Function Follows Form - Enforcement of Restrictive Covenants After Company Acquisition May Hinge on Structure of the Deal

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In late 2009 and early 2010, Pennsylvania state and federal appellate courts clarified the ability of employers to assign non-competition agreements as part of a merger or sale of a company. In both cases, the court distinguished between a stock sale and an asset sale. Both courts held that non-competition agreements with employees could be assigned, even without the employee's consent, if the change in ownership of the company is effected through a stock, rather than an asset, acquisition.

The holding of the courts in both cases was not a given. Previously, two lower court decisions, in Cumberland County and Dauphin County reached contrary conclusions. These lower court decisions applied what they believed to be the analysis of the 2002 Pennsylvania Supreme Court in *Hess v. Gebhard*, in which the court refused to enforce a non-competition agreement of an insurance salesman who resigned after his employer was sold to a new company. Noting that restrictive covenants must be construed narrowly because they restrain an employee's right to earn a living, the *Hess* court pointed out that an employee may be willing to sign a restrictive covenant as a condition of working for one employer but not another. It then held that restrictive covenants are not enforceable by an acquiring company unless the non-competition agreement specifically permits the employer to do so.

The decision in *Hess* involved an asset purchase agreement. Thereafter, questions were raised as to whether the same analysis would apply to a stock sale of a company. As noted above, some courts determined there was no difference. The Dauphin County Court opined, "unless an employee explicitly agreed to an assignability provision, an employer may not treat him as some chattel to be conveyed, like a filing cabinet, to a successor firm."

That approach was recently rejected by both state and federal appellate courts. In late 2009, in *J. C. Ehrlich Co., Inc. v. Martin*, the Superior Court of Pennsylvania noted the transaction at issue "merely accomplished a stock purchase, not the sale of Ehrlich's assets." As the employee's company remained the same (albeit under different ownership) and his duties and responsibilities did not change, the new owners could enforce the agreement that he had signed with Ehrlich.

Then in 2010, the Third Circuit Court of Appeals solidified this approach in *Zambelli Fireworks Manufacturing Co. v. Wood*. In *Zambelli*, the defendant was a highly trained pyrotechnics expert who designed, sold, and executed specially choreographed fireworks displays. Resigning after the owners of the privately held company sold their interests, he argued that his non-competition agreement was unenforceable because he never agreed to allow his employer to assign it and did not want to work for the new owners. The court disagreed, reasoning that Pennsylvania courts have historically held the transfer of a corporation's stock does not destroy the corporate entity, and therefore Zambelli's employer did not actually change.

Taking the logic of *Ehrlich* and *Zambelli* one step further, a Pennsylvania trial court recently applied the analysis to the change in ownership of a limited liability company (LLC). In *American Home Supply Mid-Atlantic v. Gannon*, the Court of Common Pleas of Lackawanna County determined the purchase of a membership interest in an LLC "was synonymous to a stock sale rather than an asset sale."

These cases highlight what can be a critical issue in the purchase of a business. A substantial portion of a company's value may consist of intangibles such as good will, trade secrets, customer information, and the specialized training and intellectual capital of its employees. Non-competition agreements are a key tool in a company's arsenal for protecting these intangibles. When acquiring a company, the buyer has a strong interest in making sure non-competition agreements are in place and will be enforceable after the acquisition. Key employees—who might bristle at a change in control or management—may be tempted to go to work for a competitor, substantially reducing the value of the newly acquired business.

Ehrlich and *Zambelli* give guidance on one aspect of how a transaction can or should be structured. If enforcement of non-competition agreements is a critical aspect of the acquisition, the purchaser should seriously consider whether a purchase of stock is a viable approach. If it is not, the purchaser should look closely at whether the existing non-competition agreements contain provisions permitting the employer to assign the agreements to another party. Absent such authorization, the purchaser should not count on acquiring the ability to enforce the restrictions. Conversely, to ensure maximum value of its assets at the time of a sale, a seller of a business would be wise to ensure that its key employee non-competition agreements contain assignment clauses.

If a deal must proceed as an asset purchase, and key employees do not have assignment provisions in their agreements, the prospective buyer may consider other options, such as:

- asking the seller to execute new restrictive covenants with key employees before the acquisition is concluded or even announced (making certain adequate consideration is provided);
- using the adequacy of the restrictive covenants as a bargaining point to negotiate a better purchase price; or,
- drafting contract provisions for post-sale price adjustments should key employees voluntarily leave within a certain timeframe.
- Ultimately, no matter what form the final deal takes, good planning is essential.