischief "1st to the party, by the loss of his livelihood, and the subsistence of his family; 2ndly, to the publick, by depriving it of an useful member"[10] no such fears are justified where the agreements are made by a vendor of property. Not only will the seller benefit from the sale, but the public will not be injured because the buyer continues in the business.[11]

In addition to the negative rationale that partial restraints should be sustained because they do no harm, there is the positive justification for anticompetitive covenants. When first considering these agreements, the American courts were quick to realize that an acceptance of partial restraints would foster economic growth by promoting the sale and purchase of productive property.[12] Thus, while the early judicial distinction between general and partial restraints is now invalid,[13] the underlying policy of protection of economically useful transactions by reasonably necessary restraints is preserved.[14]

III. Elements of Validity

The general rule is that a covenant not to compete is valid if it is ancillary to another agreement and if it is reasonable.

A. *Ancillary Requirement*

Ordinarily, a covenant not to compete cannot stand as an independent agreement, regardless of whether consideration has been given for such a promise.[15] Although the covenant must indeed be supported by consideration,[16] a noncompetitive promise is invalid unless it is ancillary to some other agreement.[17] In the case of a transfer of a business, the covenant not to compete must be incidental to the general contract which results in the transfer itself.[18]

This requirement is an outgrowth of the reasoning which supports the validity of covenants not to compete in general. The rationale provides that although

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10. Mitchel v. Reynolds, 24 Eng. Rep. 347, 350 (Q.B. 1711).
11. *Id.*
12. United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899); Wittenberg v. Mollyneaux, 60 Neb. 583, 83 N.W. 842 (1900).
13. 6A A. Corbin, *Contracts* § 1386, at 51 (1962) [hereinafter cited as Corbin].
14. *Id.* § 1379.
15. Little Rock Towel & Linen Supply Co. v. Independent Linen Serv. Co., 237 Ark. 877, 377 S.W.2d 34 (1964); Jacobson & Co. v. International Environment Corp., 427 Pa. 439, 235 A.2d 612 (1967); Corbin, *supra* note 13, § 1385, at 47; 14 S. Williston, *A Treatise on the Law of Contracts* § 1636, at 102 (3d ed. Jaeger 1972) [hereinafter cited as Williston].
16. Mouldings, Inc. v. Potter, 315 F. Supp. 704 (M.D. Ga. 1970); Desselle v. Petrossi, 207 So. 2d 190 (La. App. 1968); Allright Auto Parks, Inc. v. Berry, 219 Tenn. 280, 409 S.W.2d 361 (1966); Lefforge v. Rogers, 419 P.2d 625 (Wyo. 1966).
17. Rowe v. Toon, 185 Iowa 848, 169 N.W. 38 (1918); Jacobson & Co. v. International Environment Corp., 427 Pa. 439, 235 A.2d 612 (1967).
18. Nelson v. Leaders, 258 Iowa 919, 140 N.W.2d 921 (1966) (sale of stock); Uptown Food Store, Inc. v. Ginsberg, 255 Iowa 462, 123 N.W.2d 59 (1963) (lease); Haggin v. Derby, 209 Iowa 939, 229 N.W. 257 (1930) (dissolution of partnership).

an agreement restricting persons from pursuing a particular business is in restraint of trade, such agreements can be made in order to protect the value of the goodwill transferred.[19] The requisite ancillary contract thus insures the protective nature of the covenant and guards against agreements made solely to restrain trade.

B. *The Reasonableness Test*

The primary standard used to determine the validity of a covenant not to compete ancillary to the transfer of a business is reasonableness.[20] An anticompetitive covenant is said to be reasonable if "the restraint is such only as to afford a fair protection to the interests of the party in favor of whom it is given, and not so large as to interfere with the interests of the public."[21] In determining reasonableness, the courts view agreements involving the transfer of a business with greater liberality than they do employment contracts.[22] This distinction is based upon the presumption of more equitable bargaining positions between vendor and vendee.[23]

Although the factual indicia of a covenant's reasonableness include the nature of the business involved,[24] and the manner in which it is conducted,[25] it is the duration and the territorial limits of the restriction to which the courts primarily look.[26] A covenant not to compete should endure for a period no longer than is reasonably necessary to protect the interest acquired by the covenantee and it should extend no further than does the actual trade of the business.[27] As stated by the Iowa supreme court:

> Now whether a contract is reasonable in respect of the length of time during which the restriction is to run, and in respect of the scope of territory which is to be covered thereby, as applied to a case like the one before us, it would seem that the fair and full protection of the business and good will which the vendee has purchased and paid for may well be accepted as the test. Certainly the restriction ought not to be wider in the scope of its operation, and there can be no good reason for confining it to any narrower limits. It follows naturally that each case must be governed in the main by its own facts.[28]

