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Liquidated Damages Clause in Partnership Agreement Held Not Noncompete Agreement

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Employment Law

I. LIQUIDATED DAMAGES CLAUSE IN PARTNERSHIP AGREEMENT HELD NOT NONCOMPETITION COVENANT

In *J.W. Hunt & Co. v. Davis*[1] the South Carolina Court of Appeals held that a liquidated damages clause in a partnership agreement was not a covenant not to compete and was not subject to the reasonableness test used in evaluating noncompetition clauses.[2] In *Davis* the court of appeals continued to define covenants not to compete narrowly. However, by focusing exclusively on the classification question, the court left unresolved the more important issue of how to treat clauses that do not fall into the category of covenants not to compete but that produce the same effect.

J.W. Hunt and Company (J.W. Hunt), a public accounting firm in South Carolina, operates as a general partnership. Davis became a voting partner in 1971. In 1986 the partners adopted a new partnership agreement that included Article VII, which allows a withdrawing partner to service former clients if the partner pays J.W. Hunt liquidated damages calculated by a preset formula.[3] In 1990 Davis resigned from J.W. Hunt and began to service several of the partnership's clients. The partnership brought suit against Davis seeking

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1. ___ S.C. ___, 437 S.E.2d 557 (Ct. App. 1993).

2. The reasonableness test is described in *Rental Uniform Service v. Dudley*, 278 S.C. 674, 301 S.E.2d 142 (1983) (per curiam). The *Dudley* test requires consideration of five factors. The prohibition must be: (1) necessary for protection of the employer's legitimate interest, (2) not unduly harsh or oppressive in curtailing the employee's legitimate efforts to earn a livelihood, (3) reasonable from a sound public policy standpoint, (4) supported by valuable consideration, and (5) reasonably limited as to time and place. *Id.* at 675-76, 301 S.E.2d at 143 (citing Sermons v. Caine & Estes Ins. Agency, 275 S.C. 506, 273 S.E.2d 338 (1980)).

3. Article VII of the J.W. Hunt partnership agreement contained the following clause:

> In the event a Partner either voluntarily or involuntarily leaves the employ of the Firm and such partner either "directly or indirectly" within a period of three (3) years of such departure from the Firm does work for former or existing clients of the Firm, such partner shall pay the Firm the following as liquidated damages: An amount equal to two (2) times the annual gross billings to the client for the last full year the client was a client of the Firm, which amount shall be paid within thirty (30) days of written demand by the Firm. The meaning of "directly or indirectly" is that such Partner will not render public accounting services in any of its phases, as an individual practitioner, as a member of a partnership of which he is a partner, or as an employee for an employer; provided, however, this provision shall not apply if such partner is employed by a client as an employee on a full-time basis as a treasurer, comptroller or in a similar capacity.

Davis, ___ S.C. at ___ n.1, 437 S.E.2d at 558 n.1.

enforcement of Article VII. Using the set formula, the trial court determined that Davis owed J.W. Hunt $879,068 in damages. Davis appealed.[4]

Affirming the trial court's decision, the court of appeals examined cases concerning similar provisions in accounting partnership agreements to decide whether Article VII was a covenant not to compete.[5] In *Dixon, Odom & Co. v. Sledge*,[6] *Engel v. Ernst*,[7] and *Francis v. Schlotfeldt*,[8] the partners technically were free to practice their trade and to compete with their previous partners.[9] Similarly, Article VII does not prevent Davis from competing with his former partners; he can practice his profession anywhere and can offer accounting services to anyone, including clients of J.W. Hunt. The court noted, "Article VII neither prohibits Davis from practicing public accounting for any specific period of time nor from servicing any client in any specific geographic region."[10] The court decided, therefore, that Article VII was not a covenant not to compete.[11]

Having characterized Article VII as "nothing more than a term of an ordinary contract,"[12] the court refused to apply the reasonableness test applied to covenants not to compete. Despite the potential burden on Davis, the court enforced the provision as "'a [contractual] business arrangement'"[13] "'without inquiry into its fairness.'"[14]

