LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 32, Number 1 • November 2014

Employee Noncompete Agreements

Anticipate Them Early In the Bankruptcy Sale Process

By Robert A. Soriano

Often overlooked assets in bankruptcy sales are the noncompete agreements or noncompete covenants in employment contracts that debtors have with certain employees. Due to the low number of reported cases addressing the treatment of noncompete agreements in bankruptcy sales and abundance of conflicting precedents across different states, it is important for attorneys and their clients to anticipate and address these issues early in the bankruptcy sale process in order to avoid costly litigation and legal uncertainty.

Several different persons — including the debtors, asset purchasers, stalking horse bidders, and, of course, employees — may have an interest in how these agreements are handled in bankruptcy sales, making them increasingly relevant in bankruptcy sales considering that *The New York Times* recently reported they are on the rise (Steven Greenhouse, Noncompete Clauses Increasingly Pop Up in Array of Jobs, *N.Y. Times*, June 9, 2014, at B1).

- A debtor who is not selling all its assets may wish to retain valued employees to operate the remaining business. Alternatively, the noncompete can be an additional asset having added value that can be realized for the debtor's estate.
- A purchaser seeking to realize the going concern value of the debtor's assets may want to retain the key employees who operate those assets. Furthermore, a purchaser may not want to see key employees of the debtor go to a business competitor.
- A stalking horse bidder does not always end up being the purchaser of the debtor's assets. Nevertheless, during the course of its due diligence, it may come across employees of the debtor whom it would like to hire. Whether it may hire these employees depends, among other things, on the legal status of any noncompete agreements after the assets are sold.
- The employee who agreed to a noncompete as a condition to his employment with the debtor may not wish to work for the purchaser of the debtor's assets. Can he be forced to do so or must he find employment in another field or another place?

Following are some helpful considerations for attorneys to keep in mind when counseling clients in these matters.

The Bankruptcy Sale Process

Whether done pursuant to a plan of reorganization or § 363 of the Bankruptcy Code, bankruptcy sales follow a generally predictable process. The debtor (or a bankruptcy trustee) and the potential purchaser enter into an asset purchase agreement (APA). The debtor then seeks bankruptcy court approval of the agreement and a procedure for bringing the matter before the court. The approval process usually provides for, among other things, publishing notice of the proposed sale, giving other persons the ability to submit higher and better offers for the assets, and a breakup fee and/or expense reimbursement should the original proposed purchaser (the "stalking horse") be outbid by someone else. Competing bidders are normally given access to financial information and frequently required to execute some form of nondisclosure agreement before doing so. The stalking horse also may have entered into such an agreement.

Deadlines for completing the process are established in the sale procedures order. Among them is one for selecting which of the debtor's assets a person wishes to purchase and which executory contracts and unexpired leases it wishes to assume. Frequently, there is a list of excluded assets that the purchaser is not interested in acquiring. In some instances, the procedures provide that contracts and leases that the purchaser does not assume are deemed rejected.

Potential Problems

If the noncompete agreement is not addressed by the parties, numerous problems may arise. First, it will not be clear whether it is a part of the assets being sold. Some courts have held that a noncompete agreement "passes as an incident of the business sold, even though not specifically assigned … ." *Hexacomb Corp. v. GTW Enterprises, Inc.*, 875 F. Supp. 457, 464 (N.D. Ill. 1993), quoting *A. Fink & Sons v. Goldberg*, 101 N.J. Eg. 644, 139 A. 408, 410 (N.J. Ct. Chan. 1927). Cf. *Campbell v. Millennium Ventures, LLC*, 132 N.M. 733, 55 p.3d 429, 435-36 (N.M. Ct. App. 2002) (employment agreement not listed as asset to be purchased or excluded asset would be included in purchase as

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part of good will of business).

Other courts have held to the contrary:

> The asset sale agreement states that all contracts not listed as assumed contracts are excluded assets. The agreement lists three noncompetition covenants as "assumed contracts," but is silent regarding Burkhardt's covenant. Thus, by implication, Burkhardt's covenant, as an unlisted contract, was not included in the asset sale. (footnotes omitted)

See also Traffic Control Services, Inc. v. United Rentals Northwest, Inc., 120 Nev. 168, 176, 87 P.3d 1054 (Nev. 2004).

