Assignability of Employment Restrictive Covenants

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Noncompetition agreements have become more common. As the economy tightens, companies do whatever they can to secure their market share and compete in the marketplace. As a result, noncompetition agreements have become more common than ever. But business owners, with the hope of one day selling their company, and those pursuing the purchase of competitors to increase market share, should be aware of an important twist in Nevada law.

The decision of the Nevada Supreme Court in Traffic Controls Servs., Inc. v. United Rentals Northwest, Inc., 120 Nev. 168, 87 P.3d 1054 (2004) was an uncharacteristically pro-employee decision that significantly changed the law regarding the succession of companies in Nevada.

Traffic Controls involved (1) an asset sale and (2) the assignment of a non-compete contract without language in the contract permitting assignment to (3) a new employer. Each fact was important to the analysis of the Nevada Supreme Court. In Traffic Controls, the employee resigned his employment with United Rentals and went to work for NES Trench. The employee made the decision that he did not want to work for United Rentals. During negotiations with NES Trench, the employee sought and received assurances that NES Trench had no plans to sell its business and in particular, not to sell to United Rentals. When he joined NES Trench, the Employee signed an agreement including a noncompete covenant in favor of NES Trench.

Unfortunately for the employee, United Rentals purchased the assets of NES Trench and

the employee found himself once again working for United Rentals – a situation that he had wanted to avoid. Before the transaction between United Rentals and NES Trench closed, NES Trench asked its employees to sign a noncompete agreement. However, the employee refused to sign a new noncompete agreement in favor of United Rentals. Id. at 1056.

Dissatisfied with circumstances in which he found himself, the employee then left United Rentals/NES Trench and went to work for Traffic Controls. Id. United Rentals then filed suit against the Employee to enforce the terms of the agreement he signed in favor of NES Trench. The trial Court enforced the NES Trench agreement and the employee and Traffic Controls (his new employer) appealed. The Nevada Supreme Court reversed the decision of the trial court.

The Supreme Court declined to enforce the NES Trench Agreement holding that the agreement could not be assigned to United Rentals. The Court declined to allow the contract to be assigned because the agreement did not expressly permit it to be assigned. Indeed, to reach its decision, the Nevada Supreme Court stated:

> *Burkhardt's covenant did not contain an assignment clause. While some courts have concluded that such an omission does not bar assignment, a reading of assignability into the covenant is contrary to the intentions of the original parties to it. As we have stated, if no ambiguity exists in a contract, "the words of the contract must be taken in their usual and ordinary signification." NES, as the drafter of the covenant, was in the best position to negotiate for an assignment clause. However, for whatever reason, it chose not to do so. The plain meaning of the contract was for the benefit of NES and Burkhardt, not their assigns and successors.*

Id. at 1058 (footnotes omitted, emphasis added). The Nevada Supreme Court was unwilling to inject an assignment clause into a contract when none was there before. Further, the Nevada Supreme Court makes clear that the former employer could very well have negotiated for the right to assign the covenant not to compete.

The facts of Traffic Controls seemed to mandate some relief for the employee who found

himself working for the company that, at every opportunity, he expressed his dislike and his desire never to work for or with the company.

Nevada's merger statute provides that title to all property of the merging constituent entity is vested in the surviving entity. NRS 92A.250. Still further, Nevada's merger statute is designed to facilitate mergers:

> *The provisions of NRS 92A.3000-92A were added to Nevada's statutes by the 1995 Legislature. They are patterned after, or are identical to, the provisions of the 1984 Model Business Corporations Act ("Model Act"). In turn, the Model Act is based upon case law from Delaware and New York. The Model Act and Nevada's statutes are designed to facilitate mergers . . .*

Cohen v. Mirage Resorts, Inc., 119 Nev. 1, 10, 62 P.3d 720, 726 (2003). The decision in Cohen is consistent with Nevada's pro-business public policy as expressed through its statutes concerning enforcement of non-compete agreements, trade secrets, favorable corporate tax schemes and the like.

The Nevada Supreme Court understood this policy when it decided Traffic Controls**.** The Supreme Court stated "[w]e agree with those jurisdictions holding that noncompetition covenants are personal in nature and, therefore, unassignable as a matter of law, absent the employee's express consent." Traffic Controls, 120 Nev. at 174, 87 P.3d at 1058 (emphasis added.") Importantly, the Nevada Supreme Court then writes footnote 10 and includes citation to four cases, all of which involved agreements that did not contain an assignment provision. Id. Sisco v. Empiregas, Inc. of Belle Mina, 237 So.2d 463, 466-67 (Ala. 1970); SDL Enterprises, Inc. v. DeReamer, 683 N.E.2d 1347 (Ind. Ct. App. 1997); and Smith, Bell & Hauck, Inc. v. Cullins, 183 A.2d 528, 532 (Vt. 1962) and Corp. Exp. Office Products v. Phillips, 847 So.2d 406, 413 (Fla.2003) ("Thus when the sale of assets includes a personal service contract that contains a noncompete agreement, the purchaser can enforce its terms only with the employee's consent to an assignment.") The court in Sisco also made

the statement that "[w]hether a contract is personal is largely a matter of the intention of the parties thereto (Smith, Bell & Hauck, Inc. v. Cullins, supra), and the 'intention of the parties to a written contract is derived from the provisions of the contract . . .'" Id. at 467 (citation omitted).

