

**IN THE UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF ARKANSAS
HARRISON DIVISION**

**IN RE: DANIEL JOHN SMAKAL and
BRANDILYN NICHOLE SMAKAL, Debtors**

**No. 3:09-bk-70117
Ch. 7**

ADVANCED DETECTION SYSTEMS, INC.

PLAINTIFF

v.

No. 3:09-ap-07048

DANIEL JOHN SMAKAL

DEFENDANT

ORDER

Before the Court are the remaining causes of action in Advanced Detection's complaint to determine the dischargeability of its debt under 11 U.S.C. § 523(a)(2)(A) and § 523(a)(6).¹ The trial proceeded on February 17, 2011, as to Advanced Detection's causes of action under § 523(a)(2)(A) and § 523(a)(6), and at the conclusion of the trial, the Court took the matter under advisement. For the reasons stated below, the Court denies Advanced Detection's request for relief under § 523(a)(2)(A) and § 523(a)(6).

Jurisdiction

The Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and 28 U.S.C. § 157, and it is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I). The following findings constitute findings of fact and conclusions of law in accordance with Federal

¹ Advanced Detection's complaint originally objected to Smakal's discharge under § 727(a)(4)(A) and sought to determine the dischargeability of its debt under § 523(a)(2)(A) and § 523(a)(6). In addition, Advanced Detection alleged in its complaint that it had a claim against Smakal under the Arkansas Deceptive Trade Practices Act. On November 17, 2010, Smakal filed a motion for summary judgment, and on December 8, 2010, Advanced Detection filed a response and supporting brief. In its response, Advanced Detection withdrew its claim under the Arkansas Deceptive Trade Practices Act. The motion for summary judgment was granted in part as to the § 727(a)(4)(A) cause of action because Advanced Detection failed to allege any facts relevant to that code provision, and denied in part as to the causes of action under § 523(a)(2)(A) and § 523(a)(6).

Rule of Bankruptcy Procedure 7052.

Background

In 1995 or 1996, Smakal was employed by Advanced Detection, a small business located in Mountain Home, Arkansas, that installs and maintains security alarm systems. After a relatively short period of time at Advanced Detection, Smakal ended his employment and moved to Louisiana. While in Louisiana, Smakal worked for multiple businesses that specialized in security alarm systems and also established his own business in the same field. Smakal and Stephen Vester, owner and sole shareholder of Advanced Detection, remained in contact during the following years, and, in 2003, they began discussions regarding the possibility of Smakal purchasing Advanced Detection. Because of those discussions, Smakal relocated to Mountain Home and became re-employed by Advanced Detection as a service and installation technician while attempting to acquire financing for the purchase of Advanced Detection. Smakal and Vester agreed that Smakal would have a one-year exclusive option to buy the business.

Despite Smakal's attempts, he was unable to acquire financing for the purchase of Advanced Detection within the first year. Smakal and Vester discussed possible financing through Vester, but ultimately, Smakal unsuccessfully sought financing on his own. Over the next few years, the parties continued to work under the assumption that Smakal would eventually succeed in purchasing the business. In January 2006, Vester had each employee at Advanced Detection, including Smakal, sign a document entitled "Non-Competition, Non-Solicitation and Confidentiality Agreement" [the Agreement]. The Agreement contained separate provisions for a non-compete agreement, a non-solicitation agreement, and a confidentiality agreement, and also included a severability clause that stated that if a provision was found to be unenforceable, the remaining provisions were to be interpreted "to reasonably effect the intent of the parties." Vester stated at trial that he had become aware of potential competition from another business in the community and believed that the Agreement was necessary to protect Advanced Detection. In addition, he stated that he and Smakal had consulted about the Agreement

and both had agreed that having the Agreement would be beneficial to the business and to Smakal in the event that Smakal purchased it. Smakal was not involved in drawing up the terms of the Agreement or in the execution of the Agreement by the other employees.