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19. CORBIN, *supra* note 13, § 1385, at 47-48.
20. Kunz v. Bock, 163 N.W.2d 442 (Iowa 1968); Swigert & Howard v. Tilden, 121 Iowa 650, 97 N.W. 82 (1903); T.E. Moor & Co. v. Hardcastle, 421 S.W.2d 126 (Tex. Civ. App. 1967); CORBIN, *supra* note 13, §§ 1386-87; WILLISTON, *supra* note 15, § 1636.
21. Swigert & Howard v. Tilden, 121 Iowa 650, 660, 97 N.W. 82, 85 (1903).
22. McCook Window Co. v. Hardwood Door Corp., 52 Ill. App. 2d 278, 202 N.E.2d 36 (1964); Baker v. Starkey, 259 Iowa 480, 144 N.W.2d 889 (1966); Brecher v. Brown, 235 Iowa 627, 17 N.W.2d 377 (1945).
23. Brecher v. Brown, 235 Iowa 627, 631-32, 17 N.W.2d 377, 379 (1945).
24. Day Cos. v. Patat, 403 F.2d 792 (5th Cir. 1968).
25. *See* Solari Indus., Inc. v. Malady, 55 N.J. 571, 264 A.2d 53 (1970).
26. McCook Window Co. v. Hardwood Door Corp., 52 Ill. App. 2d 278, 202 N.E.2d 36 (1964); Kunz v. Bock, 163 N.W.2d 442 (Iowa 1968); Lavey v. Edwards, 505 P.2d 342 (Ore. 1973).
27. Kutash v. Gluckman, 193 Ga. 805, 20 S.E.2d 128 (1942); Montgomery v. Getty, 284 S.W.2d 313 (Mo. Ct. App. 1955).
28. Swigert & Howard v. Tilden, 121 Iowa 650, 660, 97 N.W. 82, 85 (1903).

In imposing their standards of reasonableness on covenants not to compete, the early Iowa courts were consistently liberal. These decisions upheld durational limits ranging from two years[29] to as long as the covenantee may be engaged in business[30] to the seller's lifetime.[31] With respect to territorial restrictions, the majority of these older cases involved covenants not to compete in the same town[32] or the same town and vicinity.[33] These limitations were routinely upheld, particularly in the situations involving the sale of a professional practice.[34]

It is only in the more recent cases concerning business transfer covenants that the Iowa supreme court has looked with what appears to be a more discerning eye toward time and space restraints. In *Kunz v. Bock*,[35] the plaintiff buyer of a Davenport building maintenance business sought enforcement of an anticompetitive covenant unlimited in time and area. Plaintiff alleged that the intended limitations were inadvertently omitted from the written contract and sought reformation of the contract to embody the true intent of the parties. This intent, the plaintiff asserted, was to restrain the seller from competition during the seller's lifetime in the states of Illinois and Iowa.[36] The court held that even those limitations were too broad, unreasonable and illegal.[37]

In *Nelson v. Leaders*,[38] the court upheld an agreement not to engage in the farm equipment business within a forty mile radius of Council Bluffs for ten years.[39] Notwithstanding this agreement, the supreme court also upheld the trial court's modification of the covenant permitting the covenantor to sell to customers living within the restricted area provided they came to his place of business located beyond the supposedly limited perimeter.[40] The decision thus left the plaintiff buyer in the unexpected position of having enforced a "reasonable" and yet, in practice, largely ineffective covenant not to compete.

IV. Performance and Breach

The essence of performance of a covenant not to compete is forbearance. The essence of breach is competition. However, beyond these obvious obligations under the contract lie more complicated questions. These include the is-

29. Sauser v. Kearney, 147 Iowa 335, 126 N.W. 322 (1910).
30. Haggin v. Derby, 209 Iowa 939, 229 N.W. 257 (1930).
31. Cole v. Edwards, 93 Iowa 477, 61 N.W. 940 (1895).
32. Proctor v. Hansel, 205 Iowa 542, 218 N.W. 255 (1928); Smalley v. Greene, 52 Iowa 241, 3 N.W. 78 (1879).
33. Cole v. Edwards, 93 Iowa 477, 61 N.W. 940 (1895); Hedge, Elliot & Co. v. Lowe, 47 Iowa 137 (1877).
34. Proctor v. Hansel, 205 Iowa 542, 218 N.W. 255 (1928); Miller v. Eller, 192 Iowa 147, 183 N.W. 498 (1921).
35. 163 N.W.2d 442 (Iowa 1968).
36. *Id.* at 444.
37. *Id.* at 446-47.
38. 258 Iowa 919, 140 N.W.2d 921 (1966).
39. *Id.* at 922, 140 N.W.2d at 923.
40. *Id.* at 921, 140 N.W.2d at 923. The modification also permitted the convenantor to appraise, pick up, deliver and service the equipment thus sold within the forty mile area.

sues of which persons are obliged to observe the covenant and what action will be deemed a breach.

A. *Persons Bound*

1. *Partners and Co-owners*

It is well-settled that where a partnership or co-ownership is sold and the owners agree in the contract not to compete, the individuals are bound thereby as well as the firm itself.[41] This rule was clearly established in Iowa in *Uptown Food Store, Inc. v. Ginsberg*,[42] when the supreme court overruled two previous contrary decisions.[43] Here, it was held that husband-and-wife joint owners were individually bound by their covenant not to compete made ancillary to a lease of their foodstore business.[44]

2. *Shareholders*

A seller of corporate stock who covenants not to engage in a business competitive with the corporation is bound thereby where he is a major stockholder, a shareholder-salesman or a shareholder who actively participates in the management of the corporate business.[45] This rule was evidenced, though not at issue, by the facts in the Iowa case of *Nelson v. Leaders*.[46] Here, at the time of incorporation, the incorporators of the business had agreed to be bound by a mutual anticompetitive covenant in the event of resignation by any stockholders from a position as director or officer.[47] One of the stockholders-officers sold his stock to the remaining incorporators and resigned. He was held to be bound by the covenant.[48]

3. *Third Parties*

Ordinarily, persons not parties to the contractual agreement not to compete are not bound.[49] However, there are two situations familiar in contract law generally which will result in restricting a nonsigner from competing with the covenantee.