The court did not address the central issue the appellant raised. The court discussed whether Article VII was a covenant not to compete, a point that neither party debated.[15] According to the court, "On appeal, Davis argues the trial judge erred in concluding Article VII is not a covenant not to compete."[16] This statement of the issue does not reflect the appellant's position. Arguing "that South Carolina law requires that Article VII of the Hunt partnership agreement be analyzed under the same rules which control

4. *Id.* at ___, 437 S.E.2d at 558.

5. *Id.* at ___, 437 S.E.2d at 559.

6. 296 S.E.2d 512 (N.C. Ct. App. 1982).

7. 724 P.2d 215 (Nev. 1986) (per curiam).

8. 704 P.2d 281 (Kan. Ct. App. 1985).

9. *See Francis*, 704 P.2d at 382; *Dixon*, 296 S.E.2d at 515; *Engel*, 724 P.2d at 217.

10. J.W. Hunt & Co. v. Davis, ___ S.C. ___, ___ 437 S.E.2d 557, 559 (Ct. App. 1993).

11. *Id.* at ___, 437 S.E.2d at 560.

12. *Id.* at ___, 437 S.E.2d at 560.

13. *Id.* at ___, 437 S.E.2d at 560 (quoting Miller v. Williams, 300 So.2d 752, 755 (Fla. Dist. Ct. App. 1974), *cert. denied*, 314 So.2d 780 (Fla. 1975)).

14. *Id.* at ___, 437 S.E.2d at 560 (quoting Francis v. Schlotfeldt, 704 P.2d 381, 382 (Kan. Ct. App. 1985)).

15. See generally Final Brief of Appellant and Final Brief of Respondent, in which both parties argue as if the provision were not a covenant not to compete.

16. *Davis*, ___ S.C. at ___, 437 S.E.2d at 558.

covenants not to compete and that the Court erred in failing to do so,"[17] the appellant indirectly conceded that Article VII is not a covenant not to compete.

By focusing on the classification of Article VII, the court of appeals missed an excellent opportunity to affirm and clarify South Carolina's position established by *Almers v. South Carolina National Bank*[18] on how to treat such clauses. In *Almers* the South Carolina Supreme Court held that a clause that does not specifically prohibit competition nevertheless is treated as a covenant not to compete when the clause accomplishes the same practical result.[19] The court's decision placed South Carolina in the minority.[20]

Because *Almers* is one of only two cases on point from South Carolina, the scope of the rule announced therein is debatable. *Almers* and *Wolf v. Colonial Life & Accident Insurance Co.*[21] each concerned forfeiture clauses in employment contracts.[22] Therefore, arguably South Carolina's rule only covers forfeiture agreements. Furthermore, whether the contract's form is a determinative factor is unresolved. For example, perhaps *Almers* should apply only to cases involving employment contracts and not partnership agreements. Had the *Davis* court applied *Almers* it would have found that distinctions of form and penalty are unimportant.

Examining the reasoning of *Almers* and *Wolf*, it becomes apparent that the rule adopted by those courts should apply equally to the present case. The *Almers* case involved a forfeiture provision if the employee competed with the employer.[23] The court held that the clause accomplished the same purpose as a covenant not to compete and should be treated similarly, stating that

> our discussion throughout this case illustrates that the covenant not to compete and forfeiture upon competing are but alternative approaches to accomplish the same practical result. Therefore, we would not substitute the reasoning of the pure logician for the realities of the business world and embark on a separate course of treatment for covenants not to compete

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17. Final Brief of Appellant at 5.

18. 265 S.C. 48, 217 S.E.2d 135 (1975).

19. *See id.* at 59, 217 S.E.2d at 140.

