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Contracts

Luther P. Cochrane

Curtis W. Martin

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By Luther P. Cochrane* and Curtis W. Martin**

This year's contract decisions offer a review of some legal issues of first impression, along with a refinement and restatement of positions taken previously by the State's appellate courts. Among other decisions, the court of appeals has ruled that an employee may recover benefits described in an employer's brochure in spite of a master employment plan that stated benefits in a more limited fashion.[1] The supreme court has refined the law governing covenants restricting competition, distinguishing between such covenants in employment contracts and sale-of-business contracts.[2] This article discusses that distinction and its implications. Our appellate courts also continued their strict view that a contract may vest absolute discretion in one party and eliminate any implied duty of good faith.[3] These decisions, among others, are the subject of this review.

One of the most interesting cases decided this year by Georgia's jurists involved principles of estoppel applied to an employee's attempt to recover benefits described in a company brochure. In *Hercules, Inc. v. Adams*,[4] the brochure given to the employee painted a broader picture of available benefits than were actually provided in the company's more detailed compensation plan, which the employee never saw. The employer's brochure stated that it would pay an injured worker the difference between Georgia workmen's compensation benefits and lost wages, without specifying any time limit on such benefits. The master plan provided for those benefits, but only up to thirteen months, giving the company the option to pay further benefits beyond that time. Plaintiff employee

* Partner in the firm of Griffin, Cochrane & Marshall, P.C., Atlanta, Georgia. University of North Carolina (B.A., 1970; J.D., 1974). Member of the State Bar of Georgia and American Bar Association.

** Associate in the firm of Griffin, Cochrane & Marshall, P.C., Atlanta, Georgia. Duke (A.B., 1974); Harvard (J.D. 1979). Member of the State Bar of Georgia and American Bar Association.

1. Hercules, Inc. v. Adams, 150 Ga. App. 223, 257 S.E.2d 289 (1979).
2. Jenkins v. Jenkins Irrigation, Inc., 244 Ga. 94, 259 S.E.2d 47 (1979).
3. Automatic Sprinkler Corp. v. Anderson, 243 Ga. 867, 257 S.E.2d 283 (1979).
4. 150 Ga. App. 223, 257 S.E.2d 289 (1979).

moved for summary judgment on the basis of the employer's summary of benefits and that motion was granted. On appeal, the court of appeals held that a summary of the terms of an employee benefit plan control the outcome of the case in spite of the existence of a more detailed master plan, but only where the trier of fact determines that the employee reasonably relied upon the summary of benefits and was not put on notice of a different and controlling master plan.

The court held that such a brochure could establish an obligation to provide benefits described therein. The issue argued by the three dissenting justices was whether the employee benefit summary relied upon by plaintiff established the employer's liability as a matter of law. The dissenting justices argued that the employee had no actual notice of the existence of a contradictory master plan, and that summary judgment was appropriate. The majority rejected this approach, however, saying that the brochure established an obligation to provide the described benefits *only* if the brochure was reasonably interpreted to reflect such an intent, without qualification. Adopting the test of *Gallo v. Howard Stores Corp.*,[5] the majority held that the brochure would bind the employer, even "without any intention to assume legal obligations, where such conduct and words [in the summary] would be understood by a reasonable man of ordinary intelligence that such words and conduct reflected his [the employer's] intention."[6] Following this rationale, the majority remanded the case for a determination as to whether the information contained in the summary booklet placed the employee "on notice that the booklet contained a summarization—which was not binding . . ."[7] and that a master plan provided more limited benefits.

This case represents a new source of liability for employers whose benefit plans are summarized in booklets provided to employees. However, under the court's ruling, the trier of fact must hold that the policy does not put the employee on notice of another controlling and potentially different plan. Whether this case should have been remanded to the trier of fact is less important than the right of recovery set forth by this decision. The court finds an obligation established by a brochure describing benefits, basing its rationale upon the actual construction of the words contained in the employer's benefit summary. If the summary implies an intent to provide benefits, then the employer is bound by the summary, regardless of its actual purpose. The employee's interpretation of the availability of benefits need only be reasonable. Thus, the court has found a possible obligation implied by an employer's statement in a brochure,

5. 145 F. Supp. 909 (E.D. Pa. 1956).
6. 150 Ga. App. at 227, 257 S.E.2d at 291.
7. *Id.*, 257 S.E.2d at 292.

regardless of actual intent, consideration, or action taken in reliance on the statement. The court does not specify its basis for the decision, but its concern for the reasonable interpretation of the brochure's promises suggests a theory of estoppel to be applied to an employer's statements regarding benefits.

