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Labor and Employment Issues in Special Servicer and Other Third-Party Management Agreements

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When a special servicer or third-party manager takes over a distressed asset or franchise, no one thinks about labor and employment issues until a problem surfaces. While a special servicer or third-party manager with its own employees in the area can usually expect a smooth transition, these arrangements often occur in places that are far-removed from the headquarters or home office. A special servicer may simply assume that it is taking over the former operator's employees, and not think twice about other labor issues.

A troubled asset owner often ignores employee risk factors that more stable employers evaluate to decide whether to hire or pass on a job applicant. Here are some of the issues to be aware of:

- First, the special servicer or manager should determine if the employees, particularly sales people or other individuals who have contact with the customers or clients, may be subject to agreements that restrict their employment with the business. Employees may have non-competition covenants or agreements prohibiting them from working for any competing company, which could apply to the special servicer or manager, even if the covenants did not apply to the former asset owner. The new operator's hiring of an individual with a non-competition agreement could result in litigation against the employee for breach of the agreement, or against the new employer and its affiliates for interfering with that non-competition agreement. An employee may also have less obvious non-solicitation provisions that under certain circumstances prohibit that individual from soliciting their former customers or clients, which may restrict the effectiveness of the employee. If the prior employer has ceased to exist, then the agreements may unenforceable, but if the employer continues to exist, such an agreement can be enforced assuming that it meets the requisite state requirements for enforcement. In this economy, there has been a great deal of litigation in this area as employees have become more desperate and employers more protective.
- Second, the special servicer or manager will want to take steps to ensure that it is not considered a successor employer to the prior employer. This is important to avoid being liable for any of the employees' existing claims under the federal and state anti-discrimination laws. If the special servicer or manager assumes all of an entity's employees at a recognized location and has notice of potential claims for unlawful discrimination or retaliation, it runs the risk of assuming defense and liability for those claims from the prior employer. To mitigate the likelihood of that result, the special servicer should have all the employees go through the normal hiring process, including the application process and any background checks required of all new hires. If the special servicer is able to have contact with management of the prior employer, it should also ask if there are any pending charges of discrimination with the Equal Employment Opportunity Commission or any similar state agency, any internal complaints or grievances, or any pending lawsuits. Presumably the reporting covenants of the asset owner mandated notice of such events, but those reports need to be available to the human resource decision-makers. If any such claims are identified, the special servicer may want to reconsider a wholesale hiring all of the current employees.
- Third, the special servicer or manager should give careful consideration to which entity will become the new employer. If a special purpose entity is created to operate as the asset manager, the manager may want the individuals to be employees of that entity in order to isolate the parent or any related company. Despite the temptation to use centralized payroll payment from the parent entity,

the safer method is to pay the new employees of a manager out of the proceeds from the continuing operation of the business if possible, or capital contributed by the sponsor to the special purpose operating entity.

- Fourth, if the special servicer or manager anticipates hiring the employees who were already working at the entity, it must be clear with the employees and the former asset owner entity about when the employees will become the special servicer's employees and the when the special servicer will be responsible for providing them pay and benefits. A distressed franchisee or asset owner will probably not want to pay the employees past the day it lost control of the entity. It may take several days, however, for the special servicer to hire the new employees formally, while they continue to provide services as normal without being sure of their employer's identity. If only a few individuals are involved, the new operator may benefit from avoiding a fight with the prior owner over what entity is responsible for those few days when it was unclear for whom the employees were working. Moreover, the new employer probably does not want to start the relationship with these new employees by having a dispute over whether it owes them compensation for the time period before they actually were hired.
- Although the financial and operational issues usually dominate the conversation about the taking over of an entity by a special servicer or a third-party manager, there are also important labor and employment issues that should be considered. Failure to consider these could result in disruption in the workplace, an inability to operate the business as expected and unanticipated potential liability.
- There are also some practical issues to consider when taking over or running a distressed business. Because of its lack of profitability, a distressed business may have less revenue available to pay wages and, therefore, may need to hire workers willing to work for these lower wages. These types of workers may lack the credentials normally required to satisfy most screening criteria or may lack the documentation required by federal law. Moreover, a distressed company that is working with a reduced roster will be required to work its employees for longer hours. This could lead to employees working overtime without receiving the required additional pay or working off the clock, both of which are violations of federal and state wage and hour laws. These realities argue strongly for taking the steps necessary to insulate the successor owner/operator from prerecovery liabilities for employees, and for careful, deliberate pre-employment screening of continuing employees.

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