The first such circumstance is where a third party joins in the breach with

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41. Uptown Food Store, Inc. v. Ginsberg, 255 Iowa 462, 123 N.W.2d 59 (1963); Southworth v. Davison, 106 Minn. 119, 118 N.W. 363 (1908).
42. 255 Iowa 462, 123 N.W.2d 59 (1963).
43. Rapalee v. John Malmquist & Son, 165 Iowa 249, 145 N.W. 279 (1914) (father and son marble business); Streichen v. Fehleisen, 112 Iowa 612, 84 N.W. 715 (1900) (lumber business co-owned by brothers).
44. Uptown Food Store, Inc. v. Ginsberg, 255 Iowa 462, 123 N.W.2d 59 (1963).
45. Nelson v. Leaders, 258 Iowa 919, 140 N.W.2d 921 (1966); Certified Pest Control Co. v. Kuiper, 294 N.E.2d 548 (Mass. Ct. App. 1973).
46. 258 Iowa 919, 140 N.W.2d 921 (1966). There is no Iowa case which explicitly states this rule. However, its application in the *Nelson* case went uncontested.
47. *Id.* at 922, 140 N.W.2d at 921.
48. *Id.* at 923, 140 N.W.2d at 922.
49. *See, e.g.*, Sineath v. Katzis, 218 N.C. 740, 12 S.E.2d 671 (1941).

the covenantor.[50] Here the courts will not hesitate to enjoin that party from further participating in the breach of a valid contract.[51]

The courts will also restrict a third party from inducing a covenantor to breach his anticompetitive agreement.[52] In *L.H. Henry & Sons v. Rhinesmith*,[53] the Iowa supreme court restrained a nonsigning co-defendant from engaging in the publishing business with the covenantors. As stated in the opinion, "[t]he decree did not attempt to enjoin [the third party] from publishing a newspaper on his own account, but only in conjunction with [the covenantors] who were parties to the contract, and from inducing them to violate the contract. This was proper."[54]

B. *What Constitutes Breach?*

It is clear that direct competition with the covenantee in the form of ownership or operation of a similar business is a breach of a covenant not to compete.[55] What is relatively obscure, however, is the issue presented by the more subtle forms of interference with the covenantee's acquired goodwill.

The leading Iowa case which sets out the standard to be applied in judging whether or not the covenantor has violated his agreement is *Wilson v. Delaney*.[56] In this case, the defendant had sold his interest in a livestock trading enterprise to the other co-owners and had agreed not to deal in livestock except for his own farm use. Covenantees brought suit alleging breach. Although defendant admitted making some transactions other than for his personal use, he asserted that he had no financial interest in the dealings as he was acting only on behalf of his son-in-law. In holding that the covenantor had violated his agreement not to compete, the court stated:

> The test, as we conceive, is mischief. And mischief begins when the scope and character of the employment is such as to result in all likelihood in substantial interference with the business which was the subject of the contract. And it will not do to say that there can be no interference if the seller shall refrain from any act which can operate to induce the customers of the old business to transfer their patronage to his new employer. Influence may be exerted indirectly as well as directly, and the purchaser of a business and its goodwill is entitled not only to protection in respect of customers then patrons, but to enter the field of competition unhampered by any adverse influence of the seller.[57]

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50. L.H. Henry & Sons v. Rhinesmith, 219 Iowa 1088, 260 N.W. 9 (1935); Owens v. Hatler, 373 Mich. 289, 129 N.W.2d 404 (1964).
51. Owens v. Hatler, 373 Mich. 289, 129 N.W.2d 404 (1964).
52. West Shore Restaurant Corp. v. Turk, 101 So. 2d 123 (Fla. 1958); L.H. Henry & Sons v. Rhinesmith, 219 Iowa 1088, 260 N.W. 9 (1935).
53. 219 Iowa 1088, 260 N.W. 9 (1935).
54. *Id.* at 1092, 260 N.W. at 10.
55. *See, e.g.*, Heinz v. Roberts, 135 Iowa 748, 110 N.W. 1034 (1907); Cole v. Edwards, 93 Iowa 477, 61 N.W. 940 (1895).
56. 137 Iowa 636, 113 N.W. 842 (1907).
57. *Id.* at 641, 113 N.W. at 844.

The *Wilson* mischief test for breach has most recently been applied by the Iowa court in the case of *Uptown Food Store, Inc. v. Ginsberg*.[58] Here, the foodstore owners had leased their enterprise and had promised not to engage in the business of food retailing in Keokuk other than at a store already operated by them.[59] Plaintiff-lessees alleged breach on the grounds that the covenantor was financing and managing his son's discount supermarket.[60] The court concluded that the lessor's activities constituted a violation of his contractual agreement under the *Wilson* test.[61]

It should be noted that in the unique instance of a covenant not to compete in the sale of a medical practice, the Iowa court, in the name of public policy, has tolerated a certain amount of competition by the selling physician. In *Oates v. Leonard*,[62] the court refused to restrain the covenantor from practicing medicine within the restricted area under certain circumstances. "We are not prepared to say that, under such a contract, a physician should be enjoined, as for a violation of the contract, when he acts in an emergency, and when another doctor cannot be secured."[63]

V. Enforcement

The "blue pencil rule" of partial enforcement of covenants not to compete, recently accepted in Iowa,[64] may facilitate the enforcement of covenants not to compete in the transfer of a business.[65] Along with this doctrine, however, the practitioner seeking to enforce a covenant should also be familiar with the effect of the parol evidence rule on anticompetitive agreements as well as the issue of what persons are entitled to bring suit.