20. *See id.* at 53-56, 217 S.E.2d at 137-38. The *Almers* court explained that the majority approach does not analogize covenants not to compete to provisions accomplishing the same result. The majority's first reason is that other penalties would not have the same immediate and overwhelming impact as a noncompetition clause that "'might disable a former employee from earning a living at what is perhaps the only occupation for which he is qualified.'" *Id.* at 55, 217 S.E.2d at 138 (quoting Couch v. Administrative Comm. of Difco Lab. Inc. Salaried Employees Profit Sharing Trust, 205 N.W.2d 24, 26 (Mich. Ct. App. 1972)). A second justification is that the freedom to contract would be impaired. *Almers*, 265 S.C. at 56, 217 S.E.2d at 138.

21. 309 S.C. 100, 420 S.E.2d 217 (Ct. App. 1992) (per curiam).

22. *See Wolf*, 309 S.C. at 103, 420 S.E.2d at 218-19; *Almers*, 265 S.C. at 50-51, 217 S.E.2d 135-36.

23. *See Almers*, 265 S.C. at 50-51, 217 S.E.2d at 136.

> and forfeiture provisions. When pruned to their quintessence, they tend to accomplish the same results and should be treated accordingly.[24]

Wolf involved an agreement that did not prohibit competition by its terms but called for forfeiture of commissions in the event of competition. The court ruled, "Such clauses are subject to the same requirements and strict analysis as covenants not to compete."[25]

In both cases, the courts examined the agreement's function and not its form to determine whether to apply the reasonableness test. Similarly, in a case like *Davis*, the form of the penalty merits application of the reasonableness test. Whether the penalty is a forfeiture or fee percentage is inconsequential.

The three policy justifications given in *Almers* for following the minority rule all support the reasonableness test's application here. First, the provision in *Almers* unduly burdened the employee. As a result, "while the employee is able to currently support himself and his family, it is likely that he or others similarly situated may be bereaved when the time for retirement has come."[26] Second, the effect of such provisions injures the general public by deterring employees from taking competitive employment.[27] Finally, the court noted the provisions' invalidity at common law. Covenants not to compete became the exception only when reasonable. However, when an employer cannot prevent the employee from competing, but can only use leverage by divesting income rights, as here, the employer attempts to avoid competition rather than to protect legitimate business interests.[28]

Since *Almers*, other courts have considered agreements similar to Article VII and have ruled that the reasonableness test applied. In *Peat Marwick Main & Co. v. Haass*[29] the Texas Supreme Court decided a case with almost identical facts and found the provision invalid.

In *Haass* two accounting firms merged pursuant to an agreement.[30] The agreement included a provision that if Haass withdrew taking clients from the merged firm, Haass would compensate the firm by paying an amount equal to "all fees and expenses, billed or unbilled, due to the Firm from such clients" and "all direct costs, . . . paid or to be paid by the Firm in connection with

24. *Id.* at 59, 217 S.E.2d at 140.
25. *Wolf*, 309 S.C. at 106, 420 S.E.2d at 220 (citing *Almers*, 265 S.C. 48, 217 S.E.2d 135).
26. *Almers*, 265 S.C. at 56-57, 217 S.E.2d at 139.
27. *Id.* at 57-58, 217 S.E.2d at 139.
28. *Id.*, 265 S.C. at 58-59, 217 S.E.2d at 140.
29. 818 S.W.2d 381 (Tex. 1991).
30. *Id.* at 382.

the acquisition of such client[s]."[31] The court held such covenants subject to the same standards of reasonableness as covenants not to compete.[32]

One of the court's reasons for its holding was the nature of the breach. Even absent a technical prohibition on competing, competition is the conduct for which damages are assessed. The penalty's deterrent effect functions as though the agreement stated expressly that the departing member will not compete when the damages are sufficiently severe. The penalty inhibits competition in virtually the same way as a covenant not to compete.[33]