In June 2006, Smakal began preparations to open his own business named Electronic Systems Technologies, Inc. [EST]. On June 22, 2006, Smakal executed and filed with the Arkansas Secretary of State the Articles of Incorporation for EST that stated that the corporation's primary purpose was "electronic systems sales and service." The Articles of Incorporation were signed by Smakal, as president, and listed his wife and himself as the incorporators. On July 1, 2006, Smakal and his wife entered into a two-year lease agreement on a building on behalf of EST for the purpose of conducting a retail business in Mountain Home.² On July 4, 2006, Smakal applied for a license for a "Class 'E' Alarm Systems Company" from the Arkansas Board of Private Investigators and Private Security Agencies on behalf of EST; the license was approved on July 26, 2006. On July 12, 2006, Smakal was terminated from his position at Advanced Detection. He then began working exclusively for EST, which installs and maintains security alarm systems in the Mountain Home area in direct competition with Advanced Detection.

Issues

Advanced Detection seeks a determination of the dischargeability of its debt under § 523(a)(2)(A) and § 523(a)(6), and alleges that the debt arises from damages caused by Smakal's breach of the provisions of the Agreement. The Court will examine what debt, if any, resulted from the alleged breach of the provisions of the Agreement and whether exception to discharge is applicable under § 523(a)(2)(A) and § 523(a)(6).

² Smakal testified that at the time he leased a building for EST, he intended to operate it only as a home theater company, which was not in competition with Advanced Detection. This testimony appears disingenuous when considered with the alarm systems company license Smakal applied for three days after executing the lease agreement.

Analysis

A. Validity of the Non-Competition Provision of the Agreement

In Arkansas, a non-compete agreement is valid if three requirements are met: (1) the covenantee has a valid interest to protect; (2) the geographical restriction is not overly broad; and (3) a reasonable time limit is imposed. *Advanced Env'tl. Recycling Techs., Inc. v. Advanced Control Solutions, Inc.*, 275 S.W.3d 162, 172 (Ark. 2008). To determine whether a restraint provision is reasonable, a court must consider whether it is “only broad enough to afford a fair protection to the interest of the party in whose favor it is given and not so large as to interfere with the interests of the public.” *Freeman v. Hiller*, 281 S.W.3d 749, 754 (Ark. Ct. App. 2008). The challenging party has the burden of showing that the non-compete agreement is unreasonable. *Moore v. Midwest Distrib., Inc.*, 65 S.W.3d 490, 493 (Ark. 2002).

Arkansas courts review covenants not to compete with stricter scrutiny when the agreement is in connection with an employment contract rather than in connection with the sale of a business. *HRR Ark., Inc. v. River City Contractors, Inc.*, 87 S.W.3d 232, 239 (Ark. 2002). While the sale of Advanced Detection from Vester to Smakal was contemplated at the time that Smakal signed the Agreement, the Court finds that the Agreement was signed under the conditions of employment rather than the sale of the business. Therefore, the non-compete provision must be reviewed with a stricter level of scrutiny. The non-compete provision of the Agreement signed by Smakal includes the following language:

- (a) Except as provided below, during the period commencing on the Effective Date and ending two years following the date employment terminates for whatever reason (the “Restrictive Period”), Employee shall not, in any county, country or other jurisdiction in which the Company does or proposes to do business:
 - (i) directly or indirectly, alone or with others, engage in the business of providing services which are Directly Competitive

The non-compete provision continues by listing positions and relationships that Smakal may not hold or assume with an entity that is directly competitive with Advanced

Detection, and also continues by stating that Smakal shall not permit his name to be used in connection with a business that is directly competitive with Advanced Detection. “Directly competitive” is defined in the Agreement as providing “products, services, technology or consulting that compete with the Company’s offerings of products, services or technology in existence at any time during employee’s employment with the Company.”