It is important to note that Phillips is the only case that the Nevada Supreme Court quoted in footnote 10. In that case, the Florida Supreme Court reviewed the issue of enforcement of a noncompete agreement, not only in the context of an asset sale, but in context of a merger, stock purchase and name change. Regarding a merger, the Florida Supreme Court stated:

> *We conclude that the surviving corporation in a merger assumes the right to enforce a noncompete agreement entered into with an employee of the merged corporation by operation of law, and no assignment is necessary. This is because in a merger, the two corporations in essence unite into a single corporate existence.*

Phillips, 847 So.2d at 414. The Florida Supreme Court reaches this conclusion based on "traditional principles of corporate law" and to preserve the sanctity of contracts and provide uniformity and certainty in commercial transactions. Id.

Florida is not alone in its understanding that a surviving company following a merger may enforce a non-compete agreement. The Indiana First District Court of Appeals reached the same conclusion in Peters v. Davidson, 172 Ind.App.39, 359 N.E.2d 556 (Ind.App. 1977). In that case, the defendant-former employee claimed that the term in his non-compete agreement began to run when his employer merged with another company and not the date that he resigned. The defendant-former employee reasoned that the surviving company was separate from the employer with whom he contracted. The Court rejected the defense based upon sound principles of corporate law:

> *The employment agreement executed by Avels and Peters specifically provided that the rights and obligations under the agreement were assignable and transferable to Avels' successors. Following the merger, the surviving corporation, Davidson, succeeded to all*

> *the rights, powers, liabilities and obligations of the merging corporation. [Citation omitted.] Davidson, therefore, by express contractual agreement and statutory authorization, obtained the rights to Peters' employment agreement. One of the rights inuring to Davidson under the agreement was the power to enforce the ancillary covenant not to compete.*

Id., 172 Ind.App. at 48, 359 N.E.2d at 562. *See also* Equifax Services, Inc. v. Hitz, 905 F.2d 1355, 1361 (10th Cir. 1990) ("In the case of merger, as here, the surviving corporation automatically succeeds to the rights of the merged corporations to enforce employees' covenants not to compete.")

Traffic Controls makes no mention of corporate name changes. To read Traffic Controls to cause such a result would contradict the clear pro-business public policy in this state and would create new law in Clark County. The Nevada Supreme Court did not intend such a result when it wrote the opinion in Traffic Controls. Once again, Phillips, which was cited with approval in Traffic Controls, sets forth the corporate law principle with regards to the effect of a corporate name change: "As the First District recognized in *Sears Termite*, neither a change in ownership of corporate stock nor a name change alters a corporation's existence, corporate identity, or corporate rights." Phillips, 847 So.2d at 414. The Indiana Appellate Court in Peters may have said it best:

> *We do not feel that an employee, who freely enters into an employment agreement containing an enforceable covenant not to compete, should be relieved of his contractual obligations simply because his employer's name changed following a valid merger whereby the rights to the employment are transferred. This would seem to be essentially true in those cases where, as here, the employee continues to accept the benefits of his agreement without objection to the merger. We, therefore, find, as did the trial court, that Peter's employment termination on December 12, 1975, constituted the condition commencing the terms of the covenant. We, further, hold that Davidson, being the rightful successor to Peter's employment agreement was entitled to enforce the covenant following Peters' termination.*

Peters, 172 Ind.App. at 49, 359 N.E.2d at 556.

By contrast, an asset sale is driven by the terms of the contract. In an asset sale, the parties to the transaction determine which assets are sold and what consideration is given for

those identified assets. Phillips, 847 So.2d at 413-4 citing William Meade Fletcher et al. *Fletcher Cyclopedia of the law of Private Corporations*, Sec. 7122 (perm.ed., rev. vol. 1990). Even in Traffic Controls, the Nevada Supreme Court examined the terms of the asset sale which did not list non-compete agreements as one of the assumed contracts. Traffic Controls, 120 Nev. at 175, 87 P.3d at 1059. The absence of the non-compete from the list influenced the Court's decision.