A. *Partial Enforcement*

In some jurisdictions the penalty for drafting what is judicially construed to be an unreasonable covenant not to compete remains the harsh one of complete unenforceability.[66] As succinctly noted by the Iowa supreme court at one time, "[c]ovenantees . . . desiring the maximum protection have no doubt a difficult task. When they fail, it is commonly because, like the dog in the fable, they grasp too much and so lose all."[67]

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58. 255 Iowa 462, 123 N.W.2d 59 (1963).
59. *Id.* at 464, 123 N.W.2d at 60.
60. *Id.* at 464, 123 N.W.2d at 61. Convenantor's activities included loaning $20,000 to his son, co-signing a $10,000 note, signing as surety on a $36,000 fixtures contract, helping to negotiate the lease, overseeing remodeling of the building and the advertising, making retail sales and knowing the amounts of gross volume and sales.
61. *Id.* at 474, 123 N.W.2d at 66.
62. 191 Iowa 1004, 183 N.W. 462 (1921).
63. *Id.* at 1010, 183 N.W. at 465. *See also* Powers v. Strout, 67 Iowa 341, 25 N.W. 273 (1885).
64. Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368 (Iowa 1971).
65. This, however, is not entirely clear. *See* text accompanying note 80 *infra*.
66. *See, e.g.*, Somerset v. Reyner, 233 S.C. 324, 104 S.E.2d 344 (1958).
67. Brecher v. Brown, 235 Iowa 627, 633, 17 N.W.2d 377, 380 (1945), *citing* Herreshoff v. Boutineau, 17 R.I. 3, 7, 19 A. 712, 713 (1890).

Today, however, an ever increasing majority of states permit the partial enforcement of anticompetitive covenants which have been drafted so as to unreasonably restrict the covenantor.[68] A descendant of the common law "blue pencil rule" whereby the English courts lined out with a pencil the unreasonable portions of the covenant,[69] partial enforcement works to sever these overly restrictive elements. The court is then free to enforce the covenant to the extent necessary to afford reasonable protection to the covenantee.[70]

Iowa adopted the rule of partial enforcement in 1971 in a case involving an anticompetitive covenant ancillary to an employment contract,[71] after having rejected it a number of times in the past.[72] In this decision, *Ehlers v. Iowa Warehouse Co.*,[73] the supreme court overruled *Brecher v. Brown*,[74] also an employment contract case, and reasoned that "equity should not permit an injustice which might result from total rejection of the covenant merely because the court disagrees with an employer's judgment as to what restriction is necessary to protect his business."[75]

In *Ehlers* the written covenant prohibited the employee from engaging for two years in a competitive business within 150 miles of the employer. The court held that the territorial restriction was unreasonable but it partially enforced the covenant by enjoining the employee from contacting, soliciting or doing business with any person listed on the employee-compiled customer roster.[76]

The fact that both the *Ehlers* case and the overruled *Brecher* decision involved noncompetitive covenants in employment contracts creates an as yet unsolved dilemma with respect to analogous agreements in business transfer contracts. Although the court in *Ehlers* specifically acknowledged the distinction between the two types of contracts,[77] it left unchallenged the most recent business transfer contract decision, *Kunz v. Bock*,[78] wherein the Iowa court again had rejected the partial enforcement rule.[79] Thus, nowhere in the present Iowa case law is there direct authority for the proposition that the partial enforcement rule applies to covenants not to compete ancillary to the transfer of a business.[80] This is not to say, however, that the rule is inapposite; indeed, as noted by the

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68. *E.g.*, Hill v. Central W. Pub. Serv. Co., 37 F.2d 451 (5th Cir. 1930); McQuown v. Lakeland Window Cleaning Co., 136 So. 2d 370 (Fla. Ct. App. 1962); Solari Indus., Inc. v. Malady, 55 N.J. 571, 264 A.2d 53 (1970); Igoe v. Atlas Ready-Mix Inc., 134 N.W.2d 511 (N.D. 1965); Ramey v. Combined Am. Ins. Co., 359 S.W.2d 523 (Tex. Civ. App. 1962); Wood v. May, 438 P.2d 587 (Wash. 1968).
69. *See* WILLISTON, *supra* note 15, § 1647B, at 290.
70. *Id.* §§ 1647B, 1647C.
71. Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368 (Iowa 1971).
72. Kunz v. Bock, 163 N.W.2d 442 (Iowa 1968); Baker v. Starkey, 259 Iowa 480, 144 N.W.2d 889 (1966); Brecher v. Brown, 235 Iowa 627, 17 N.W.2d 377 (1945).
73. 188 N.W.2d 368 (Iowa 1971).
74. 235 Iowa 627, 17 N.W.2d 377 (1945).
75. Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368, 374 (Iowa 1971).
76. *Id.* at 373.
77. *Id.* at 369. *See* text accompanying note 22 *supra*.
78. 163 N.W.2d 442 (Iowa 1968).
79. *Id.* at 446.
80. *See* Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368, 375-77 (Iowa 1971) (dissenting opinion); 21 DRAKE L. REV. 641 (1972) (case note on *Ehlers* decision).

dissent in *Ehlers*, "[t]he reasons for going to the partial enforcement doctrine are much more persuasive in [cases involving business transfers] than they are in employment contracts."[81]

B. *Parol Evidence*

It is imperative that the terms of the covenant not to compete which the promisee seeks to enforce be written. This is necessary in light of the accepted rule that provides where a contract for the transfer of a business expressly conveys the goodwill of the business, parol evidence is inadmissible to prove the transferor's anticompetitive covenant.[82] The failure to include a written protective covenant in a contract which expressly transfers the goodwill of the business creates a conclusive presumption that the written contract embodies the entire agreement.[83] Hence, the admission of parol evidence to assert the existence of a covenant would alter the terms of the contract—a clearly impermissible result under the general law of contracts.[84]

The parol evidence rule has also been applied to bar enforcement of an alleged oral covenant not to compete where although the contract has not expressly conveyed goodwill it nevertheless appears complete on its face.[85] However, where the business transfer contract is incomplete, parol evidence is admissible under the rationale that it is necessary to explain the contract terms.[86]

