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Employment Contracts—Covenants Not to Compete: Inseverable and Unreasonable Covenants Not to Compete May Be Enforced to a Reasonable Extent.—Wood v. May, 73 Wn. 2d 307, 438 P.2d 587 (1968)

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EMPLOYMENT CONTRACTS—COVENANTS NOT TO COMPETE: INSEVERABLE AND UNREASONABLE COVENANTS NOT TO COMPETE MAY BE ENFORCED TO A REASONABLE EXTENT.—*Wood v. May*, 73 Wn. 2d 307, 438 P.2d 587 (1968).

Plaintiff-employer sought to prevent defendant-employee from competing with him in the horseshoeing business within a proscribed area and time as set forth in an employment agreement between them.[1] The trial court found the area of restriction to be excessive and thus unreasonable and refused to modify the covenant not to compete. It held that the unreasonable restriction was not severable from the remainder of the covenant and that the whole covenant was thus unenforceable.[2] Plaintiff appealed, claiming error in the findings of unreasonableness and indivisibility and in the refusal to modify or enforce the covenant.[3] The Washington Supreme Court upheld the finding of unreasonableness but rejected the divisibility test as a criterion for judicial enforcement. The case was remanded with instructions to enforce time and area restrictions that would be reasonable under the circumstances. *Wood v. May*, 73 Wn. 2d 307, 438 P.2d 587 (1968).

Covenants not to compete have been discussed extensively by the Washington courts.[4] But before *Wood* it had not been concluded that such covenants, unreasonable as written, should be enforced to the extent they can be made reasonable by judicial modification. In *Wood* the court identified traditional contract issues[5] and asked one additional

[1] The original agreement read:

> [F]or a period of five years from and after the time he shall leave the . . . employer [Wood], either if by resignation or by discharge, that he shall not engage directly or indirectly in any business or enterprise the nature of which is competitive to the very employers [sic] business, that is to say he shall not engage in the practice of Horseshoeing or Blacksmithing, within a radius of one hundred (100) miles from the Oakwood Horseshoeing presently situated at Route 1, Box 1491, or any branch of the Oakwood Horseshoeing during the tenure of this time.

Wood v. May, 73 Wn. 2d 307, 308, 438 P.2d 587, 588 (1968).

[2] Wood v. May, 73 Wn. 2d 307, 309, 438 P.2d 587, 588 (1968).

[3] Brief for Appellant at 5, Wood v. May, 73 Wn. 2d 307, 438 P.2d 587 (1968).

[4] National School Studios v. Superior School Photo Service, 40 Wn. 2d 263, 242 P.2d 756 (1952); Schneller v. Hayes, 176 Wash. 115, 28 P.2d 273 (1934); Racine v. Bender, 141 Wash. 606, 252 P. 115 (1927).

[5] These included: "(1) [a]re the restrictive covenants not to compete after termination of employment void for reasons of public policy? (2) if such covenants are not void, were the covenants in this contract supported by adequate consideration? (3) if supported by adequate consideration, were the restrictions reasonable as to time and area as to both the parties and the public? . . ." Wood v. May, 73 Wn. 2d 307, 309, 438 P.2d 587, 589 (1968).

question, viz., ". . . if the restrictions [in the covenant] were unreasonable, can a court exercising its equity jurisdiction modify such restrictive covenants and enforce them in a more reasonable manner?"[6] The affirmative answer given by the court is the subject of this discussion.[7]

Traditionally, the enforcement of unreasonable covenants not to compete has been made to depend upon whether the unreasonable portions could be removed, while still leaving enough of an agreement to enforce. If what is unreasonable is not severable, there can be no enforcement; if unreasonable parts can be segregated out, the reasonable provisions remaining will be enforced. This approach has become known as the "blue pencil" rule.[8] More recently, however, courts have sought to find a severability of thought rather than of words,[9] and some courts have even ignored the traditional test altogether, disregarding severability in favor of examining the reasonableness of each covenant in the light of attendant circumstances.[10] Implicit in each of these methods is an effort to determine the limits of reasonableness of the restrictions with respect to the employer, the employee, and the public.[11]

The interests to be protected are clear. The employer has a business which in many cases is built upon goodwill and trade secrets. In order to protect these interests from competitors who would "pirate" his employees or from the unfair competition of former employees, he is

[6] Wood v. May, 73 Wn. 2d 307, 309, 438 P.2d 587, 589 (1968).

