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Competing Policies in Covenants Not to Compete

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COMPETING POLICIES IN COVENANTS NOT TO COMPETE

Showe-Time Video Rentals, Inc. v. Douglas[1]

The Missouri Court of Appeals, Southern District recently decided *Showe-Time Video Rentals, Inc. v. Douglas,*[2] which upheld the circuit court's refusal to enforce a covenant not to compete. The resolution of *Showe-Time* required balancing the policies of fostering contractual freedom and of encouraging competition.[3] This Note will discuss freedom of contract in the context of covenants not to compete and conclude that the *Showe-Time* court did not give sufficient weight to individuals' contractual freedom and erred in not enforcing the covenant.

The facts of the case are simple. The Douglases operated a small grocery store, and Showe-Time rented video cassettes.[4] The contract between them called for Showe-Time to place video cassettes in the Douglas' store.[5] The Douglases were to manage the rentals and retain thirty percent of the receipts, with the remainder going to Showe-Time.[6] The contract was terminable at will by either party[7] and contained the following covenant against competition:

> It is hereby agreed between the parties that if this agreement is terminated for any reason with or without cause, that [the Douglases] shall be prohibited from engaging in, assisting in, organizing, managing or having any interest whatsoever in, any movie tape rental, sales or service or any vcr or vcp sales, service or rental for a period of TWO (2) years within the county limits of Butler County, Missouri.[8]

Upon commencement of the contract, Showe-Time advertised the availability of its movies at the Douglas' store,[9] thereby establishing a customer base. After thirteen months, Showe-Time terminated the agreement, according to the

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1. 727 S.W.2d 426 (Mo. Ct. App. 1987).
2. *Id.*
3. Willman v. Beheler, 499 S.W.2d 770, 777 (Mo. 1973).
4. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 427.
5. *Id.*
6. *Id.*
7. The provision read:
   This agreement shall continue in full force and effect until such time as either party shall notify the other party in writing, giving TWO (2) days' notice of their intention to terminate this agreement. Upon the termination of this agreement by either party as set out above, [the Douglases] shall within ONE (1) day of said termination return all outstanding tapes and records to SHOWE-TIME.

   Id.
8. *Id.* at 427-28.
9. *Id.* at 428.

terms of the contract, due to the low profitability of the operation.[10] After termination, the Douglases purchased their own movies and went into competition with other Showe-Time outlets in the county.[11] Showe-Time sought an injunction to prevent the violation of the covenant not to compete.[12] The trial court denied the injunction and the court of appeals affirmed, holding that where "the party in whose favor the covenant runs terminates the arrangement *without* good cause, enforcement by injunction is not so clearly established."[13]

This ruling is contrary to the clearly expressed intent of the parties as they entered the contract. As such, the *Showe-Time* decision is a marked departure from Missouri's commitment to freedom of contract and is detrimental to both economic efficiency and contractual reliance.

The strongest argument supporting contractual freedom posits that economic efficiency and value maximization are increased when individuals are allowed to determine which agreements will maximize their well being. These benefits are realized, however, only when the parties can expect that those agreements will be enforced.[14] In determining whether to enforce a contract, Posner states "[t]he economic test . . . is whether the imposition of liability will create incentives for value maximizing conduct in the future."[15] "If a rule of contract law is inefficient, whatever its noneconomic merits, the parties will simply contract around it; if forbidden to do so, there will be a price adjustment."[16]

Showe-Time does not allow parties to take advantage of a promise of future noncompetition so as to achieve the present benefit of lower prices or — as here — greater rental profits. Had the Douglases not been able to contract away their right to future competition, Showe-Time likely would have either required a higher percentage of the rents or perhaps would not have even entered into an arrangement. Without the noncompetitive agreement, Showe-Time would risk losing established customers by directing them to the Douglases yet would be unprotected if the rental arrangement turned out to be unsuccessful. In either case, the Douglas' present value would have been diminished, and accordingly the arrangement would have led to economic inefficiency.

