THE EFFECT OF A SALE OF BUSINESS TRANSACTION ON NEVADA NONCOMPETITION AGREEMENTS

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The Nevada Supreme Court recently revisited the effect of a sale of business transaction on noncompetition agreements. See *HD Supply Facilities Maintenance, Ltd. v. Bymoen,* 210 P.3d 183 (Nev. 2009). The opinion was in response to certified questions from the U. S. District Court for the District of Nevada as to the scope of the Nevada Supreme Court's previous decision in the area, *Traffic Control Services, Inc. v. United Rentals Northwest, Inc.,* 120 Nev. 168, 87 P.3d 1054 (2004).

Background

The issue addressed in these cases generally arises when the following sequence of events occurs:

1. An employee enters into a noncompetition agreement with his employer.
2. The employer sells the business.
3. Either before or shortly after the sale, the employee leaves the employ of the company, voluntarily or involuntarily.
4. Prior to the expiration of the term of the noncompetition agreement, the employee engages in conduct which violates the agreement.

The issue is whether the business under new ownership receives the benefit of the agreement such that the employee can be prohibited from engaging in the competitive conduct, assuming the agreement is otherwise enforceable. There is a surprising disparity among the states on how noncompetition agreements are affected by a sale of the underlying business. The courts that do not allow enforcement of the agreement after the sale tend to rely on the premise that a noncompetition agreement is personal to the employee and thus not assignable without the employee's consent or that there is a risk of increasing the scope of the restraint. The courts that allow enforcement tend to rely on the general rule that contracts are assignable unless the contract provides otherwise or in the case of a statutory merger that the surviving corporation succeeds to the contractual rights of the other constituent corporations.

The Combination of *Bymoen* and *Traffic Control Services*

The combination of the *Bymoen* case with the court's previous decision in *Traffic Control Services* provides bright line rules for the assignability of noncompetition agreements, depending on the particular form of the sale of business transactions. In summary, pursuant to *Traffic Control Services*, in a sale of assets transaction, the noncompetition agreement is not assignable without the employee's express consent unless there is an express assignability clause in the agreement which was negotiated at arm's length for separate consideration. Pursuant to *Bymoen*, in a merger, and likely a sale of stock transaction, the noncompetition agreement remains enforceable. The apparent state of Nevada law after these two cases is defensible when viewed on a piecemeal basis, because there are cases from other jurisdictions and rationale supporting the disparate result in each case. The primary rationale for the *Traffic Control Service* result is protecting the employee from an expansion in the scope of the restraint which was not bargained for. The primary rationale for the *Bymoen* result is applying the statutory legal effects of a corporate merger which vests the rights and liabilities of existing contracts in the surviving corporation. However, the fairness and economic rationale seems weaker when the rules, as adopted in these two cases, are examined as a whole. As noted in the *Bymoen* concurrence, "[w]hether an employer's business is transferred by asset sale, as opposed to merger or stock sale, should make little difference...." *Bymoen*, 210 P.3d at 189.

One important corollary emerges from the set of rules adopted in these cases. From a planning perspective, parties negotiating noncompetition agreements are now forewarned to anticipate a future sale of the business. Essentially all of the effects of the rules imposed by the two cases could be avoided by addressing the specific impact of the various forms of sale of business transactions in the agreement. This is small comfort to those who are already parties to existing noncompetition agreements, although it would not be surprising if the *Traffic Control Services* holding is revisited at some future time.

An Alternative Approach

Reasonable minds can differ and there does appear to be a split among the courts in the various states, but much of Justice Pickering's concurrence in *Bymoen* is worthy of consideration. The concurrence argues that the public policy limitations imposed on noncompetition agreements would sufficiently protect an employee in the event of a sale of the employer's business and, accordingly, the normal rule of free assignability of contracts should apply to allow the assignment of the employee's noncompetition agreement. If the effect of the sale transaction renders the terms of the agreement an unreasonable restraint on the employee, then the agreement would not be enforceable after the transaction. In particular, the concurrence cites NRS 613.200(4) as a legislatively enacted public policy which provides that a noncompetition agreement is not prohibited "if the agreement is supported by valuable consideration and is otherwise reasonable in its scope and duration." The reasonableness test is generally the same as imposed by the common law. As noted above, the concurrence also argues that the treatment of the noncompetition agreement in a sale of business transaction should not depend on the form of the transaction.

The concurrence refers to the general rule that contracts are freely assignable, subject to exceptions, including in particular that a contract is not assignable if it would materially increase the burden on a party. The focus of the concurrence, however, is on the application of the reasonableness test based on the post-merger facts. While the reasonable test is critical, the increased burden exception to assignability also bears emphasis in the context of noncompetition agreements.

Ideally the issue of whether an assignment of a noncompetition agreement in a sale of business transaction materially increases the burden on the employee should be addressed separately from the reasonableness of the agreement post-sale, because they are distinct tests. The increased burden test involves more the original intent and expectations of the parties while the reasonableness test involves more of an application of public policy. The court first should ascertain the original intent and expectations of the parties and then determine whether the application of the contract as so intended would be reasonable.