[7] This note does not include a discussion of the significant problems in the determination of reasonableness. This determination requires a balancing of the interests of the employer, employee, and public in light of the surrounding circumstances. Welcome Wagon v. Morris, 224 F.2d 693 (4th Cir. 1955). For a discussion of the determination of reasonableness under *Wood* see Note, *Contracts—Partial Enforcement of Unreasonable Restrictions on Competition*, 4 GONZAGA L. REV. 343 (1969).

[8] 5 WILLISTON, CONTRACTS, § 1659, at 4681 (1937); 6A CORBIN, CONTRACTS, § 1390, at 67-69 (1962).

[9] [S]ome courts have held a severance in the thought expressed in the covenant to justify striking out or ignoring so much of the promise in unreasonable restraint of trade, leaving the remainder of the covenant valid and enforceable.
5 WILLISTON, CONTRACTS, § 1659, at 4681 (1937).

[10] *See, e.g.*, Mason v. Briggs Co., 221 Ky. 127, 297 S.W. 1106 (1927); New England Tree Expert Co. v. Russell, 306 Mass. 504, 28 N.E.2d 997 (1940); Schmidtl v. Central Laundry and Supply Co., 13 N.Y.S.2d 817 (Monroe Co. Ct. 1939); Burroughs Adding Machine Co. v. Chollar, 79 S.W.2d 344 (Tex. Civ. App. 1935); O. Hommel Co. v. Fink, 115 W. Va. 686, 177 S.E. 619 (1934); General Bronze Corp. v. Schmeling, 208 Wisc. 565, 243 N.W. 469 (1932); Bromley v. Smith, [1909] 2 K.B. 235.

[11] Schneller v. Hayes, 176 Wash. 115, 28 P.2d 273 (1934); Racine v. Bender, 141 Wash. 606, 252 P. 115 (1927); John Roane, Inc. v. Tweed, 33 Del. Ch. 4, 89 A.2d 548 (1952).

allowed to exact from his employees a covenant not to compete within specified limits of time and area upon their termination. The usual consideration for the covenant is the present and continued employment of the employee.[12] On the other hand, the interests of the employee are to be free from restrictions which will impair his opportunity for advancement or threaten his economic freedom. Where he is bound by unreasonable restrictive covenants not to compete he is for all practical purposes tied to his present employer, for he cannot take a similar job without risking litigation. The public interest is expressed in the policy that attempts at overreaching or monopolization should not receive judicial sanction. Since overreaching ordinarily occurs when the agreement is the product of inequality of bargaining power, it is natural that the courts should interfere when that inequality operates to the detriment of the weaker party. But it is even more important that such an agreement be restrained by the court when the restriction of the covenant is so unreasonable that the employee who quits his job becomes a public burden due to his inability to find another similar job which does not violate the agreement. Monopolization runs counter to the policy of free competition, a policy warranting refusal to enforce agreements aiming at monopolization of labor.[13] The

[12] Rosellini, J., noted in the dissenting opinion that this consideration was very weak since the defendant could have gotten the same training in a five week college course at much less overall cost to him than was required of him in his contract with plaintiff. The majority, however, points out rightly that the consideration is sufficient for the agreement even though there may be a question as to its adequacy. 73 Wn. 2d 307, 316, 438 P.2d 587, 592 (1968). *But see* Schneller v. Hayes, 176 Wash. 115, 28 P.2d 273 (1934).