Posner argues that a court is not as well equipped as the parties to a contract to determine what terms are reasonable.[17] In other words, he believes there is a presumption that the parties will reach an agreement that maximizes values for themselves. Any court action to change that agreement is

10. *Id.* There was no evidence indicating that the Douglases failed to turn over receipts due *Showe-Time. Id.* at 428-29.
11. *Id.* at 428.
12. *Id.*
13. *Id.* at 433 (emphasis in original).
14. R. POSNER, ECONOMIC ANALYSIS OF LAW 65-100 (2d ed. 1977).
15. *Id.* at 68.
16. *Id.* at 87.
17. *Id.* at 70-71.

presumed economically inefficient. However, if this presumption can be rebutted without inquiry into the reasonableness of the contract terms, then the court should not enforce those terms.[18] Posner concludes, however, that "[e]conomic analysis, at least, reveals no grounds other than fraud, incapacity, and duress . . . for allowing a party to repudiate the bargain that he made in entering into the contract."[19]

In contrast to the very limited inquiry called for by Posner, the *Showe-Time* court apparently determined that it was unreasonable for the Douglases to risk future opportunities in attempting to maximize present profits in their relationship with Showe-Time. The Douglases explicitly agreed not to compete for two years after termination.[20] Relying on that promise, Showe-Time supplied the Douglases with movies and advertising to promote those movies to both the general public and established Showe-Time customers.[21] Because the court refused to enforce the covenant, Showe-Time lost a part of its bargain and risks losing pre-existing customers. More fundamentally, however, the court's refusal to enforce the covenant fails to respect the parties' superior ability to structure business arrangements that maximize both their individual profits and general economic efficiency.

Missouri courts' historical protection of individual contractual freedom provides another argument that favors enforcement of the covenant. *Sanger v. Yellow Cab Co.*[22] discussed freedom of contract in the context of a release in a personal injury case:

> [i]t is the policy of the law to encourage freedom of contract and the peaceful settlement of disputes. A person under no disability and under no compulsion may convey his property or relinquish his rights for as small consideration as he may decide. To hold otherwise, while it would relieve the instant appellant of the effects of a bad bargain, would establish a harmful precedent not only as to personal injury claims, but as to contracts in general. Such a policy would make it difficult to settle controversies respecting damages to persons or property without resort to the courts.[23]

In refusing to enforce the Douglas-Showe-Time covenant not to compete, the Southern District Court of Appeals attempted to distinguish two Missouri cases which support the policy of freedom of contract in the context of covenants not to compete.[24]

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18. *Id.* at 71.

19. *Id.* at 87; *see also* Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983).

20. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 427-28.

21. *Id.* at 428.

22. 486 S.W.2d 477 (Mo. 1972) (en banc); *see also* Landmark N. County Bank & Trust Co. v. National Cable Training Centers, Inc., 738 S.W.2d 886, 890 (Mo. Ct. App. 1987); Christeson v. Burba, 714 S.W.2d 183, 195 (Mo. Ct. App. 1986); Dewitt v. Lutes, 581 S.W.2d 941, 945 (Mo. Ct. App. 1979).

23. *Sanger*, 486 S.W.2d at 480 (quoting Vondera v. Chapman, 352 Mo. 1034, 1039, 180 S.W.2d 704, 705-06 (1944)).

24. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 432.

First, in *American Pamcor, Inc. v. Klote*[25] plaintiff terminated the defendant's employment without cause[26] yet the court upheld a covenant prohibiting solicitation of the plaintiff's customers.[27] The *Showe-Time* court distinguished *American Pamcor* upon the grounds that the nonsolicitation agreement in *American Pamcor* was narrower than the noncompetition agreement in *Showe-Time*.[28] But this distinction ignores the breadth which the *American Pamcor* court gave the agreement. That court found that by the mere act of sending his salesmen "into the forbidden territory" and accepting orders the defendant had breached the covenant.[29] The defendant argued his termination without cause should bar enforcement of the agreement.[30] In reinforcing Missouri's commitment to freedom of contract the court stated "[h]owever appealing that argument may be, it does not free us from following the maxim that equity follows the law. We must accord the parties their lawful rights as they set those rights by their contract."[31]

The second case the *Showe-Time* court distinguished is *Willman v. Beheler*.[32] In *Willman,* Dr. Willman hired Dr. Beheler to work in his medical practice.[33] When they became partners, Beheler agreed that if he left the partnership "voluntarily or involuntarily . . . he [would] not practice medicine for a period of 5 years" in the same area.[34] Willman later terminated the partnership without cause.[35] The Missouri Supreme Court refused to enforce the covenant by injunction but rather directed the lower court to determine and award money damages.[36] The *Showe-Time* court found this remedial distinction adequate to negate the applicability of *Willman* to the Douglas-Showe-Time dispute.