This latter reasoning was applied in an early Iowa case where a buyer sought enforcement of an alleged oral agreement not to compete made at the time he purchased a restaurant.[87] The seller asserted that the written bill of sale for the business was the total contract between the parties and thus that parol evidence of any allegedly ancillary agreement was inadmissible.[88] In affirming the lower court's rejection of this interpretation of the asserted contract, the supreme court held:

> When the written instrument does not purport to state the entire agreement in respect to the subject-matter, but is used merely to transfer title, in execution of an agreement which it does not profess to show, oral evidence of the true agreement is competent.[89]

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81. Ehlers v. Iowa Warehouse Co., 188 N.W.2d 368, 375 (Iowa 1971) (dissenting opinion). *See also* Baker v. Starkey, 259 Iowa 480, 144 N.W.2d 889 (1966); Arthur Murray Dance Studios v. Witter, 105 N.E.2d 685 (Ohio Ct. C.P. 1952).

82. Joseph v. Hopkins, 158 So. 2d 660 (Ala. 1963); Brintnall v. Briggs, 87 Iowa 538, 54 N.W. 531 (1893); Huston v. Dickson, 322 P.2d 920 (Ore. 1958). See exceptions as noted in Annot., 11 A.L.R.2d 1227 (1950).

83. Wessell v. Havens, 91 Neb. 426, 136 N.W. 70 (1912).

84. Joseph v. Hopkins, 158 So. 2d 660 (Ala. 1963); Brintnall v. Briggs, 87 Iowa 538, 54 N.W. 531 (1893).

85. *See* Ginsburg v. Warczak, 330 Ill. App. 89, 69 N.E.2d 733 (1946); Tees v. Lee, 234 Wis. 607, 291 N.W. 792 (1940).

86. Durham v. Lathrop, 95 Ill. App. 429 (1901); Lazar v. Berg, 179 Wis. 610, 191 N.W. 966 (1923).

87. Hall v. Barnard, 138 Iowa 523, 116 N.W. 604 (1908).

88. *Id.* at 524, 116 N.W. at 604.

89. *Id.* at 524, 116 N.W. at 604-05.

C. *Persons Entitled to Enforce*

1. *Covenantees*

It may appear to be a facile statement that a covenantee of an agreement not to compete is entitled to enforce such a promise. However, the outward simplicity of this assertion belies the potential complications which can develop in certain instances when a covenantee seeks to enforce the promise.

One such difficulty arises when the enforcing covenantee fails to comply with a law or regulation pertinent to the type of business or profession he is pursuing.[90] In the Iowa case of *Rowe v. Toon*,[91] a seller-physician breached his covenant not to compete with the young doctor who had purchased his medical practice. The seller sought to defeat the covenantee's enforcement action on the ground that the latter had failed to comply with a doctors' filing law. This statute obligated physicians to file with the county recorder a certificate of authority to practice from the Iowa Board of Medical Examiners and prohibited collection of fees by legal proceedings until proper filing was effected.[92] Although plaintiff was in violation of the law due to his having mistakenly filed with the county clerk, the court held that this was insufficient ground to deny enforcement of the agreement which sought to protect the goodwill of the practice.[93]

A similar result was reached in *Miller v. Eller*,[94] where the covenantor-dentist asserted that the buyer of his dentistry practice was not entitled to enforce either the contract of sale or the ancillary covenant not to compete because the buyer had failed to take the state dental examination.[95] The court enforced both the sale contract and attendant anticompetitive agreement on the basis that while the state had an interest in the covenantee's practice of dentistry, the party to a contract of sale did not.[96] Thus, the seller-covenantor could not renege on either the promise to transfer the practice or the covenant not to compete.

When the covenantee himself breaches the general contract, the fact that the validity of the covenant not to compete will be brought into issue may create additional enforcement problems for the covenantee. In one of the earliest Iowa cases dealing with covenants not to compete,[97] the buyer of a medical practice claimed breach of the covenant and attempted to set off against the mortgage note the damages stipulated in the contract for failure to observe the anticompetitive agreement. The seller brought an action to foreclose the mortgage. Because the covenantee had claimed breach of the promise not to com-

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90. Miller v. Eller, 192 Iowa 147, 183 N.W. 498 (1921); Rowe v. Toon, 185 Iowa 848, 169 N.W. 38 (1918).
91. 185 Iowa 848, 169 N.W. 38 (1918).
92. *Id.* at 858, 169 N.W. at 42.
93. *Id.*
94. 192 Iowa 147, 183 N.W. 498 (1921).
95. *Id.* at 150, 183 N.W. at 499.
96. *Id.* at 150-51, 183 N.W. at 499.
97. Powers v. Strout, 67 Iowa 341, 25 N.W. 273 (1885).

pete, the validity of the covenant became an issue.[98] The court upheld the covenant's validity, found no breach and foreclosed the mortgage.[99]

2. *Assignees*

It has long been settled that a covenant not to compete ancillary to the transfer of a business is not a personal promise, but rather one that runs with the property actually transferred.[100] Hence, such agreements are assignable and can be enforced by the assignees[101] even where the contract itself is not actually transferred.[102] As explained by the Iowa supreme court:

> [E]ven if there is no express transfer of the contract, the good will assigned by the first seller follows the business into the hands of the second purchaser, without any express mention, as an incident to the business . . . . To construe such contracts as personal only where the design to so narrow or restrict their effect is not clearly expressed is to deprive them of much, if not most, of their value.[103]

VI. Remedies

For breach of a covenant not to compete, the buyer of a business may seek injunctive relief and damages. A declaratory judgment action is available to the covenantor who seeks to have the contract construed prior to breach.