[13] Historically, covenants not to compete were not favored because of the harmful effect on competition and supply, but eventually considerations of protecting the established businessman began to prevail. At first these restraints were regarded as against public policy from both the public's and the employee's standpoints. The public was deprived of the employee's skills and he might become a public charge. At the time courts were much more concerned about losing an active participant in industry since the public interest depended to a great extent on each individual's production. This was particularly true when master craftsmen produced nearly all of a given item and the restraint of any one of them would seriously impair the supply of that item. With the advent of better transportation and the decline of the skilled craftsman this problem became less critical and the economic effect of one restrained workman became relatively less significant. As early as 1711 the distinction between a general and a partial restraint was recognized with qualified approval given to the latter. By the end of the nineteenth century the validity of an agreement in restraint of trade was determined by whether it was limited as to time and area. The current trend is to disregard the distinction between a general and partial restraint with a rule of reasonableness being applied in each case. *See* Renwood Food Products v. Schaefer, 240 Mo. App. 939, 223 S.W.2d 144, 150-51 (1949); 17 C.J.S. *Contracts* §§ 238 *et seq.* (1963). *See also* RESTATEMENT OF CONTRACTS § 515 (1932).

critical inquiry in comparing approaches to judicial enforcement is to ask which one most fairly balances these competing interests of employer, employee, and public.

The traditional "blue pencil" rule has as its base the rationale that it is up to the parties to include reasonable covenants in their agreements. Under this rule the courts will not write reasonable covenants for the parties in place of unreasonable ones. A rule of reasonable enforcement, reason the "blue pencil" courts, would encourage use of *in terrorem* tactics by the employer. Since the employer is almost always the stronger party, he could include particularly onerous restrictions in the covenant in order to deter the employee from competing, knowing all the while that even if the *in terrorem* tactics are unsuccessful, judicial modification will leave him with a reasonable bargain.[14] Overprotection of the employer would be the result. A stronger party guilty of intentional overreaching should not be allowed to complain that his covenant is not enforceable. In such a case his purpose is to rely on the *in terrorem* effect of the covenant to maximize the benefit to himself at the expense of valid interests of the weaker party.

The "blue pencil" rule is hard to fault in cases of conscious overreaching; the difficulty is that the rule, depending as it does on the mechanical application of the concept of severability, involves the threat of overkill. When neither party is in a position to overreach the other or when one in such a position has not used it adversely, then strict application of the rule seems arbitrary. For example, bad draftsmanship by an employer could leave him completely unprotected if the unreasonable portions of the covenant are not severable from the remainder. This hazard is particularly emphasized when circumstances

[14] The English courts have traditionally adhered to the "blue pencil" rule as a result of this effect:

> Later English cases have clarified the "blue-pencilling" test, explaining that it is not sufficient that the excessive limitation is separately stated so that it can be stricken from the covenant, but that the unlawful clause must be merely an additional stipulation not going to the principal purpose of the contract. Otherwise, the whole covenant is invalid despite the grammatical severability of the excessive promise. The policy on which this qualification is based is to prevent promisees of superior bargaining position from deliberately extorting unreasonable and oppressive promises, stated in divisible terms, confident that they will in any case secure the maximum protection of the law.

5 WILLISTON, CONTRACTS, § 1659, at 4681-82 (1937).

Williston explains that the difference in emphasis between American courts and English courts is the reason that the RESTATEMENT OF CONTRACTS states the rule as invalidating the whole covenant only when the covenant is part of a plan to obtain a monopoly. 5 WILLISTON, CONTRACTS, § 1659, at 4682 (1937).

change and restrictions that were reasonable at the time the agreement was signed are unreasonable at the time of the dispute. When the employer diligently seeks to include only reasonable restrictions but has these restrictions held to be unreasonable by the court, his diligence is rewarded by a judicial refusal to enforce the covenant at all. In this way the penalty designed for the employer who would unfairly use his position for his own advantage is extended to the employer who seeks only to provide for reasonable protection.