The past year's decisions reveal a substantial number of cases seeking interpretation of restrictive covenants arising out of employment agreements. Most of these decisions routinely interpret those restrictive covenants in accordance with general principles governing the enforceability of such agreements only when they are properly limited. However, in *Jenkins v. Jenkins Irrigation, Inc.*,[8] the supreme court held that a restrictive covenant associated with the sale of a business would be interpreted far more liberally than restrictive covenants associated with employment. The case arose out of a restrictive covenant in a contract where a fifty percent shareholder of a business sold his stock to another party. The court held that the territorial restriction in the covenant was unreasonable, but nevertheless stated that the covenant would be upheld by applying the "blue pencil" theory of severability. The court in effect rewrote the territorial limitation to encompass a smaller, more reasonable area and upheld the restrictive covenant as modified. The court thus treated this covenant associated with the sale of a business far more liberally than those ancillary to employment contracts.

The court's rationale for this different treatment was based upon the seller's receipt of full consideration for executing the agreement. The court reasoned that in a sale of a business covenant the seller "receives an equivalent for his partial abstention from that business in the increased price paid for it on account of his covenant. . . . "[9] The court asserted that the ability to sign such a covenant enhances the seller's position by allowing him to get the full benefit of the sale of the company, including its good will.

To the extent that the court's rationale rests upon this theory of additional consideration received by the seller for the signing of a restrictive covenant, we must necessarily compare this situation to a covenant associated with an employment contract. It could be argued that by signing an agreement not to compete, an employee may under some circumstances bargain for and receive greater compensation in exchange for the agreement not to compete as the seller of a business receives greater value for his sale of stock. While it may be true that employees are generally in a less favorable bargaining position than sellers of stock, the court's rationale as to the consideration received for the restrictive covenant

8. 244 Ga. 94, 259 S.E.2d 47 (1979).
9. *Id.* at 98, 259 S.E.2d at 50.

necessarily rests on an arbitrary line, assuming as it does that the seller has greater ability to bargain for consideration for the restrictive covenant than does the employee. The court has made the judgment that the seller of a business is more likely to receive compensation for his undertaking the covenant than is the employee. This generalization is probably defensible, because in most circumstances the seller of a business has more bargaining power than an employee, and thus could expect to receive greater consideration for the execution of the restrictive covenant. However, it must also be recognized that employees under some circumstances would similarly have the ability to bargain for consideration in exchange for the signing of such a covenant. As such, the distinction drawn by the court as a result of its analysis may be somewhat arbitrary although generally defensible.

The second theory offered by the supreme court to support its decision, however, seems less persuasive. The court states that restrictive covenants associated with the sale of a business are not intended to restrict competition, and, in fact, have little effect on restricting competition. The opinion suggests that after the sale of the business, the business continues to exist and do business with the public, and that the vendor can switch businesses or pursue the same line of business in another locality. However, taken strictly, we find these arguments unpersuasive, as they seem to apply equally to an employee.

The court suggests that restrictive covenants in connection with the sale of the business are not intended to restrict competition and do not restrict competition, as the business remains to serve the public. Whether restrictive covenants in connection with the sale of the business are intended to restrict competition is a question which must at best remain open. As to the second point, however, the court's distinction seems illusory. The court says that a restrictive covenant in connection with the sale of a business is not anticompetitive because the sold business continues to serve the public. However, this would also appear to be true of a business which loses an employee under the threat of a restrictive covenant. Indeed, there seems to be little difference between the effects on the public of the two restrictive covenants. The fact that the vendor might pursue another line of business seems little different from the employee's ability to assume another line of work. Indeed, the sole difference would be that the vendor might have funds from the sale of the business which would allow him more flexibility. Thus, the sale of a business covenant does not seem materially different from an employment covenant under this theory.

The court's ruling in *Jenkins* is perhaps best understood as a distinction which is based upon the nature of that transaction and a generalization as to bargaining power. Indeed, although this rationale is not explicit, the court's reference to *Rita Personnel Services International,* *Inc. v. Kot*[10] indicates that the court had this distinction in mind. By rejecting the blue pencil theory of severability for restrictive covenants ancillary to employment contracts, the supreme court seeks to prevent employers from writing broad covenants not to compete with the knowledge that they will be enforced as reasonable. Thus, the court's rationale as to employee covenants is to induce the employer to write the restrictive covenant as narrowly as possible, in the hopes that the contract will be enforceable, thereby reducing the *in terrorem* effect on employees.[11] The court assumes, probably correctly in most cases, that the seller of a business bargains for and receives consideration for this right in most cases, and that the covenant in such a transaction therefore has no *in terrorem* effect.

