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DISTINGUISHING BETWEEN NON-COMPETITION AGREEMENTS IN EMPLOYMENT AGREEMENTS AND THOSE IN THE SALE OF A BUSINESS

BY JAMES V. IRVING, ESQUIRE

While non-competition arrangements are subject to strict scrutiny in the context of employment agreements, enforceability is governed by a more flexible standard when the agreement arises in the context of the sale of a business.

In *Capital One Financial Corporation v. Kanas and Bohlsen*, the Honorable Liam O'Grady of the U.S. District Court for the Eastern District of Virginia was presented with the rare opportunity to delineate the characteristics that distinguish between the two arrangements and to test the reasonableness of a five-year restriction with nationwide limits on competition.

Over many years, Kanas and Bohlsen ('the Partners") develop a very successful banking business in the New York Metropolitan area; so successful that in 2006, Capital One acquired North Fork Bank from the Partners for $13.2 billion. The terms of the sale included post-sale employment for the Partners with Capital One and a Restrictive Share Agreement providing that the Partners would not engage in "competitive business" for five years after ending their employment with Capital One. While most of the post-employment restrictions were national in scope, the range of each restriction was carefully tailored to the lines of business that were considered competitive.

The Partners left Capital One in July 2007. In May 2009, they formed BankUnited in Florida, where Capital One had no branches. However in 2011, within the restricted period, BankUnited acquired mortgage loan portfolios within the restricted area and then acquired a Maryland bank that made equipment loans nationwide. Conscious of the non-compete, BankUnited and the Partners implemented a "ring-fencing structure" in an effort to isolate the Partners so that they were "not providing services" within the meaning of the non-compete. Capital One did not find the ring-fencing to be adequate and brought suit to enforce the non-competition agreements. The Partners responded by filing a Motion for Summary Judgment, asking the Court to void the non-competition agreement.

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In reviewing the Partners' Motion for Summary Judgment, Judge O'Grady pointed out that Virginia courts have developed two frameworks for analyzing non-competition agreements, depending on whether the covenant is ancillary to the sale of a business or arises from an employment relationship. When analyzing non-competes between a seller and a buyer of a business, greater latitude is allowed in determining the reasonableness of the restraint. Since the Capital One dispute contained elements of both types of arrangement, Judge O'Grady's first step was to determine which analytical template applied.

According to Judge O'Grady, the two key features of the Sale of Business framework are that the owner of a business conveys its "full value on its sale by contracting not to destroy the goodwill of that business through immediate competition" and that the transaction is the result of "an arms-length negotiation between sophisticated parties of comparable bargaining power."

In the case of the Partners' separation from Capital One, the body of the Separation Agreement is consistent with "the metes and bounds of the parties' employer/employee relationship" and there is no reference to the sale of North Fork's goodwill or the other assets of the business. Judge O'Grady also found other characteristics particular to the employment relationship: that confidential information received "during their employment" was provided to the Partners during the term of their employment; that the non-compete ran from the termination of employment and not the date of the sale; and that the covenant not to compete was not a condition of the sale of North Fork. The Judge concluded that while "it is true that… policy considerations favor proceeding under the sale-of-business framework…. [n]onetheless, policy considerations alone cannot dictate the applicable framework." The determination that the far stricter employment standard of analysis applied, was a preliminary victory for the Partners.

Judge O'Grady then evaluated the enforceability of the non-competition agreement under the well-established test of reasonableness of duration, geography and function in light of the employers legitimate business interests. Particularly in light of the five-year duration and the national scope of the functional prohibition, the restriction appeared vulnerable under the employment test.

However, the Court also found it to be indisputable that Kanas and Bohlsen had, during the course of their employment, access to confidential information and personal contact that allowed them to developed strong professional relationships with Capital One's customers. Moreover, Capital One had legitimate reason to fear "the Defendants' ability to grow a bank into a formidable competitor. After all, they had done it before." In light of the Partners' unusual ability to compete successfully, the Court found that the provision was reasonable in both geographical scope and duration. Because it was "no broader than reasonably necessary," the provision was enforceable.