Another difficulty with the mechanical application of the "blue pencil" rule is the ease with which it can be circumvented by the overreaching party. The employer who includes arbitrary or monopolistic restrictions in the covenant not to compete will not suffer serious injury if he drafts the covenant so as to permit severance of all of the unreasonable provisions. He can rely on the *in terrorem* effect of the unreasonable terms confident that even if these provisions are challenged their severance will leave the other portions of the covenant untouched. In some cases this problem has been attentuated by the application of an exception to the "blue pencil" rule which refuses to enforce the covenant at all if the design of the employer is arbitrary or monopolistic.[15] But if this exception is not applicable or is not employed, the efficacy of the rule is undermined by the ability of the stronger party to retain a skillful draftsman to enable an attempt at conscious unfairness without risk of penalty.

Under the traditional "blue pencil" rule there is no consideration of degrees of unreasonableness. An unreasonable covenant, if inseverable, is unenforceable *in toto*. Even if a particular unreasonable provision is severable, that provision is unenforceable *in toto*. The "finding" of unreasonableness is the only necessary determination on the question of enforceability; the "degree" of unreasonableness is not relevant to the inquiry. Thus, although the relative equities of the parties are examined in the initial determination of reasonableness or unreasonableness, once a determination of unreasonableness has been made these equities are no longer considered.[16]

[15] This exception is based on the reasoning that where the design of the agreement manifests an intent to create a monopoly, the whole agreement is void as against public policy. RESTATEMENT OF CONTRACTS § 518 (1932).

[16] Where the previously mentioned exception to the "blue pencil" rule is honored, the court would, however, consider whether the design of the employer was arbitrary or monopolistic. *See* note 15 and accompanying text *supra*.

In recognition of the shortcomings of the "blue pencil" rule some courts have turned towards enforcing the covenant to the extent it is reasonable.[17] In so doing, these courts have sought to apply equity principles to achieve a finer balance of the interests of the parties and the public. Under this doctrine, all surrounding circumstances, including evidence of overreaching, are taken into account. An unreasonable covenant need not lie totally unenforced, it may be modified by the court and enforced after restriction to a reasonable scope. This is the approach of *Wood*.

There is a continuum of remedy under the *Wood* doctrine; enforcement may range between complete enforcement and no enforcement at all.[18] The degree of enforcement is directly porportional to the relationship between the parties as shown by the circumstances of the case and as modified by public policy. If the covenant is reasonable, it will be enforced completely. If it is unreasonable wholly or partially, it can be restricted and enforced only to a reasonable extent. However, if the covenant constitutes an effort of conscious overreaching or an attempt to monopolize, it can be argued that the court can decide not to enforce it all.[19] Under the rule of reasonable enforcement, there is

[17] *See* note 10 *supra*.

[18] Note the analogous approach, as regards unconscionable contracts or clauses in the sales area, found in UNIFORM COMMERCIAL CODE § 2-302 (1):

> If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

UNIFORM COMMERCIAL CODE § 2-302, Comment 3 should also be consulted.

[19] The majority opinion in *Wood* does not expressly support this thesis. The court did say:

> The trial judge felt he was obligated to either accept or reject the restrictions *in toto* rather than to modify them on the basis of his factual findings. We do not believe he could properly decide the issues before him while operating under this assumption.

73 Wn. 2d at 311, 438 P.2d at 590. It also said:

> We do not limit the court upon new trial to any given formula for determining reasonable restrictions, nor do we read any of the cases cited in this opinion as so limiting a trial court.