The court's distinction in *Jenkins* between restrictive covenants associated with employment agreements and those ancillary to the sale of a business has already required interpretation where a contract appeared to have elements of both employment and the sale of a business. In *Redmond v. Royal Ford, Inc.*,[12] the supreme court was faced with a restrictive covenant included in a contract for employment which also gave the employee a ten percent stock interest, but provided for other stock interest to be sold back to the company upon the employee's termination. The employer argued that the covenant was ancillary to the sale of an interest in a business and that it should be interpreted and upheld under *Jenkins*. The court rejected this theory, holding that the contract was in fact executed in connection with employment, and related more to the purchase of an interest in a business, than its possible eventual resale. In other words, the court held that the existence of a repurchase option in the contract would not in itself render the restrictive covenant subject to the blue pencil theory of severability. As the court stated, that restrictive covenant "was not made by the seller in conjunction with the sale of the business; it was made by the buyer in conjunction with the acquisition of an interest in the business."[13] This decision demonstrates the questions of interpretation which will be faced by Georgia judges in light of the supreme court's distinction in *Jenkins* between restrictive covenants in employment contracts and sale of business contracts.

The court of appeals rejected an interesting theory supported by California case law in *Butts v. Atlanta Federal Savings & Loan Association*.[14] In that case, the plaintiffs were a couple purchasing a home to be con-

10. 229 Ga. 314, 191 S.E.2d 79 (1972).

11. *See* Blake, *Employee Agreements Not To Compete*, 74 HARV. L. REV. 625 (1960); *See, e.g.*, Rita Personnel Services Int'l, Inc. v. Kot, 229 Ga. 314, 191 S.E.2d 79 (1972).

12. 244 Ga.711, 261 S.E.2d 585 (1979).

13. *Id.* at 714, 261 S.E.2d at 588.

14. 152 Ga. App. 40, 262 S.E.2d 230 (1979).

structed by a contractor who went bankrupt. The lender in that case was required to perform periodic inspections to assess the degree of completion in connection with making periodic progress payments to the contractor based upon those inspections. Dissatisfied with the construction, plaintiffs sued the lender for the damages resulting from defective workmanship, on the theory that the lender's inspections gave rise to a duty of care towards plaintiffs. Relying upon *Connor v. Great Western Savings & Loan Association*,[15] a California case, plaintiffs argued that the lender's inspections were not only to determine the degree of completion, but also were intended to benefit plaintiffs by assuring quality workmanship.

The court of appeals rejected this theory, noting that plaintiffs had in fact authorized disbursements to the contractor by their own signature, and that the lending institution conducted its inspections for its own benefit and owed no special duty to plaintiff to protect it from defective construction. This result would seem to be the best view. In most cases the construction lender does not owe any duty of vigilance over workmanship to the purchaser, and no such duty is expected by the parties or written into the contract. Indeed, there is no reason to expect lending institutions to share the liability of a contractor's defective workmanship. The existence of a duty for one purpose cannot be interpreted as a duty for a completely different purpose. While a lending institution has an interest in the adequacy of construction, this interest does not require the lending institution to undertake a general duty to protect the home buyers through the lender's inspections, which are conducted for an entirely different purpose and solely for the benefit of the lender. It is worth noting that the California Legislature has followed the *Connor* case by enacting a statute[16] exempting lenders from liability to third parties arising from defects in construction absent some rule beyond the lending of money or some affirmative participation in misrepresentations with respect to the construction. Thus, Georgia's decision on this issue leaves the *Connor* case as it should be, an isolated exception to the general rule that the lender owes no special duties to borrowers for the detection or reporting of liability of a third party.

The supreme court used broad language in one of last year's decisions to uphold the vesting of absolute discretion in one party to a contract. The language used by the court in *Automatic Sprinkler Corp. v. Anderson*[17] may be broader than necessary and may, as a result, create future inequities. The case involved an employment contract specifying that the company could pay incentive compensation to an employee in its sole dis-

15. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).
16. CAL. CIV. CODE § 3434 (West 1970).
17. 243 Ga. 867, 257 S.E.2d 283 (1979).