But this ignores the fact that the Supreme Court determined in *Willman* that the agreement was enforceable in equity. The court simply refused to equitably enforce the agreement because the original five year period had expired. It thus felt money damages would be more appropriate than the imposition of an injunction beyond the date called for in the contract.[37] The *Willman* court honored the freedom of contract more than did the *Showe-Time* court. Basically, the *Showe-Time* court did not enforce the contract because Showe-Time terminated without cause.[38] Yet the *Willman* court stated that "[u]nder

25. 438 S.W.2d 287 (Mo. Ct. App. 1969).
26. *Id.* at 289.
27. *Id.* at 291.
28. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 432.
29. *American Pamcor, Inc.*, 438 S.W.2d at 291.
30. *Id.*
31. *Id.*
32. 499 S.W.2d 770 (Mo. 1973).
33. *Id.* at 773.
34. *Id.*
35. *Id.* at 774.
36. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 432.
37. *Willman*, 499 S.W.2d at 777-78.
38. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 434.

this contract it was not necessary for Willman to show that he had good cause . . . to dissolve the partnership. The partnership agreement contained no such requirement as a precondition to dissolution and none will be read into the contract by judicial construction."[39] This statement clearly indicates that Missouri law would allow the termination of an arrangement without cause and still enforce a covenant not to compete. Both the *Willman* and *American Pamcor, Inc.* decisions provide a solid basis of freedom of contract that outweighs the competing policy of encouraging competition. The *Showe-Time* court should have given more weight to this policy and enforced the contract as the parties had agreed.

In *Christeson v. Burba*,[40] Judge Crow, who wrote the opinion in *Showe-Time*, stated that "the policy of the law is to let the parties weigh the benefits pro and con and to leave them free to make whatever contract between themselves that they please."[41] He also stated that "[t]he general rule of freedom of contract includes the freedom to make a bad bargain."[42] Yet this policy was not even mentioned in the *Showe-Time* case. The remainder of this Note will explore possible explanations for the exclusion of consideration of this policy by the *Willman* court, and conclude that none of them are satisfactory.

One reason for not enforcing the covenant, though not explicitly mentioned in the opinion, is that the contract may have seemed so harsh that the court treated it as an unconscionable adhesion contract. Refusal to enforce the contract on the basis of its being an adhesion contract falls under the category of procedural unconscionability.[43] Professor Kronman describes an adhesion contract as one where "there is a striking imbalance in the bargaining power of the parties to a contract, so that one is able to dictate terms to the other . . . ."[44] This description does not fit the facts of this case. While Showe-Time is larger than the Douglas' store, they are both business operations and should be treated as such. It would be difficult to say that Showe-Time was in an unfair or superior bargaining position. Further, in the context of an employment contract, the court of appeals has indicated that to preclude enforce-

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39. *Willman*, 499 S.W.2d at 776.

40. 714 S.W.2d 183 (Mo. Ct. App. 1986).

41. *Id.* at 195 (citing Hathman v. Waters, 586 S.W.2d 376, 385 (Mo. Ct. App. 1979)).

42. *Id.*

43. In referring to unconscionability under the Uniform Commercial Code, the doctrine is described as follows:

> [A] distinction is made between "substantive" and "procedural" unconscionability. By substantive unconscionability is meant an undue harshness in the contract terms themselves. On the other hand, procedural unconscionability in general is involved with the contract formation process, and focuses on high pressure exerted on the parties, fine print of the contract, misrepresentation, or unequal bargaining position.

Funding Sys. Leasing Corp. v. King Louie Int'l, Inc., 597 S.W.2d 624, 634 (Mo. Ct. App. 1979).