The Nevada Supreme Court also cites to the Supreme Court of Pennsylvania's decision in Hess v. Gebhard & Co., Inc., 570 Pa. 148, 808 A.2d 912, 917 (2002). Even in Hess, the employment agreement at issue did not contain a provision that allowed for its assignment by the company. Further, the same is true for all the other cases cited in Traffic Controls and by Soderquist. Indeed, an opinion of the Supreme Court of Vermont subsequent to Smith, Bell and Hauck (cited in footnote 10 of Traffic Controls) makes clear that presence of an assignment clause in the agreement is outcome determinative. The same Vermont Supreme Court, just four (4) years after deciding Smith, Bell and Hauck stated:

> *To be sure, there are cases where the assignment of an employment contract has been held invalid because it was inherently personal to the parties. Smith, Bell & Hauck v. Collins, supra. In that case, the contract contained no provision for assignability, or that such eventuality was contemplated or considered by the parties at the time of their agreement. This was the turning point in that case. In the case at bar, the contract expressly states that it is assignable, and no facts appear to demonstrate a contrary intention.*

Abalene Pest Control Service, Inc. v. Hall, 126 Vt. 1, 8, 220 A.2d 717, 721 (1966). The Nevada Supreme Court's reliance on Smith, Bell & Hauck, when Abalene had already been decided, indicates an understanding of the important difference between a contract that includes an assignment provision, and one that does not. This important distinction certainly did not escape the Nevada Supreme Court, when it was so clearly recognized by the Vermont

Supreme Court just four years after deciding Smith, Bell & Hauck.

It was not long before the decision in Traffic Controls created new issues for the Nevada Supreme Court. Last year, in HD Supply Facilities Maintenance, Ltd. v. Bymoen, 210 P.3d 183 (2009), the Nevada Supreme Court revisited its decision in Traffic Controls. The United States District Court for the District of Nevada certified three questions to the Nevada Supreme Court:

> *[w]hether the Nevada rule stated in Traffic Control Servs. v. United Rentals, 120 Nev. 168, 172, 87 P.3d 1054, 1057 (2004), that 'absent an agreement negotiated at arm's length, which explicitly permits assignment and which is supported by separate consideration, employee [noncompetition] covenants are not assignable,' applies when a successor corporation acquires a noncompetition covenant[, or a covenant of nonsolicitation or confidentiality] as a result of a merger?"*

The Nevada Supreme Court answered the questions in the negative and clarified that the rule of nonassignability does not apply when a successor corporation acquires restrictive employment covenants as the result of a merger.

The issue facing the Nevada Supreme Court was whether the apparent broad language of Traffic Controls - "absent an agreement negotiated at arms length, which explicitly permits assignment and which is supported by separate consideration, employee noncompetition covenants are not assignable" - should be narrowly limited to the facts in Traffic Controls. When revisiting its opinion, the Nevada Supreme Court stated that the decision in Traffic Controls had a "single minded concern with preserving an employee's individualized choice to covenant not to compete with a particular employer..." Bymoen, 210 P.3d at 186. The Nevada Supreme Court further concluded that "Traffic Controls rule of nonassignability stands for the general proposition, grounded in the law of contractual assignments, that personal services contracts are not assignable absent consent." Id. Further, the rule logically applies to the "contractual setting" of an asset purchase.

The Nevada Supreme Court rejected the employee's suggestion that the rule in Traffic Controls should be generalized to other forms of corporate transactions, including mergers. Contrary to the employee's position, a majority of courts had ruled that in a merger, the right to enforce the restrictive covenants rests with the surviving entity. Nevada courts and statutes have historically recognized the distinction between the implications of a merger, which is a creature of statute, and with an asset purchase agreement, which is not.

The Nevada Supreme Court then concluded that the rule of nonassignability expressed in Traffic Controls does not apply when a successor corporation acquires restrictive employment covenants as the result of a merger.

The decisions of the Nevada Supreme Court in Traffic Controls and Bymoen must both be considered carefully when purchasing the assets of another entity or considering a merger. If the hope is to gain access to good will, customers and market share managed and maintained by key employees who are subject to employment restrictive covenants, then an asset purchase will not achieve the result. In that instance, a new agreement must be reached with the key employees wherein they agree to the assignment of the restrictive covenants by the asset purchaser and receive separate consideration. However, after the decision in Bymoen, the resulting entity in a merger may enforce the preexisting agreements. However, the Nevada Supreme Court left open the question of whether the rules expressed in Traffic Controls and Bymoen would apply beyond noncompetition agreements, and be applicable to confidentiality or other restrictive covenants.

Either way, an understanding of this nuance in Nevada law is key to a successful transaction.