cretion. When none was paid, and the employee voluntarily terminated his employment, he sued for unpaid compensation, alleging that the company had a duty to exercise its discretion in good faith and without any abuse of discretion. The court upheld the discretion vested in the contract, however, holding that the contract did not require any incentive compensation and the company had retained the discretion to determine what compensation would be paid. In doing so, the court used exceptionally broad language, which, if carried into other areas, would absolve parties of any responsibility to act in good faith or use discretion without abuse. The court quoted the following language from a previous decision of the court of appeals: "What the intent of the parties was in making the contract must control; it is possible to so draw a contract as to leave decisions absolutely to the uncontrolled discretion of one of the parties and in such a case the issue of good faith is irrelevant."[18] The court continued, "There can be no breach of an implied covenant of good faith where a party to a contract has done what the provisions of the contract expressly give him the right to do."[19]

It is this broad language that is troubling. It is certainly true that in this case the contract expressly provided no standard by which the employer was required to exercise discretion in determining the extent of incentive compensation. In other cases there may be such a yardstick, express or implied, giving rise to a duty of good faith in employing such discretion. For example, a construction contract may call for the architect, as the owner's representative, to exercise his sole discretion in interpreting the plans and specifications. The plans and specifications themselves form a standard for their interpretation. If the language from *Anderson* is applied to that situation, however, the architect would have no good faith requirement to follow the intent of the plans and specifications. In fact, under this decision, the architect would be free to impose any decision he desired for the owner, absent an express requirement that he was to exercise that discretion in good faith. The authors note that many contracts vest absolute power in a third party as an arbiter of disputes. The case under discussion, however, would give that right to a party to the contract, without any requirement of fair dealing or good faith. Such uncontrolled discretion may be appropriate here, where expressly reserved by the contract. We are concerned, however, about this rule's possible application to other circumstances, where there has been no such reservation. In those cases, we believe the contract should include an implied condition of good faith.

Of course, it is possible to reconcile the example of the architect with

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18. *Id.* at 868, 257 S.E.2d at 284 (citations omitted).
19. *Id.*

Anderson by suggesting that the reference to or the existence of plans and specifications might itself be a distinguishing factor, requiring good faith in following the intent of such a document as an implied standard where no such guidelines exist. Alternatively, the rule enunciated in *Anderson* may be limited to those situations where the contract clearly and unambiguously vests absolute discretion upon one of the parties. This limited interpretation is suggested in the penultimate paragraph of the opinion,[20] distinguishing *Montgomery Ward & Co. v. Reich*,[21] and further supported by the court's more recent decision in *Clear-Vu Cable, Inc. v. Town of Trion*,[22] which in another context adopted the view of the *Restatement (Second) of Contracts* that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[23] If, on the other hand, the court's intention is to render absolute any vesting of discretion unless expressly qualified, then the court will have imposed a substantial injustice on parties who agree to vest discretion for an act or decision on one party, by precluding the requirement of good faith or noncapricious use of that discretion.

The supreme court ruled in *Jim Walter Corp. v. Ward*[24] that the reasonable diligence in uncovering fraud to toll the statute of limitations should be measured by an objective standard. In that case, plaintiff brought suit when it discovered the forgery of certain security deeds and loan instruments by defendants. Defendants cited the statute of limitations as their primary defense. In order to avoid the statute,[25] for fraud, defendants had to show, *inter alia*, that they had been reasonably diligent in discovering the cause of action. The trial court charged the jury that "[i]n determining whether the plaintiffs exercised the required degree of diligence to discover the actual fraud, you are authorized to consider all of the facts and circumstances of this case including the mental capacity and education of the plaintiffs."[26] The supreme court reversed this decision, remanding it to the trial court for a new trial, stating that reasonable diligence must be measured by an objective standard, as what would have been understood by a reasonably prudent person. It is significant to note, however, that the court's standard is not an unyielding one. In fact, although diligence is to be judged by an objective standard, the court's opinion carefully notes that this objective standard must be ap-

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20. *Id.* at 869, 257 S.E.2d at 285.
21. 131 Colo. 407, 282 P.2d 1091 (1955).
22. 244 Ga. 790, 262 S.E.2d 73 (1979).
23. *Id.* at 792, 262 S.E.2d at 75, *quoting* RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tent. Draft).
24. 245 Ga. 355, 265 S.E.2d 7 (1980).
25. GA. CODE ANN. § 3-807 (Supp. 1980).
26. 245 Ga. at 356, 265 S.E.2d at 8.

plied to the circumstances of each case. With this flexibility, the court recognizes and gives the judge or jury the opportunity to consider the circumstances which might make it more difficult for the *reasonably prudent person* to uncover fraud with reasonable diligence and thus avoid the statute of limitations.