By sustaining a non-competition agreement with a five-year duration and national restrictions on competition, Judge O'Grady upheld a provision outside the generally accepted boundaries of reasonableness under the employee-employer framework. But, the Judge also reminds us that in Virginia, non-competes must always be analyzed on a case-by-case basis – what is unreasonable in one context might be acceptable in another. In this case, the value of the consideration to the Partners, their business sophistication, and their admitted ability to make a living without violating the non-compete all argued that, even under the strict employer-employee standard, the five-year non-compete was no broader than necessary to protect Capital One's legitimate interests, and that is the ultimate measure of enforceability.

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ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

BY RACHELLE E. HILL, ESQUIRE

Prior to the statutory creation of corporations, limited liability companies and limited partnerships, a partnership was a commonly employed business entity. As a result of parties seeking to limit their liability, most entities created today employ one of the foregoing statutorily created entities. Yet, partnerships still frequently appear, whether created prior to the statutory changes or implied on the basis of the parties' activities. Although partnerships are often overlooked, this entity offers advantages and disadvantages, particularly when working jointly with third parties.

One unique aspect of the partnership is the ease with which it is created and/or implied. Virginia adopted the Revised Uniform Partnership Act, which defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." Va. Code 50-73.79. A "partnership agreement" is an agreement, whether written, oral or implied, among the partners concerning the partnership. Virginia Code Section 50-73.79. Notably, a written agreement is not required to create a partnership.

Regardless of the parties' intent, a partnership is created as soon as two or more parties associate to carry on a business. The law presumes that a person who shares in the profits of a business is a partner of the business unless such profits are received in payment of a debt, rent, annuity, interest on a loan, sale of goodwill of a business or for services of an independent contractor. Therefore, a partnership is presumed to have been created in some cases, whether or not the parties intended to engage in such a joint venture.

On the other hand, where parties intend to create a partnership but their activities do not meet the definition, a Court will not defer to the parties' intent. Virginia courts follow a minority rule which requires a partnership to be based on more than a single transaction. The Virginia Supreme Court has expounded on the Partnership Act to make "to carry on" a defined term meaning: "the conduct of a business for a sustained period for the purposes of livelihood or profit and not merely the carrying on of some single transaction." *Walker, Mosby & Calvert v. Burgess*, 153 Va. 779, 787, (1930). Therefore, where parties enter into an agreement that pertains to one specific transaction – for example the purchase, renovation and resale of a single property – it is not a partnership agreement by definition. Most jurisdictions recognize partnerships for a particular purpose that dissolve upon completion. Co-ownership of partnership property is an essential element of a partnership.

In *Walker*, the Plaintiff owned three lots and contracted with a second party, Senseney, to construct a house on each lot. Pursuant to the parties' agreement, the Plaintiff was to provide the land and capital for each project, and Senseney was to provide material and labor. The agreement provided that whichever party sold the house would receive a commission, but after all houses were sold, the profits or losses would be shared equally. Despite the profit loss agreement, the Virginia Supreme Court held that the written agreement did not create a partnership because only a single transaction was contemplated, and there was no language indicating the parties were co-owners of the property. The Court found that Senseney was an independent contractor who was to be paid a share of the profits.

It is also presumed that partners share profits equally. In a partnership where one party contributes 1 percent of capital and the other contributes 99 percent, the two will share the profits equally unless a different arrangement is reached.

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Parties must be careful when working jointly with a third party, as certain conduct may lead to the creation of a partnership, whether or not the parties intend to create one or are aware of the creation. The partnership entity exposes each partner to unlimited liability, regardless of the party's contribution. Therefore, where a party only contributes 1 percent of the capital, he or she could be liable for 100 percent of damages attributable to the partnership. Parties seeking to limit their liability should create a different entity, such as a limited partnership or limited liability company.

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