A. *Injunctive Relief*

Since the essence of a covenant not to compete is forbearance, it is not surprising that the overwhelming majority of actions on these agreements involve a prayer for injunctive relief.[104] This remedy, if granted, will most closely recreate the positions of the parties prior to breach and is most likely to provide the covenantee the full value of his contract.

The principal basis of equity jurisdiction in this area is the difficulty, if not impossibility, of computing the damages sustained by the business as a result of the breach.[105] In addition, equity jurisdiction is invoked to impede the ongoing and future injury to the enterprise caused by the continued competition on the part of the covenantor.[106]

To invoke equity jurisdiction, a plaintiff generally must show some injury in fact to the acquired goodwill of the business.[107] However, the mere breach

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98. *Id.* at 343, 25 N.W. at 273-74.
99. *Id.*
100. Hedge, Elliot & Co. v. Lowe, 47 Iowa 137 (1877).
101. Sickles v. Lauman, 185 Iowa 37, 169 N.W. 670 (1918).
102. *Id.* at 43, 169 N.W. at 672.
103. *Id.* at 43-44, 169 N.W. at 672-73.
104. Kunz v. Bock, 163 N.W.2d 442 (Iowa 1968); L.H. Henry & Sons v. Rhinesmith, 219 Iowa 1088, 260 N.W. 9 (1935); J.D. Nichols Stores, Inc. v. Lipschutz, 120 Ohio App. 286, 201 N.E.2d 898 (1963); York v. Dotson, 271 S.W.2d 347 (Tex. Civ. App. 1954).
105. *See, e.g.*, Proctor v. Hansel, 205 Iowa 542, 218 N.W. 255 (1928); Bonneau v. Meaney, 343 Mass. 368, 178 N.E.2d 577 (1961).
106. Proctor v. Hansel, 205 Iowa 542, 218 N.W. 255 (1928).
107. Prentice v. Rowe, 324 S.W.2d 457, 463 (Mo. Ct. App. 1959).

of a protective anticompetitive covenant creates a presumption of irreparable injury.[108]

B. *Damages*

An injunction serves as an order for specific performance to mandate the covenantor's forbearance in competing with his covenantee. However, where breach has occurred, a buyer of a business also is entitled to seek damages for the injury and loss to the business caused by the seller's failure to forbear.[109]

If provable, the covenantee may recover the actual amount of loss and impairment to goodwill and lost profits.[110] The fact that these damages are incapable of precise ascertainment is not a bar to recovering damages in general.[111] As stated by one court:

> It is recognized that in such cases damages through loss of profits and impairment of good will are seldom susceptible of accurate proof with any degree of mathematical certainty, and the law does not require such proof.[112]

Where the parties stipulate a sum in the contract which is to be paid upon breach of the covenant, these liquidated damages provisions will be upheld.[113]

C. *Declaratory Relief*

An action for declaratory judgment to construe the rights of parties under a contract[114] is an accepted remedy where the issue involves covenants not to compete.[115] In the comparatively few cases where a declaratory judgment action has been brought by a party to a business transfer contract, it is the covenantor who seeks the relief as a means of testing the validity of the covenant itself where action is contemplated that would constitute breach.[116]

In the leading case on the right of a covenantor to seek declaratory relief under the restrictive covenant,[117] the Connecticut court reasoned why the remedy should be available:

> If the fact that a promisor has received a valuable consideration does not preclude him from defending against the enforcement of a contract because it is against public policy, or from seeking affirmative relief against it by way of cancellation or the like, we cannot see why that fact should preclude him from seeking a declaratory judgment to

108. Hedberg v. State Farm Mut. Auto. Ins. Co., 350 F.2d 924, 932 (8th Cir. 1965), *citing* Thermorama, Inc. v. Buckwold, 267 Minn. 551, 125 N.W.2d 844 (1964); Uptown Food Store, Inc. v. Ginsberg, 255 Iowa 462, 123 N.W.2d 59 (1963).

109. Smalley v. Greene, 52 Iowa 241, 3 N.W. 78 (1879); Leiman-Scott, Inc. v. Holmes, 142 Mont. 58, 381 P.2d 489 (1963).

110. Basic Food Sales Corp. v. Moyer, 55 F. Supp. 449 (W.D. Pa. 1944).

111. White v. Universal Underwriters Ins. Co., 347 Mass. 367, 197 N.E.2d 868 (1964).

112. Vancil v. Anderson, 71 Idaho 95, 105, 227 P.2d 74, 80 (1951).

113. Miller v. Eller, 192 Iowa 147, 183 N.W. 498 (1921); *cf.* Heinz v. Roberts, 135 Iowa 748, 110 N.W. 1034 (1907).

114. IOWA R. CIV. P. 262.

115. Beit v. Beit, 135 Conn. 195, 63 A.2d 161 (1948); Igoe v. Atlas Ready-Mix, Inc., 134 N.W.2d 511 (N.D. 1965).

116. Igoe v. Atlas Ready-Mix, Inc., 134 N.W.2d 511 (N.D. 1965).

117. Beit v. Beit, 135 Conn. 195, 63 A.2d 161 (1948).

determine whether or not it is an enforceable agreement.[118]

The cases where declaratory relief has been sought by a covenantee are rare,[119] no doubt because injunctive relief is the most effective remedy for this party. However, as rights under a contract may be construed in an action for declaratory judgment, either before or after a breach,[120] it is suggested that declaratory relief would aid greatly a covenantee seeking to prevent what he perceives to be imminent violation of his protective covenant.