In analyzing the validity of non-compete agreements, Arkansas courts recognize that a business’s customer base is its most important asset, and that it has a legitimate interest to protect that asset. *Freeman*, 281 S.W.3d at 755. Arkansas courts also acknowledge the special vulnerability of a business’s customer base where an employee works and builds personal relationships with customers away from the business site. *Id.* This situation occurs in the present case. Smakal worked as a service and installation technician, and later as the service manager, and he and one other technician regularly entered customers’ homes and businesses to install and service alarm and other monitoring systems. As such, they were the “face of the company” according to Vester. Advanced Detection was potentially vulnerable to the loss of customers at the hands of its employees because of the employees’ opportunity to build trust and personal relationships with the customers away from the business site. Accordingly, the Court finds that Advanced Detection’s customer base was a valid interest it sought to protect through the use of a non-compete agreement.

However, the Court finds that the geographic restriction provided in the non-compete provision is overly broad. The Agreement states that the employee shall not directly compete in “any county, country or other jurisdiction in which the Company does or proposes to do business.” Vester testified that the trade area of Advanced Detection’s business at the time the Agreements were signed radiated from a central point in Mountain Home and included the following range: to the west, as far as Berryville, Arkansas; to the east, as far as Jonesboro, Arkansas; to the north, as far as West Plains, Missouri; and to the south, “to Mountain View or Heber Springs area.” In addition, he

testified that Advanced Detection has continued to do business only within that same range. However, counsel for Smakal argued, and this Court agrees, that the language of the non-compete provision is overly-broad because it is written to include not only Advanced Detection's established business range but also "any county, country or other jurisdiction" in which Advanced Detection "*proposes to do business.*" This open-ended language provides for a geographic restriction on any new trade area of business--ostensibly anywhere in the world--that Advanced Detection contemplated at that time or at some time in the future. The result is an ambiguous and unenforceable geographic range. In the past, the Arkansas Supreme Court has affirmed a trial court's ruling that a similarly ambiguous geographic term rendered a non-compete agreement unenforceable because, as the trial court noted, it "apparently leaves the corporation in control of designating a prohibited geographic location at some time without the assent of the employee." *HRR Ark.*, 87 S.W.3d at 239. In the same way, the language in the non-compete provision of the Agreement reserves the right for Advanced Detection to extend the geographic restriction to additional places of business without the consent of the employee. The Court finds that the geographical restriction is overly broad and, therefore, that the non-compete provision of the Agreement is not valid. Because the overly-broad geographical restriction renders the non-compete provision invalid, it is unnecessary to make a finding regarding the two-year time limit provided in the non-compete provision.

Because of the Court's finding that the non-compete provision is invalid, there can be no debt resulting from an alleged breach of that provision. Without a debt, § 523(a)(2)(A) and § 523(a)(6) are not applicable. However, the severability clause within the Agreement preserves the remainder of the Agreement for the Court's consideration under § 523(a)(2)(A) and § 523(a)(6).

B. § 523(a)(2)(A) and § 523(a)(6) Causes of Action

1. § 523(a)(2)(A)

Section 523(a)(2)(A) excepts from discharge a debt resulting from "money, property,

services, or an extension, renewal, or refinancing of creditor to the extent obtained, by . . . false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." Advanced Detection's basis for this cause of action appears to rest on the deposition of Lucretia Self, a former Advanced Detection customer who died prior to trial. In her deposition, which was conducted in preparation for a prior state court proceeding and was entered into evidence at this trial, Self stated that she switched from Advanced Detection to EST because an EST representative had come to her home and told her that Advanced Detection had merged with EST, or, at least, that Advanced Detection was no longer doing business. Advanced Detection alleges that this misrepresentation by an unnamed EST representative to Self is the kind of misrepresentation contemplated under § 523(a)(2)(A).

To prevail under § 523(a)(2)(A), Advanced Detection, as the creditor, must prove by a preponderance of the evidence the following:

- (1) that the debtor made a representation;
- (2) that at the time the debtor knew that the representation was false;
- (3) that the debtor made the representation deliberately and intentionally with the intention and purpose of deceiving the creditor;
- (4) that the creditor justifiably relied on such representation; and
- (5) that the creditor sustained the alleged loss and damage as the proximate result of the representation having been made.