If the purchaser wants to obtain the noncompete agreement, it should list it as an executory contract to be assumed, but that does not necessarily mean it will be transferred. The noncompete agreement may not be an executory contract at all. The classic definition of an executory contract is "a contract under which the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *Lubrizol Ent., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmand Finishers, Inc.*), 756 F.2d 1043, 1045 (4th Cir. 1985), quoting V. Countryman, Executory Contracts in Bankruptcy: Part I, 57 *Minn. L. Rev.* 439, 460 (1973). Therefore a noncompete or a restrictive covenant in an employment contract may not be executory if the employment contract is terminated and nothing is later to be performed by either party. If so, it cannot be assumed and assigned. *See AutoMed Technologies, Inc. v. Eller*, 160 F. Supp. 2d 915, 924 (N.D. Ill. 2001). CF. *In re Noco*, 76 B.R. 839 (Bankr. N.D. Fla. 1997) (covenant not to compete in franchise agreement not executory and therefore cannot be assumed or rejected).

And even if the noncompete is treated as an executory contract, it may not be subject to assignment to a new party. Some states do not permit the assignment of a noncompete agreement without the consent of the employee. *See, e.g., Corporate Express Office Products, Inc. v. Phillips*, 847 So. 2d 406, 412 (Fla. 2003) ("In an asset purchase, the liabilities and responsibilities of each party would be set forth in the parties' agreement. … Thus, when the sale of the assets includes a personal service contract that contains a noncompete agreement, the purchaser can enforce its terms only with the employee's consent to an assignment.") (Florida law); *Traffic Control Services, Inc., supra* (Nevada law); *Hess v. Gebhard & Co., Inc.*, 570 Pa. 148, 808 A.2d 912, 918-22 (Pa. 2002) (Pennsylvania law); and various cases cited therein holding that this is the law in Alabama, Connecticut, Vermont, Delaware, Indiana, New York, and Ohio. Bankruptcy Code § 365(c)(1) does not permit the assumption or assignment of a contact if "(i) applicable law excuses [the non-debtor party] to such contract … from rendering performance to an entity other than the debtor, and (ii) the non-debtor party does not consent to the assumption or assignment."

… even if the noncompete is part of an agreement that is deemed executory and rejected as part of the sale process, it may still be enforceable.

To complicate the issue still further, even if the noncompete is part of an agreement that is deemed executory and rejected as part of the sale process, it may still be enforceable. There are lines of cases that arise in connection with franchise and personal services agreements that contain noncompete provisions and are rejected in a bankruptcy case. In one line, courts hold that the covenant not to compete remains enforceable notwithstanding rejection. *See Top Rank, Inc. v. Ortiz* (*In re Ortiz*), 400 B.R. 755, 770 (C.D. Cal. 2009) ("bankruptcy court's conclusion that the trustee's rejection of the contract … terminated the contract and extinguished any claim for breach [of a boxing exclusivity provision] … was erroneous."); *In re Steaks To Go*, 226 B.R. 35 (Bankr. E.D. Mo. 1998) (noncompete provision in franchise agreement remains enforceable after rejection); *In re Klein*, 218 B.R. 787 (Bankr. W.D. Pa. 1998)(same).

The other line of cases hold that a rejection of the agreement also constitutes rejection of the noncompete. *Silk Plants, Etc. Franchise Systems, Inc. v. Register*, 100 B.R. 360 (M.D. Tenn. 1989); *In re Rovine Corp.*, 6 B.R. 661 (Bankr. W.D. Tenn. 1980).

Practice Pointers

If you are the debtor-employer, consider their potential value and whether you have the ability to realize that value in connection with the sale. This will depend upon how the agreement or provision is drafted and the jurisdiction whose law governs the agreement. On the other hand, if you wish to retain certain employees after a sale, make that clear.

If you are a potential purchaser of assets of the debtor, as early as possible in the process consider how important being able to retain the debtor's staff is to you. If it is, you should address it as early as in any nondisclosure agreement you enter into — even before you enter into an asset purchase agreement. Make sure you will have the right to solicit such employees after the sale even if you ultimately are not the successful bidder for the assets. Be sure to include these contracts as part of the assets you wish to purchase in the asset purchase agreement and list them on executory contracts to be assumed. It may be advisable (and perhaps even necessary) to obtain the employee's consent to the assignment of the contract.

If you are an employee subject to a noncompete, review the law in your jurisdiction and analyze your options. You may have rights to protect and the ability to leverage your position in connection with the sale.

Planning ahead and taking the right steps upfront can help minimize the issues and maximize the successful outcomes in the long run.