44. Kronman, *supra* note 19, at 770.

ment of an agreement as an adhesion contract, one must show that the offeree had no choice but to accept the agreement.[45] In *Showe-Time,* there is no indication that the Douglases were in that type of situation in accepting Showe-Time's offer. In fact, after the relationship was terminated, the Douglases bought their own movies and rented them to the public.[46] They did "have a real choice" whether or not to sign the contract.[47]

Another possible argument against enforcement of the Showe-Time-Douglas covenant is that if the Douglases had read and understood the contract, they would never have signed it. This argument would fit the category of substantive unconscionability.[48] One commentator, in describing this type of unconscionability, stated:

> [v]ery speculative contracts which turn out badly, involving substantial loss, nearly always look foolish and unfair to the person who has lost. And his predicament will often attract the sympathy of third parties who may feel that the other party to the transaction has not really deserved his gains.[49]

This appearance of unfairness and the resultant sympathy, however, is not sufficient reason for refusing to enforce the contract as entered. "[O]ne who signs a paper, without reading it, if he is able to read and understand, is guilty of such negligence in failing to inform himself of its nature that he cannot be relieved from the obligation contained in the paper thus signed. . . ."[50] The policy of freedom of contract should prevail over the court's sympathy for the Douglases.

The strongest reason, and the one this court relied on, for overcoming the policy of contractual freedom is the opposing policy favoring competition and narrow construction of restraints on trade.[51] Missouri, however, historically has placed a greater emphasis on contractual freedom, as opposed to the policy against restraint of trade, than did the *Showe-Time* court.[52] Generally, for a covenant against competition to be enforceable, it "must serve a proper interest of the employer in protecting the good will of a business, and must be reasonably limited in time and space."[53] The covenant in *Showe-Time* appears

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45. USA Chem., Inc. v. Lewis, 557 S.W.2d 15, 24 (Mo. Ct. App. 1977).

46. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 428.

47. "[T]he purchaser who is offered a printed contract on a take it or leave it basis does have a real choice: he can choose to refuse to sign, knowing that if better terms are possible another seller will offer them to him." R. POSNER, *supra* note 14, at 85.

48. *See supra* note 43.

49. P. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 82 (1979).

50. Sanger v. Yellow Cab Co., 486 S.W.2d 477, 481 (Mo. 1972) (en banc) (quoting Higgins v. American Car Co., 324 Mo. 189, 193, 22 S.W.2d 1043, 1044 (1929)).

51. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 186, 188 (1979).

52. Willman v. Beheler, 499 S.W.2d 770 (Mo. 1973); American Pamcor, Inc. v. Klote, 438 S.W.2d 287 (Mo. Ct. App. 1969). For an in-depth treatment of *Willman* and *American Pamcor, Inc.*, *see supra* notes 25-39 and accompanying text.

53. Osage Glass, Inc. v. Donovan, 693 S.W.2d 71, 74 (Mo. 1985) (en banc). The

to meet all of these elements. The interest that Showe-Time was seeking to protect was erosion of its customer base.[54] This interest is sufficient for enforcement of the covenant.[55] The time and space restrictions also appear to be reasonable.[56] The Douglases were only restricted for two years and only within Butler County.[57] Reasonableness, and correspondingly enforcement, further depends on the public not being harmed.[58] The covenant against competition in *Showe-Time* would have little effect on the public, as there were several other video cassette outlets in the county.[59] The supply of cassettes and the number of competitors in the county would not be substantially reduced by enforcement of the covenant. The reason the covenant was not enforced boils down to the court not recognizing the freedom of the Douglases to agree not to compete after termination of the relationship without cause in exchange for Showe-Time's commitments under the contract.

In reaching its conclusion the court principally relied on the Massachu-

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origins of this reasonableness standard have been explained as follows:

> Covenants of the kind here involved, being in restraint of trade, were first regarded by the courts as contrary to public policy and hence invalid. The reason for such rule was two fold, namely, injury to the public and injury to the employee. The restraint worked injury to the public by depriving it of the industry to which the employee was best suited, and tended to cast the employee and his family upon the public for support. It also fostered monopolies, prevented competition, and tended to raise prices. . . . The doctrine had its origins at a time when the field of human enterprise was limited, and each man's activity was necessary to the material welfare of his community. Travel was difficult, and the conditions of the times were unfavorable to the migration of persons seeking employment. . . . But with improved facilities of travel, and the growing ability of workers to adapt themselves to different applications, the reason for the rule disappeared, with the result that the courts began to uphold reasonable restraints on employment on the theory that such covenants were beneficial to both parties—being beneficial to the employee for the reason that it enabled him to dispose of his services advantageously, and beneficial to the employer because it protected him against a competition which would not otherwise have existed except for the employment.

Renwood Food Prods., Inc. v. Schaefer, 240 Mo. App. 939, 951, 223 S.W.2d 144, 150-51 (1949).