VII. Tax Considerations

The taxation elements of covenants not to compete in the transfer of a business have significant implications for the parties involved. While this discussion is not intended to provide a complete analysis of these considerations,[121] it is important for the drafter of anticompetitive covenants to be at least rudimentally familiar with their potential tax ramifications.

A. *Ordinary Income or Capital Gain?*

The taxation issue arises from the fact that when a business is conveyed, the purchase price ordinarily exceeds the value of the tangible assets transferred. For tax purposes, the excess must then be allocated to one of two intangible assets—goodwill or the attendant covenant not to compete.[122]

This allocation is important to the parties because of the differing tax treatment of the intangibles. If the value received is assigned to the covenant, it is then treated as ordinary income to the vendor.[123] The vendee is then allowed an amortization deduction for the amount allocated to the agreement because it is considered either an ordinary and necessary business expense,[124] or a wasting asset.[125] However, if the value given in excess of the tangible assets is attributed to the goodwill of the business, the vendor has sold a capital asset and the income to him is treated as capital gain.[126] In this instance, a buyer cannot deduct the excess purchase price because goodwill is considered to have an unlimited life.[127] These competing tax interests thus lead the vendee to seek in

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118. *Id.* at 201, 63 A.2d at 164.

119. Bonneau v. Meaney, 343 Mass. 368, 178 N.E.2d 577 (1961). Convenantee sought declaratory judgment "and other equitable relief" and was granted an injunction.

120. Iowa R. Civ. P. 262, 263.

121. *See* Dykes, *Agreements Not to Compete*, 56 A.B.A.J. 799 (1970); Note, *Judicial Treatment of Covenants Not to Compete: The Third Circuit Takes a Giant Step*, 24 Tax. L. Rev. 513 (1969); Comment, *Tax Treatment of Covenants Not to Compete: Ordinary Income or Capital Gain?*, 1973 U. Ill. L. Forum 756.

122. *See* Comment, *Tax Treatment of Covenants Not to Compete: Ordinary Income or Capital Gain?*, 1973 U. Ill. L. Forum 756.

123. Beals' Estate v. Commissioner, 82 F.2d 268, 270 (2d Cir. 1936): "A promise not to work for others or for oneself is no more a conveyance of property than is a promise to enter the promisee's employ. Payment for either promise is income, not proceeds received on disposal of a capital asset."

124. Int. Rev. Code of 1954, § 162(a).

125. *See* Int. Rev. Code of 1954, § 167; Treas. Reg. § 1.167(a)-3 (1960).

126. Rodney Horton, 13 T.C. 143, 149 (1949) ("Good will is a capital asset and any gains resulting from the sale thereof are capital gains"); Aaron Michaels, 12 T.C. 17 (1949).

127. Treas. Reg. § 1.167(a)-3 (1960).

the bargaining stage a greater allocation to the covenant than is advantageous for the seller.[128]

B. *Judicial Allocation: The Three Tests*

The Internal Revenue Service and the courts usually become involved in the allocation issue when one of the parties either fails to treat it in his tax return or later realizes the adverse tax consequences of his bargain. The question of whether the consideration was paid for the goodwill or for the covenant is regarded as one of fact.[129] To make this determination, the courts now apply one of three tests: severability, economic reality or specific allocation.[130]

1. *The Severability Test*

In applying the severability test, the question asked is whether "the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will."[131] If the covenant meets this test and is nonseverable from the goodwill, then no part of the excess purchase price can be assigned to the covenant not to compete.[132]

Much comment has underscored the fact that the test's distinction between severability and nonseverability is largely imaginary.[133] All legally enforceable covenants not to compete are drafted in order to protect the goodwill of the business being transferred. Thus, strict application of the severability test would necessitate allocation to the covenant for tax purposes only where the covenant itself is invalid. This contradiction serves to explain both the difficulty of application of the severability test and the resulting irreconcilable judicial decisions.[134]

2. *The Economic Reality Test*

The economic reality test, formulated in the Ninth Circuit,[135] requires that the covenant not to compete "have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement."[136]

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128. *See* Comment, *Tax Treatment of Covenants Not to Compete: Ordinary Income or Capital Gain?*, 1973 U. ILL. L. FORUM 756, 757. "If the parties are tax knowledgeable and have equal bargaining power, their antithetical tax motives should produce an allocation in accord with the economic substance of the transaction."

129. Note, *Judicial Treatment of Covenants Not to Compete: The Third Circuit Takes a Giant Step*, 24 TAX. L. REV. 513 (1969).

130. See Comment, *Tax Treatment of Covenants Not to Compete: Ordinary Income or Capital Gain?*, 1973 U. ILL. L. FORUM 756 for an extensive discussion of these tests.

131. Ullman v. Commissioner, 264 F.2d 305, 307-08 (2d Cir. 1959).

132. Aaron Michaels, 12 T.C. 17 (1949); Rev. Rul. 65-180, 1965-2 CUM. BULL. 279.

133. *See, e.g.*, Note, *Judicial Treatment of Covenants Not to Compete: The Third Circuit Takes a Giant Step*, 24 TAX L. REV. 513 (1969).

134. *Compare* Rinehart Oil News Co., P-H Tax Ct. Mem. 1965-178, *aff'd per curiam*, 369 F.2d 692 (5th Cir. 1966) *with* Wilson Athletic Goods Mfg. Co. v. Commissioner, 222 F.2d 355 (7th Cir. 1955).

135. Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961).

136. *Id.* at 55.