Merchants Nat'l Bank of Winona v. Moen (In re Moen), 238 B.R. 785, 790 (B.A.P. 8th Cir. 1999) (quoting *In re Ophauq*, 827 F.2d 340 (8th Cir. 1987)). These requirements make clear that the misrepresentation must be made by the debtor with the intent of deceiving the *creditor*, and the *creditor* must have justifiably relied on that misrepresentation to its detriment. However, the only misrepresentation alleged by Advanced Detection, according to Self, occurred between an EST representative and Self, a third party.

Finally, there was no evidence or argument showing that at the time Smakal executed the Agreement, he did not intend to comply with its provisions. Since there was no misrepresentation in that regard either, the Court must deny relief on Advanced Detection's cause of action under § 523(a)(2)(A).

2. § 523(a)(6)

Finally, Advanced Detection's complaint also includes a cause of action under § 523(a)(6), which excepts from discharge a debt resulting from "willful and malicious injury by the debtor to another entity or to the property of another entity." A party seeking to avoid discharge of a debt under § 523(a)(6) must prove by a preponderance of the evidence that the injury that occurred was both a willful injury and a malicious injury. *Sells v. Porter (In re Porter)*, 539 F.3d 889, 893 (8th Cir. 2008). Advanced Detection bases its § 523(a)(6) cause of action on the alleged breach of the Agreement by Smakal. However, "a simple breach of contract is not the type of injury addressed by § 523(a)(6)." *Prewett v. Iberg (In re Iberg)*, 395 B.R. 83, 89 (Bankr. E.D. Ark. 2008) (quoting *Snoke v. Riso (In re Riso)*, 978 F.2d 1151, 1154 (9th Cir. 1992)). For an intentional breach of contract to fall under the rule of § 523(a)(6), there must also be malicious and willful tortious conduct. *Id.* In the present case, Smakal signed the Agreement, which, in addition to the non-compete provision, included a non-solicitation provision that stated Smakal would not solicit employees or customers of Advanced Detection for his own benefit. Because the Court previously found that the non-compete provision of the Agreement is invalid, the non-solicitation provision is the remaining relevant provision the Court must consider in relation to Advanced Detection's § 523(a)(6) cause of action.³ Before the Court is whether Smakal breached the non-

³ The Agreement also includes a Confidentiality provision to protect "all information, data, trade secrets, customer lists, or any other information or facts that are confidential in nature." The provision states that the employee must surrender all data upon termination from Advanced Detection, and Vester testified at trial that Smakal failed to surrender all business forms and other information, including a billing statement with a list of customers, at the time of his termination. However, Advanced Detection did not argue or show that it suffered any specific damages as a result of the alleged

solicitation provision of the Agreement, and, if so, whether Smakal injured Advanced Detection in both a willful and malicious manner as required under § 523(a)(6).

The non-solicitation provision of the Agreement reads as follows:

Employee further agrees that during the Restricted Period:⁴

- (A) Employee will not directly or indirectly solicit or attempt to solicit away employees of the Company for Employee's own benefit or for the benefit of any other person or entity; and
- (B) Employee will not directly or indirectly interfere with or take away or attempt to take away suppliers or customers of the Company.

Mike Bentley, general manager at Advanced Detection in 2006,⁵ testified regarding 27 customer accounts that Advanced Detection serviced prior to Smakal's termination and that Advanced Detection alleges Smakal "took" after he was terminated.⁶ Bentley stated that he believed these customers had transferred to EST after Smakal's termination. However, Bentley conceded that while he knew these customers left Advanced Detection, he did not have personal knowledge that these customers transferred to EST. More critically, Bentley did not testify as to whether Smakal solicited or "took away" any of the 27 customers. Three of the 27 customers named by Bentley also testified, and while they confirmed making the switch from Advanced Detection to EST after Smakal's termination, all three denied that they were ever solicited by Smakal. Therefore, the Court is unable to conclude from this line of testimony that Smakal solicited any of the

breach of the Confidentiality provision alone, and the Court will not speculate as to related damages, if any.

