RESOURCES

Businesses Beware: NC Supreme Court Confirms Continued Application of "Strict Blue Pencil Doctrine" to Non-Competition Agreements

On March 18, 2016, in *Beverage Systems of the Carolinas, LLC, v. Associated Beverage Repair, LLC*, the North Carolina Supreme Court held that North Carolina courts will not rewrite unreasonable non-competition agreements, even where the parties have expressly authorized the courts to do so in their contract. Instead, North Carolina's courts are limited to use of the "strict blue pencil doctrine," discussed below.

Many businesses seek to protect their interests and investments in customer relationships, company trade secrets, and company confidential information through the use of "restrictive covenants" such as non-competition and customer non-solicitation agreements. Companies often use these types of agreements in two different settings: (1) when they purchase a competing business and contract to restrict the seller's ability to compete with the buyer for a period of time after the sale; and (2) by having their employees enter into written contracts in which employees agree not to compete with the business of the company and/or solicit its customers for a period of time after their employment ends. Although greater latitude generally is allowed in covenants given by the seller in connection with the sale of a business than in the employment setting, North Carolina courts consider all such restrictive covenants to be contracts in restraint of trade. As such, North Carolina courts will not enforce such covenants unless they are found to be reasonable as to the length and geographic scope of the restrictions, among other things.[i]

What happens if a court views the time and territory restrictions as unreasonably long or broad? In many other states, courts have the discretion (and in some states the obligation) to rewrite an unreasonable covenant to make it reasonable, and then enforce that covenant as rewritten. For example, if an employee working within a fifty-mile-radius sales territory agreed not to compete with his employer anywhere in the United States for a period of five years after employment termination, courts in many other states could rewrite the covenant so that the restriction was limited to a period of one year and only within that fifty-mile radius. But not in North Carolina….

More than fifty years ago, the North Carolina Supreme Court adopted the "strict blue pencil doctrine," under which a court "cannot rewrite a faulty covenant but may enforce divisible and reasonable portions of the covenant while striking the unenforceable portions." Under this doctrine, the unreasonable portions must be separable from the rest of the provision, and the remainder must be reasonable and enforceable on a "stand-alone" basis. Under the "strict blue pencil doctrine," businesses need to draft the scope of the restrictive covenants properly or risk having their covenants be adjudged unenforceable, thus losing all protection under the covenant. That is precisely what happened to the plaintiff in *Beverage Systems*.

In Beverage Systems, the plaintiff, Beverage Systems, bought two related businesses in the same field as its own. In connection with the purchases, the selling business owners agreed not to compete for a period of five years "in the states of North Carolina or South Carolina." The problem was that neither the sellers nor Beverage Systems did business throughout either all of North Carolina or all of South Carolina. As such, the court found the geographic restriction to be unreasonably broad and unenforceable because it covered areas where no parties had engaged in business. The Supreme Court then held that under the "strict blue pencil doctrine," striking the unreasonable portion of the territory (the states of North Carolina and South Carolina) left no territory within which to enforce the covenant.

Beverage Systems argued that, notwithstanding the "strict blue pencil doctrine," the trial court could rewrite their territorial restriction to make it reasonable because in their contract the parties had expressly agreed that if a court held any restriction to be unreasonable, then "the maximum period, scope or geographical area that are reasonable under such circumstances shall be substituted for the [unreasonable period, scope or area], and … the court shall be allowed to revise the restrictions contained [therein] to cover the maximum period, scope and area permitted by law." The Supreme Court rejected this argument, and held that North Carolina's courts will not allow the parties to circumvent the strict blue pencil doctrine through such a clause: "Allowing litigants to assign to the court their drafting duties as parties to a contract would put the court in the role of scrivener, making judges postulate new terms that the court hopes the parties would have agreed to be reasonable at the time the covenant or would find reasonable after the court rewrote the limitation. We see nothing but mischief in allowing such a procedure. Accordingly, the parties' Agreement is unenforceable at law and cannot be saved."

Was the result in Beverage Systems avoidable? Absolutely. In its agreement Beverage Systems could have drafted the restrictive covenant's territory consistent with the territories within which it and/or the sellers operated. Also, if it was difficult to define the relevant territory precisely, it could have separately identified each area (e.g., by county) believed to be part of the territory, or it could have defined the geographic territory in terms of separable but expanding territorial components based on the specific circumstances involved. For example, depending on the precise circumstances, a Greensboro employer who does business primarily in the Piedmont Triad area of North Carolina but also does some business in other parts of the state might choose to define the restricted territory as "(a) Guilford County, North Carolina; and (b) all counties which are contiguous to Guilford County, North Carolina; and (c) the State of North Carolina. If a court finds item (c) too broad, for example, it has the discretion to "blue pencil" that out and enforce the rest, allowing the employer to still get protection in its "core" territory.[ii]

As to restrictive covenants, business owners should consider the following:

- Most businesses have customer/supplier relationships and/or confidential information that provide value to the business.
- The proper use of well-drafted restrictive covenants can provide significant protection for valuable company interests and resources, including customer relationships and company information.
- At a minimum, businesses should use properly drafted non-disclosure agreements to protect trade secrets and confidential information.
- It is really tough to put the toothpaste back in the tube. A company that does not have its employees sign restrictive covenants usually can do very little to prevent them from soliciting its customers and competing with that company when they leave. It is better to put the "cap" on at the outset.
- Restrictive covenants are not "one size fits all." Using restrictive covenants that are not tailored to your specific business and circumstances increases the likelihood that they will be found unenforceable.
- Strongly consider seeking the assistance of counsel experienced with restrictive covenants and non-disclosure agreements.
- Because North Carolina restrictive covenant law has evolved over the last several years, businesses should consider seeking a review of their restrictive covenant agreements to confirm whether they are enforceable under current law.
- For businesses with multiple employees, the cost of preparing a well-drafted restrictive covenant agreement for use often can be amortized over multiple uses.

[i] Generally speaking, to be enforceable under North Carolina law, restrictive covenants between an employer and employee must be: (1) in writing; (2) made part of a contract of employment; (3) based on valuable consideration; (4) reasonable both as to time and territory; and (5) not against public policy.

[ii] It should be kept in mind that in North Carolina, a court's application of the blue pencil doctrine is discretionary, not mandatory.

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