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COVENANTS NOT TO COMPETE IN THE REAL PROPERTY CONTEXT: AN UPDATE

by Lynda Butler* and Matthew Klepper**

Covenants which restrict the use of land for the purpose of protecting against competition have been consistently enforced by Virginia courts so long as the covenants are reasonable, not contrary to public policy, not in restraint of trade and not for the purpose of creating a monopoly.¹ Restrictive covenants of any type are strictly construed due to the strong policy reasons supporting the unrestricted use of land.² Drafting an enforceable restrictive covenant is generally of little value, however, unless the covenant can be enforced against subsequent purchasers of the property. Although Virginia courts traditionally have refused to enforce noncompetition covenants as real covenants against successors to the burdened land by a judgment for damages at law,³ the courts have allowed enforcement by injunction in equity under the doctrine of equitable servitudes.⁴

The doctrine of equitable servitudes was first described in the famous English case of Tulk v. Moxhay.⁵ In that case the court ruled that equity would enforce an agreement to use or

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³RESTATEMENT (THIRD) OF PROPERTY (SERVITUDES) § 3.6 cmt. a (Tentative Draft No. 2, 1991). The courts apparently reasoned that covenants not to compete could not meet the touch and concern requirement. See, e.g., Tardy v. Creasy, 81 Va. 553 (1886) (building restriction held not to run with the land because the benefit did not touch and concern). A restrictive covenant runs with the land—and therefore benefits or burdens a subsequent owner of the land—when the covenant involves an enforceable promise, the parties intend for the covenant to run and bind successors in interest, the covenant touches and concerns the land, and privity of estate exists between the covenanting parties. See Net Realty Holding Trust v. Franconia Properties, Inc., 544 F. Supp. 759, 762 (E.D. Va. 1982). See generally 20 AM. JUR. 2D Covenants, Conditions, and Restrictions § 1, 2 (1982); 21 C.J.S. Covenants § 25 (1990).

⁴See, e.g., Carneal v. Kendig, 196 Va. 605 (1955) (covenant not to use land as a movie theater upheld in equity).

⁵2 Phil. 774 (Ch. 1848).
abstain from using land in a particular way or manner against any purchaser or possessor with notice regardless of whether the agreement created a valid covenant running with the land at law. Early on, the Virginia courts applied the doctrine of equitable servitudes to noncompetition agreements, enforcing the burden of competition restrictions in equity against all purchasers with notice.\textsuperscript{7} In \textit{Oliver v. Hewitt},\textsuperscript{8} the court upheld a covenant restricting the sale of groceries and soft drinks on conveyed land and cited with approval the doctrine of \textit{Tulk v. Moxhay}. The earlier holding of the court in \textit{Tardy v. Creasy},\textsuperscript{9} which exemplified the traditional disfavor of noncompetition covenants in the law, was distinguished by an exceptionally narrow reading. Relief was denied in \textit{Tardy}, according to the court in \textit{Oliver}, "primarily upon the ground that the restrictive covenant was illegal and unenforceable because it constituted a general restraint of trade."\textsuperscript{10}

The most troubling question about noncompetition covenants facing Virginia courts during the first part of this century was whether the benefit of a competition restriction could be enforced in equity by a subsequent purchaser.\textsuperscript{11} The Virginia Supreme Court, in \textit{Hercules Powder Co. v. Continental Can Co.},\textsuperscript{12} held that the benefit may pass to subsequent purchasers when there is proof that the parties intended the benefit to attach to the land in equity. The \textit{Hercules} court articulated a standard for when the benefit would pass to successors in interest which revolved solely around intent: "the intention of the parties [is] the criterion of the existence of the right. . . ."\textsuperscript{13} This standard was important because it failed to mention the touch and concern requirement that was a traditional element of both real covenants and equitable servitudes. Although the touch and concern requirement presented a serious obstacle to

\textsuperscript{6}The promisee's rights and entitlements are known as the "benefit," while the promisor's duties are known as the "burden." See Richard Powell, \textit{The Law of Real Property} § 673[2] n.30 (P. Rohan rev. ed. 1990).

\textsuperscript{7}See Oliver v. Hewitt, 191 Va. 163 (1950) (covenant not to sell groceries on conveyed land enforced in equity).

\textsuperscript{8}Id.

\textsuperscript{9}81 Va. 553 (1886).

\textsuperscript{10}Oliver v. Hewitt, 191 Va. at 169-70 (quoting Tardy v. Creasy, 81 Va. at 561-62 (1886)).


\textsuperscript{12}196 Va. 935 (1955).

\textsuperscript{13}Id. at 947 (quoting Cheatham v. Taylor, 148 Va. 26, 39 (1927)).
enforcement of noncompetition covenants at law, the requirement was generally of little consequence in equitable servitude cases. As one commentator explained,

Equitable servitudes invariably involve negative covenants—promises with respect to how land should not be used. Such promises clearly do touch and concern the land, so the courts of equity, for the most part, have not stated nor found it necessary to state touch and concern as a separate requirement.

Virginia courts appear to have ignored the touch and concern requirement in evaluating the enforceability of noncompetition covenants in equity, and seem to have followed the suggestion of many commentators to focus squarely on the public policy issues involved. Focusing on the public policy issues allows the courts to avoid artificial manipulations of the already difficult touch and concern test and thus minimizes further frustration of the expectations of lawyers and their clients.

In evaluating noncompetition clauses in the real covenant context, at least one court has substituted a "reasonableness" test for the traditional touch and concern requirement as its pivotal inquiry. The court in Davidson Bros., Inc. v. D. Katz & Sons, Inc. explained that courts today recognize that "parties in commercial-property transactions" may need "to protect themselves from competition by executing noncompetition covenants"; without the covenants, the parties may hesitate to invest substantial sums in the property. "A 'reasonableness' test allows a court to consider the enforceability of a covenant in view of the realities of today's commercial world and not in the light of out-moded theories developed in a vastly different commercial environment."