An anticompetitive agreement is economically realistic if it is necessary to complete a transfer of goodwill. An allocation to such a covenant is ordinary income to the vendor and amortizable by the vendee,[137] whereas an allocation to an agreement without economic reality is treated as capital gain.[138]

3. *The Specific Allocation Test*

This test is applied where a specific allocation to the covenant has been made in the contract and is later contested by one of the parties. In *Ullman v. Commissioner*,[139] the court of appeals stated that:

> [W]hen the parties to a transaction such as this one have specifically set out the covenants in the contract and have there given them an assigned value, strong proof must be adduced by them in order to overcome that declaration.[140]

The "strong proof" aspect was then strengthened in *Commissioner v. Danielson*,[141] wherein it was held that a party cannot attack the tax consequences of the specific allocation as construed by the Commissioner unless he can produce evidence of undue influence, mistake or fraud at the time the contract was executed.[142]

Thus, the specific allocation test amounts in effect to a conclusive presumption where a party to the contract challenges the allocation. However, the *Danielson* court emphasized that if the Commissioner challenges the allocation, the test would be inapplicable and the economic substance of the covenant, rather than the mere written form, is then examined.[143]

VIII. Conclusion

To the person acquiring a business or an interest in a business from another, a covenant not to compete can be a useful device. There is no question but that protection is needed to guard the enterprise against unfair competition from its former owner. Where properly contemplated,[144] drafted,[145] policed,[146] and enforced,[147] an anticompetitive covenant can do much to assure the covenantee the true and full benefit of his bargain under the contract.

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137. Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966).
138. Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961). Here, the covenant was not needed to insure the goodwill because the vendee knew that, among other factors, the covenantor had neither the technical ability nor the desire to compete.
139. 264 F.2d 305 (2d Cir. 1959).
140. *Id.* at 308.
141. 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967).
142. *Id.* at 775.
143. *Id* at 774. In *J. Leonard Schmitz*, 51 T.C. 306 (1968), *aff'd sub nom., Throndson v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972), the Tax Court refused to apply the *Danielson* rule. Rather, it applied the *Ullman* strong proof requirement and held that the contesting seller had met the burden to overcome the specific allocation to the covenant.
144. *See* the discussion of the tax considerations at division VII *supra*.
145. *See* division III *supra*.
146. *See* the discussion of performance and breach in division IV *supra*.
147. *See* division V *supra*.

THE INDEPENDENT CONTRACTOR RULE AND ITS EXCEPTIONS IN IOWA

The rule developed early at the common law that a master is subject to liability for the torts of his servant if that servant is acting within the scope of his employment.[1] It furthermore developed by way of exception to this general rule that the employer of an independent contractor is not liable for the wrongful acts of the contractor or the servants of the contractor.[2] However, considerable controversy has attended this latter rule relating to the non-liability of the employer of an independent contractor, so much so that it has been said that "the rule is now primarily important as a preamble to the catalogue of its exceptions."[3] Moreover, aside from being weakened by numerous exceptions, the general rule has encountered serious challenges to its economic justifications.[4] This Note will examine to what extent the many inroads into the contractee's immunity from liability have been reflected by the decisions in Iowa.

I. DETERMINING THE CONTRACTEE-INDEPENDENT CONTRACTOR RELATIONSHIP

Preceding the question of the employer's liability for the torts of an independent contractor is the initial determination that there in fact exists a contractee-independent contractor relationship. The significance of this deter-

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1. 57 C.J.S. *Master & Servant* § 555 (1948); 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 26.6 (1956); W. PROSSER, LAW OF TORTS 460 (4th ed. 1971) [hereinafter cited as PROSSER]; RESTATEMENT (SECOND) OF AGENCY § 219 (1958); *see* Hughes v. Western Union Tel. Corp., 211 Iowa 1391, 236 N.W. 8 (1931). "The general rule as to the liability of the master for the wrongful acts of his servant while within the scope of his employment is too well settled to need citation of authority." *Id.* at 1392, 236 N.W. at 8.

2. DeMoss v. Darwin T. Lynner Constr. Co., 159 N.W.2d 463, 468 (Iowa 1968); 41 AM. JUR. 2d *Independent Contractors* § 24 (1968); 57 C.J.S. *Master & Servant* § 584 (1948); 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 26.11 (1956); PROSSER, *supra* note 1, at 468; RESTATEMENT (SECOND) OF TORTS § 409 (1965). The justification most usually cited for the rule is that "since the employer has no power over the manner in which the work is to be done by the contractor, it is to be regarded as the contractor's own enterprise, and he, rather than the employer, is the proper party to be charged with the responsibility of preventing the risk, and bearing and distributing it." RESTATEMENT (SECOND) OF TORTS § 409, comment *b* at 370 (1965).

3. Pacific Fire Ins. Co. v. Kenny Boiler & Mfg. Co., 201 Minn. 500, 503, 277 N.W. 226, 228 (1937). The *Restatement* devotes no less than nineteen sections to all the exceptions. *See* RESTATEMENT (SECOND) OF TORTS §§ 410-29 (1965). *See also* Brown, *Liability for the Torts of Independent Contractors in West Virginia*, 55 W. VA. L. REV. 216 (1953); Comment, *Liability for the Torts of Independent Contractors in California*, 44 CALIF. L. REV. 762 (1956); Comment, *Employer's Liability for Negligence of His Independent Contractor*, 30 TENN. L. REV. 439 (1963); Comment, *Responsibility for the Torts of an Independent Contractor*, 39 YALE L.J. 861 (1930).

4. *See, e.g.*, F. HARPER, A TREATISE ON THE LAW OF TORTS § 292 (1933); Douglas, *Vicarious Liability and Administration of the Risk*, 38 YALE L.J. 584, 594 (1929); Morris, *Torts of an Independent Contractor*, 19 ILL. L. REV. 339 (1934); Note, *Risk Administration in the Marketplace: A Reappraisal of the Independent Contractor Rule*, 40 U. CHI. L.REV. 661 (1973).