54. *See Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 428.

55. *Osage Glass, Inc.*, 693 S.W.2d at 75.

56. *See generally* Osage Glass, Inc. v. Donovan, 693 S.W.2d at 71 (upholding covenant not to compete for 3 years in employment contract); Willman v. Beheler, 499 S.W.2d at 770 (upholding covenant not to compete for 5 years within a 20 mile radius of the city limits); Herrington v. Hall, 624 S.W.2d 148, 152 (Mo. Ct. App. 1981) (upholding covenant not to compete for 3 years within a 10 mile radius); R.E. Harrington, Inc. v. Frick, 428 S.W.2d 945, 950-51 (Mo. Ct. App. 1968) (upholding covenant not to compete for 3 years in any state in which the employer did business); Prentice v. Rowe, 324 S.W.2d 457, 463 (Mo. Ct. App. 1959) (upholding covenant not to compete for 2 years within the large service area).

57. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 432.

58. *See supra* note 53.

59. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 434.

setts case of *Economy Grocery Stores Corp. v. McMenamy*[60] and the Texas case of *Security Services, Inc. v. Priest*.[61] Each refused to enforce covenants not to compete. Both, however, are distinguishable from *Showe-Time*. In *Economy Grocery*, an employee was terminated without cause under an employment at will contract.[62] The court refused to enforce the noncompetition covenant.[63] This result in *Economy Grocery*, however, did not frustrate the intentions of the parties to the contract in that the agreement provided for noncompetition if the relationship was terminated "voluntarily or involuntarily."[64] The contract was silent on whether it was applicable to a termination without cause. In other words, a termination may be voluntary or involuntary regardless of whether it is with or without cause. In *Showe-Time*, the contract specifically said that the noncompetition agreement would be applicable if the "agreement is terminated for any reason with or without cause."[65] *Security Services, Inc.* is distinguishable because, in addition to the fact that there was no cause for termination of the relationship, there was also proof that the plaintiff acted in bad faith in entering into the contract in that he intended to only hire the defendant for long enough to obtain his customer contacts and then discharge him.[66] In contrast, there is no proof of bad faith on the part of Showe-Time in entering into the arrangement. In fact, the relationship continued for thirteen months before Showe-Time terminated it.[67]

The concurring opinion of Chief Justice Williams in *Security Services, Inc.* is also of interest. He stated:

> I concur only in the result reached by the majority. In my opinion the judgment should be affirmed on the sole ground that plaintiff has failed to present sufficient evidence that defendant's admitted competitive endeavors have damaged plaintiff's business so as to justify the issuance of an injunction. . . .
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> However, I wish to disassociate myself from the remainder of the majority opinion. The record reveals that the parties entered into a perfectly legal contract which gave each the right to terminate the same without cause. I fail to see any issue concerning cancellation of the contract. I cannot accept the admitted dicta in cases from other states which attempt to weaken the established law in Texas dealing with contracts that include covenants against competition.[68]

This statement reflects Justice Williams' view that freedom of contract is being dishonored by the decision in *Security Services, Inc.*. In adopting the opinions of these two courts, the Southern District Court of Appeals has under-

60. 290 Mass. 549, 195 N.E. 747 (1935).
61. 507 S.W.2d 592 (Tex. Civ. App. 1974).
62. *Economy Grocery Stores Corp.*, 290 Mass. at 551, 195 N.E. at 748.
63. *Id.* at 553, 195 N.E. at 749.
64. *Id.* at 550, 195 N.E. at 747.
65. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 427.
66. *Security Servs., Inc.*, 507 S.W.2d at 593, 595.
67. *Showe-Time Video Rentals, Inc.*, 727 S.W.2d at 428.
68. *Security Servs., Inc.*, 507 S.W.2d at 596 (Williams, C.J., concurring).

mined Missouri's clearly established policy of contractual freedom.[69]

When individuals no longer have confidence that the parties with whom they deal will be forced to stand by their promises, they have no incentive to enter contracts establishing economically efficient arrangements. Such a lack of incentive discourages the combination of capital so as to accomplish objectives which are individually unattainable. The result is both individual and societal injury. Such injury should weigh in a court's decision not to enforce a freely entered contract. In *Showe-Time*, however, it was ignored.

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69. *See supra* notes 22-42 and accompanying text.