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20 Id. at 295.

21 Id.
In defining its reasonableness test, the court in Davidson borrowed from an analogous standard used to determine the validity of employment noncompetition covenants. This standard allows enforcement of an employee noncompetition covenant if it "protects the legitimate interest of the employer" without imposing "undue hardship" on the employee and "is not injurious to the public." Touch and concern considerations played only a small role in the court's development of "reasonableness" factors. According to the court, "[a]spects of the 'touch and concern' test. . . remain useful in evaluating the reasonableness of a covenant" by helping to distinguish between promises that were intended to affect the use and value of the land and bind subsequent owners and those that were intended to be personal to the covenanting parties only. The court then rejected a narrow approach to determining whether the use and value of land were benefitted by a noncompetition covenant. The appropriate benchmark was not the size of the burdened property relative to the market area, but rather the lessening of competition in the market area. Furthermore, this benchmark was but one of many factors to consider in evaluating the reasonableness of the covenant.

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22 Id. at 296. For a discussion of Virginia's approach to employment noncompetition covenants, see the article by Robert Billingsley, which appears next in the Fee Simple.

23 Strangely, the court neglected to mention the touch and concern test when listing the reasonableness factors. This omission could be interpreted as evidence that the court did in fact abandon the touch and concern test, despite the court's assertion to the contrary. More likely, however, the touch and concern element is implied in one of the first two factors listed by the court ("intention[s] of the parties" and "considerations exchanged"). See FRANZESE, supra note 17, at 251.

24 Davidson, 579 A.2d at 296.

25 Id. at 297.

26 Factors listed by the court in Davidson include:

1. The intention of the parties when the covenant was executed, and whether the parties had a viable purpose which did not at the time interfere with existing commercial laws, such as antitrust laws, or public policy. 2. Whether the covenant had an impact on the considerations exchanged when the covenant was originally executed. This may provide a measure of the value to the parties of the covenant at the time. 3. Whether the covenant clearly and expressly sets forth the restrictions. 4. Whether the covenant was in writing, recorded, and if so, whether the subsequent grantee had actual notice of the covenant. 5. Whether the covenant is reasonable concerning area, time or duration. Covenants that extend for perpetuity or beyond the terms of a lease may often be unreasonable. 6. Whether the covenant imposes an unreasonable restraint on trade or secures a monopoly for the covenantor. This may be the case in areas where there is limited space available to conduct certain business activities and a covenant not to compete burdens all or most available locales to prevent them from competing in such an
The court in *Davidson* was clearly attempting to free the policies behind the touch and concern requirement from the technical rules that governed application of the requirement. Although numerous commentators have posited opinions on the proper interpretation of the touch and concern test, one of the most sensible statements of the test focuses on the reasonable expectations of the ordinary purchaser. This analysis asks whether the reasonable layman would expect the promise to be personal, tied up with the land, or both. Any analytical tool, including the complicated reasonableness formula posited by the court in *Davidson*—which successfully realizes the policy goals underlying the touch and concern test while pulling back the mysterious shroud of the touch and concern test—serves a valuable function in defining why some sort of limitation on restrictive covenants is necessary. Analysis which is directed at effectuation of the policy goals of the traditional touch and concern test, whether it be the ordinary purchaser test or a complicated reasonableness formula, applies equally well in the equitable servitudes context as in the real covenant area.

Virginia's courts have steadfastly resisted the use of real covenant law in evaluating the enforceability of noncompetition covenants against subsequent purchasers. The only case in the recent past which has even mentioned the requirements of a real covenant while evaluating a noncompetition agreement was *Net Realty Holding Trust v. Franconia Properties, Inc.*, a federal case applying Virginia state law. Simply stated, noncompetition covenants are generally valid when reasonable and are enforceable in equity against subsequent purchasers with notice of the agreement when the parties intended the agreement to bind successors in title. Both benefits and burdens of noncompetition covenants may pass to subsequent purchasers with notice when the intent requirement is satisfied. Virginia law today has taken an important step towards a principled reconciliation of the competing policies implicated by noncompetition covenants. The importance of allowing free alienability of land while still respecting the ability of private parties to meaningfully contract regarding the future use of land is recognized by Virginia law, which focuses clearly on the intent of the contracting parties, the fairness of

activity. 7. Whether the covenant interferes with the public interest. 8. Whether, even if the covenant was reasonable at the time it was executed, "changed circumstances" now make the covenant unreasonable.

*Id.* at 295.


29 *Id.* at 211.


enforcement by and against subsequent purchasers, and the protection of the public interest. The next step for the Virginia courts is to consider the possibility of making a clean break with the past and focusing directly on the public policy considerations of enforcing noncompetition agreements against subsequent purchasers--perhaps even without regard for the original parties' intent.32

32 The draft Restatement (Third) of Property makes significant breaks with traditional servitudes law in at least two instances. First, the Restatement combines easements, profits, real covenants, equitable servitudes, and irrevocable licenses into the primary category of servitudes. The draft presents servitude law as an integrated body of rules and principles. The drafters explain that, except in a few instances, "all the servitude devices are functionally similar." Restatement (Third) of Property (Servitudes) introduction at xxiii (Tentative Draft No. 1, 1989). Second, the Restatement proposes the elimination of the horizontal privity of estate requirement and the touch and concern requirement from servitudes law. Id. § 2.4.; id. § 3.2 (Tentative Draft No. 2, 1991).