The following example may show the difference between the two tests. A manager of an independent hardware store operating in one location enters into a noncompetition agreement which prohibits the employee from competing for one year after termination of employment at any location within two miles of the employer. There was never any

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discussion of expansion or sale of the business. The employer then receives an offer and sells the business to the owner of another hardware store located in the same area which plans to operate both stores and to employ the manager. Based on the locations of the two stores, read literally, the geographic scope of the noncompetition agreement would effectively expand to five miles from the manager's place of business. While this expanded scope likely would be viewed as a reasonable restriction for public policy purposes, there is a legitimate issue as to whether it is within the original expectations of the parties and creates a material increase in burden on the employee. If instead the store was sold to a national chain with multiple stores throughout the area, then the expanded geographic scope would likely fail the reasonableness test as well as the increased burden test. It seems that a reasonable solution in both situations, absent specific contract language, would be to allow the new owner to enforce the agreement but only to the extent of the original geographic scope.

The imposition of both tests before enforcing a noncompetition agreement should provide enough comfort for the court to allow free assignability in an asset sale. Consistent with the views expressed in the *Bymoen* concurrence, this would allow the agreements to be treated consistently in a merger or asset sale. As pointed out in the concurrence, the reasonableness test would be applied even in the merger situation notwithstanding that the buyer succeeds to the seller's rights under the contract. The same logic would call for the increased burden test to also apply. Another point to consider is that Nevada courts have been generally protective of employees and fairly strict in assessing the reasonableness of noncompetition agreements. A case which would be relevant to the above hypothetical is *Camco, Inc. v. Baker*, 113 Nev. 513, 936 P.2d 829 (1997). In *Camco*, the court held that a noncompetition agreement was overly broad to the extent that the employee would have been prohibited from competing in territory targeted by the employer for future expansion as contrasted to areas in which the employer was presently operating. It could be argued that expansion of the scope of the restriction through a sale of the business presents an analogous situation from a policy perspective.

In summary, an alternative approach would be to allow noncompetition agreements to remain in effect after a sale of business, regardless of the form of the transaction, unless the agreement provides otherwise (or in an asset sale, the agreement is not assigned to the buyer). Prior to enforcement of any noncompetition agreement, the court would construe the scope of the contract in light of the post-transaction setting based on the original intent of the parties and then assess its reasonableness.

Addressing the Issue in the Contract

From a planning perspective, most, if not all, of the issues arising from a sale transaction could be avoided by drafting the contract to anticipate a potential transaction. For example, consider the following guidelines:

1 An employer who wants the noncompetition agreement to be assignable in an asset sale needs to comply with the *Traffic Control Services* requirements to expressly provide for an assignability clause and document that the clause was negotiated at arm's length for separate consideration.

2. An employee who wants the agreement not to be assignable in an asset sale should specifically provide that the contract is not assignable to protect against the contingency that *Traffic Control Services* may be overruled.

3. An employee who does not want the agreement to remain in effect after a merger or sale of stock should include a typical change of control provision which provides that a change of more than a specified level of ownership, often 50 percent, would be deemed an assignment which requires the employee's consent.

4. An employer who wants to assure that the agreement remains in effect after a merger or sale of stock may wish to expressly provide for that, but the risks of not including such a provision appear low.

5. Draft the language of the restriction with enough specificity to avoid interpretive issues. For example, the restriction in the hypothetical could have been written in terms of the distance from a particular address of the employer's place of business, rather than simply a particular distance from the employer.

6. An employer may wish to anticipate an expansion of the scope of the restrictions in the event of a

potential sale of the business. Without a particular sale transaction on the table at the time, however, the enforceability of such a provision is questionable under *Camco*. If a particular transaction is being negotiated then the safest course from the buyer's perspective may be to require a new noncompetition agreement between the buyer and the employee as a condition of closing.

Conclusion

There is significant disparity among the jurisdictions as to the effect of a sale of the business on existing noncompetition agreements.[1] While Nevada's present approach is certainly supportable, there may be a better alternative. Most importantly, issues can be avoided with careful drafting in anticipation of possible sale transactions. NL

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1 A national survey is beyond the scope of this article. Nevada's current rules are based to a significant extent on *Corporate Express Office Products, Inc. v. Phillips*, 847 So.2d 406 (Fla. 2003). *Sogeti USA LLC v. Scariano*, 606 F. Supp. 2d 1080 (D. Ariz. 2009) and *AutoMed Technologies, Inc. v. Eller*, 160 F. Supp. 2d 915 (N.D. Ill. 2001) allow for assignability in an asset sale. *Aon Consulting, Inc. v. Midland Financial Benefits, Inc.*, 748 N.W. 2d 626 (Neb. 2008) held that the agreement remains enforceable after a merger which seems the prevalent position. Most of the disparity among the jurisdictions seems to involve asset sales. *Astromick International, Inc. v. Koch*, 759 N.E.2d 385. (Ohio Ct. App. 2001) and *Alexander & Alexander, Inc. v. Koelz*, 722 S.W. 2d 311 (Mo. Ct. App. 1986) provide some support for the approach suggested in this article.