In *Philip G. Johnson & Co. v. Salmen,*[34] the Supreme Court of Nebraska, considering another similar set of facts, reached the same result. An accounting firm brought action for accounting and to recover damages against a former partner. The departing partner, Salmen, withdrew from the partnership and later accepted professional employment from the firm's former clients. The accounting firm argued that the provision was not a covenant not to compete because it did not prohibit Salmen from continuing in the accounting field but obligated him to remit the fees he earned from servicing certain clients during the three years after his withdrawal from the partnership.[35] The court quickly dismissed this argument, stating that "we consider the distinction put forth by appellant to be artificial and meaningless in any real sense. The effect of the provision, if valid, is to prevent Salmen from earning income by competing for clients served by Johnson at any time."[36]

The appellant's second argument was that the arrangement concerned not employers and employees but partners. The Nebraska Supreme Court explained that the court had passed previously on the question of covenants not to compete between partners.[37] More importantly, the court noted that "a partner with such a minor interest as that held by Salmen is in a real sense no different than an employee."[38] In *Davis* the court should have considered a similar analysis.

Finally, the *Davis* court seemed to place some weight on Article VII's "afford[ing] Davis protection against withdrawing partners from the time of the Article's adoption until Davis' withdrawal."[39] The mutual benefit seems to have influenced the court in its decision to enforce strictly the provision. In *Henshaw v. Kroenecke*[40] the Texas Supreme Court also recognized the

31. *Id.* at 383 n.3.
32. *Id.* at 385.
33. *Id.*
34. 317 N.W.2d 900 (Neb. 1982).
35. *Id.* at 902-03.
36. *Id.* at 903.
37. *See id.* (citing Adams v. Adams, 58 N.W.2d 172 (Neb. 1953)).
38. *Id.*
39. J.W. Hunt & Co. v. Davis, ___ S.C. ___, ___, 437 S.E.2d 557, 559 (Ct. App. 1993).
40. 656 S.W.2d 416 (Tex. 1983).

importance of mutuality of benefit. *Henshaw* involved the enforceability of a covenant not to compete in a partnership agreement which provided for liquidated damages similar to the J.W. Hunt agreement.[41]

The *Henshaw* court explicitly rejected that only the partnership could benefit from the agreement and that the agreement was unreasonable because the only one of the partners, Henshaw, benefitted from the agreement.[42] The court held that Henshaw could benefit from the agreement and explained that the other partner, Kroenecke, benefitted too: "The covenant not to compete was an integral part of the pre-partnership formation negotiations. Henshaw was the person for whose benefit the restraint was imposed. Kroenecke, however, also benefitted by coming into an established business."[43]

Nevertheless, the court applied a reasonableness test to the covenant. In determining the terms' reasonableness, the court noted that "Henshaw had a right to protect himself from the possibility that Kroenecke would establish a rapport with the clients of the business and upon termination take a segment of that clientele with him."[44] Further, the court explained that Henshaw's having a legitimate business interest to protect made the covenant reasonable.[45]

Similarly, the *Davis* court should have taken note of the mutual benefit provided by Article VII. However, the court should have considered it merely a factor in determining the provision's reasonableness.

The South Carolina Court of Appeals republished a definition of covenants not to compete in *Davis*. The more interesting and useful questions about the scope of South Carolina's rule regarding pseudo-covenants not to compete remained uninvestigated. Future cases involving this question may find that South Carolina courts will rely on recent cases from other jurisdictions and the reasoning of South Carolina cases. If so, *Almers'* scope will be expressly expanded to include all contractual provisions involving employment. Such a holding would remain consistent with the policy underlying the *Almers* case and with other cases.

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41. *See Davis*, ___ S.C. at ___ n.1, 437 S.E.2d at 558 n.1; *Henshaw*, 656 S.W.2d at 417.
42. *Henshaw*, 656 S.W.2d at 418.
43. *Id.*
44. *Id.* (citing Hospital Consultants v. Potyka, 531 S.W.2d 657 (Tex. Ct. App. 1975)).
45. *Id.*