⁴ The Restricted Period is defined in the Agreement as "the period commencing on the Effective Date and ending two years following the date employment terminates for whatever reason."

⁵ Mike Bentley testified that at the time of the trial, he was still employed by Advanced Detection.

⁶ The parties repeatedly referred to a list of 30 customers that Advanced Detection alleges Smakal "took" after termination. However, this list was not entered into evidence, and Bentley specifically testified about 27 named customers.

27 customers named by Bentley.

Ryan Kelley, an employee who worked with Smakal, also testified that approximately two weeks before Smakal was fired, Smakal told Kelley that based on conversations he had with four Advanced Detection customers, he believed those customers would transfer their business to EST as soon as EST was established. When Smakal was asked whether he had solicited the individuals or entities named by Kelley, Smakal denied soliciting one of the customers and could not recall whether he had solicited two other customers named by Kelley.

From Kelley's testimony, the evidence is not sufficient to show by a preponderance of the evidence that Smakal breached the non-solicitation provision of the Agreement. The non-solicitation provision stated that Smakal would not "directly or indirectly" solicit employees or customers of Advanced Detection for his own benefit. Kelley's testimony implies that Smakal *may* have violated the terms of the non-solicitation provision in relation to the four customers Smakal believed would switch to EST once the business was established.⁷ However, there was no evidence about the nature of the alleged conversations Smakal had with these four customers, other than Smakal's subsequent belief that the customers would switch to EST. None of the four customers named by Ryan testified, and the Court is without sufficient facts to determine whether Smakal actually solicited these customers in the course of the alleged conversations. Even if the Court did have evidence of what was said between these four customers and Smakal in the alleged conversations, the non-solicitation provision's overly-broad language is problematic. Smakal was barred from soliciting Advanced Detection customers "directly

⁷ Kelley also testified that Smakal solicited him to leave Advanced Detection and work for EST. Smakal confirmed this testimony. However, the record does not show whether Smakal solicited Kelley before or after Smakal signed the Agreement. Even if the Court assumes that Smakal solicited Kelley *after* signing the Agreement, in violation of the non-solicitation provision, Advanced Detection suffered no injury from Smakal's solicitation because Kelley remained at Advanced Detection and never became an employee of EST.

or indirectly,” and the Agreement does not include a definition of indirect solicitation. The Court cannot find by a preponderance of the evidence that Smakal solicited Advanced Detection’s customers.

Section 523(a)(6) excepts from discharge debts resulting from a willful and malicious injury. Because Advanced Detection did not prove by a preponderance of the evidence that Smakal breached the non-solicitation provision of the Agreement, there are no recoverable damages and, thus, no debt to consider. Therefore, further analysis regarding Smakal’s alleged willful and malicious injury to Advanced Detection is unnecessary, and the Court denies Advanced Detection’s cause of action under § 523(a)(6).

Conclusion

Advanced Detection failed to present evidence sufficient to prove that Smakal made a misrepresentation to Advanced Detection that Advanced Detection relied on to its detriment; therefore, the Court finds there is no basis for a denial of dischargeability under § 523(a)(2)(A). In addition, the Court finds that the non-compete provision of the Agreement is not enforceable because of its overly-broad geographic restriction, and that Advanced Detection did not prove by a preponderance of the evidence that Smakal breached the remaining relevant non-solicitation provision. Therefore, Advanced Detection also failed to present evidence showing that Smakal caused a willful and malicious injury to Advanced Detection as contemplated under § 523(a)(6). For those reasons, the Court denies Advanced Detection’s causes of action under § 523(a)(2)(A) and § 523(a)(6).

IT IS SO ORDERED.

April 21, 2011
DATE



BEN T. BARRY
UNITED STATES BANKRUPTCY JUDGE

cc: Gail Inman-Campbell, attorney for the debtors
William Eric Berger, attorney for Advanced Detection Systems, Inc.
William M. Clark, Jr., trustee