73 Wn. 2d at 312, 438 P.2d at 590. Evidence adduced at trial might include evidence of purposeful overreaching or monopolistic design. Nothing in the *Wood* opinion indicates that such evidence cannot be considered. Thus, it is arguable that such evidence is relevant and since relevant could suffice to support a decision not to enforce the agreement at all. A monopolistic purpose is against public policy. RESTATEMENT OF CONTRACTS §§ 515(c), 518 (1932). Under the "blue pencil" rule such a purpose has been considered sufficient to warrant denial of enforcement as to reasonable severable provisions. RESTATEMENT OF CONTRACTS § 518 (1932). It should similarly suffice to warrant refusal to enforce the covenant at all under the "reasonable enforcement" rule.

On the other hand, there is authority supportive of the proposition that the "ten-

available a spectrum of alternatives adaptable to the particularized facts of a case rather than just the rigid single choice between reasonable or unreasonable, enforceable or unenforceable present under the "blue pencil" rule.

The dissent in *Wood* argues that courts should be reluctant to enforce covenants not to compete in employment contracts because of the unduly oppressive effect on the employee.[20] In effect the dissent expresses the concern that the employer will rely on the court to modify unreasonable agreements if the *Wood* rule is adopted; that the rule provides no incentive to employers to avoid conscious overreaching because the only penalty, upon a finding of overreaching, is to give him the benefit of a reasonable bargain. Read this way, the *Wood* rule gives the employer the unfair advantage discussed above—that is, the ability to include onerous restrictions with the foreknowledge that the court will enforce the agreement to some extent in any case.[21] The dissent, however, disregards the fact that trial courts are well equipped to handle these types of considerations, and can do so without sacrificing the interests of the parties or public.

With the *Wood* rule trial courts in Washington can look beyond the memorial of the agreement in determining how to treat the parties. In doing so they may determine whether a restriction to be imposed

dency" of the covenant to restrain competition is the only relevant factor—with "motive" not being a relevant consideration. *See, e.g.*, Palumbo v. Piccioni, 89 N.J. Eq. 40, 103 A. 815, 817 (1918). Cf. Amarillo Oil Co. v. Ranch Creek Oil & Gas Co., 271 S.W. 145, 151-52 (Tex. Civ. App. 1925). Motive being immaterial, the court could reasonably enforce the covenant despite any monopolistic design of the employer. The language of the *Wood* majority quoted above is consistent with the approach of *Palumbo, supra*, if it is interpreted to refer only to the formulation of a reasonable covenant and not at all to the intent of the employer.

It is submitted that the better view is to treat motive as a proper consideration. Such an approach comports with the treatment of monopolistic purposes as justification for denial of any enforcement to the covenant under the "blue pencil" rule. RESTATEMENT OF CONTRACTS § 518 (1932). It avoids the problem posed by the *Wood* dissent whereby a monopolistically motivated or overreaching employer could draft onerous covenants with confidence that at least reasonable enforcement would be obtainable. It also furthers the policy of allowing the trial court maximum flexibility in balancing the interests of employer, employee, and the public and developing the most appropriate remedy. Nothing in *Wood* prohibits consideration of motive; courts can and should consider motive and deny any enforcement to a covenant aimed at monopoly or overreaching. Although this approach involves penalty for an employer actuated by improper motives, the penalty is amply justified by the need to discourage purposeful drafting of unreasonable covenants not to compete by employers relying on the *in terrorem* effect and on the assurance of a reasonable enforcement in any event.

[20] Rosellini, J., dissenting in Wood v. May, 73 Wn. 2d 307, 320, 438 P.2d 587, 595 (1968).

[21] *See* note 14 and accompanying text *supra*.

should be time-bound, geographical, or merely a restriction as to former customers. The court can even determine that only a special class of customers should be included in the restraint.[22] And upon discovery of overreaching, the court should be able to deny enforcement altogether. *Wood* has given trial courts a free hand in assessing the balance of interests between the parties against the background of the public interest—a view preferable to that of the dissent and a significant advance over the mechanical approach of the "blue pencil" rule.

[22] Wood v. May, 73 Wn. 2d 307, 316-321, 438 P.2d 587, 592-96 (1968).