Alert

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COZEN O'CONNOR

Rethinking Restrictive Covenants: Delaware Courts' Movement in Favor of the Restricted

In the first half of 2023, the Delaware Chancery Court issued two decisions regarding non-competition and non-solicitation provisions that should make parties carefully consider whether restrictive covenants are appropriately tailored to protect their legitimate business interests. Although the Delaware Supreme Court has not yet weighed in on the issue, parties should take into consideration these decisions when drafting new or re-evaluating existing restrictive covenants, both in the mergers and acquisitions context and in limited liability company agreements, limited partnership agreements, and agreements with their employees.

Ainslie v. Cantor Fitzgerald L.P.

In *Ainslie v. Cantor Fitzgerald, L.P.*, No. 9436-VZ, 2023 WL 106924 (Del. Ch. Jan. 4, 2023), the court determined that restrictive covenants contained in Cantor Fitzgerald's limited partnership agreement were unreasonable and therefore unenforceable. It is important to note that the case did not involve Cantor Fitzgerald seeking to enforce such restrictive covenants, but instead, was the result of Cantor Fitzgerald claiming that the limited partners' failure to comply with these restrictive covenants in a limited partnership agreement discharged Cantor Fitzgerald from its obligation to pay those limited partners certain amounts owed to them under Cantor Fitzgerald's limited partnership agreement. The court was not moved by Cantor Fitzgerald's attempt to dissuade the court from reviewing the restrictive covenants on the merits because such provisions were merely conditions precedent to Cantor Fitzgerald's obligation to pay its partners, stating that "In order for an action to breach a restrictive covenant, that restrictive covenant must be enforceable" (*i.e.*, if Cantor Fitzgerald wanted to escape its payment obligation, the underlying condition precedent to such obligation had to be analyzed for enforceability). The court examined two restrictive covenants: (1) a one-year non-compete and (2) a two-year non-solicit of customers and employees.

The court stated that Delaware courts carefully review non-compete and non-solicit agreements to ensure that they (1) are reasonable in geographic scope and temporal duration, (2) advance a legitimate economic interest of the party seeking its enforcement, and (3) survive a balancing of the equities.

The court found several problems with the language of the restrictive covenants. First, there was no geographic limitation on any of the restrictions (*i.e.*, the restrictive covenants applied worldwide). Cantor Fitzgerald's argument that it is a "global business" did not persuade the court in this regard. Second, the court held that the definition of the restricted "Competitive Activities" was also overbroad, in part because it included activities competitive not just with Cantor Fitzgerald but with any of its affiliates (the court noted that the breadth of this definition could result in a partner unknowingly engaging in a competitive activity). Finally, the court found that a provision in the limited partnership agreement providing that the managing general partner determines when competition has occurred further "exacerbated" the overbreadth of the provisions as a whole by expanding the scope of "prohibited employment from competing to employment that may not actually compete, and therefore not harm any legitimate Cantor Fitzgerald interest so long as the Managing General Partner believes in good faith that the employment was a Competitive Activity."

Other notable elements of the court's decision include (1) the court's refusal to apply the "blue pencil" doctrine to edit and remove the aspects of the provisions that would make them unenforceable and make the restrictive covenants reasonable (even though the limited partnership agreement contained a "blue pencil" provision); (2) the court's comment that contractual provisions stipulating reasonableness as to restrictive covenants will not insulate such restrictive covenants from scrutiny; and (3) the court's application of the "sale of the business" standard (a typically "pro-enforceability" standard) to the case and still ruling the restrictive covenants unenforceable.

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Intertek Testing Systems v. Eastman

In *Intertek Testing Systems v. Eastman*, 2023 WL 2544236 (Del. Ch. Mar. 16, 2023), the court ruled that a non-compete provision contained in a stock purchase agreement was facially unenforceable due to its unreasonable geographic scope, after applying the same reasonableness analysis used in *Ainslie v. Cantor Fitzgerald*. The stock purchase agreement was entered into in connection with Intertek Testing Systems NA, Inc.'s acquisition of Alchemy Investment Holdings, Inc., and the agreement contained various restrictive covenants restricting Jeff Eastman, a major stockholder, cofounder of Alchemy, and chief executive officer at the time of the transaction, from competing with Alchemy post-acquisition. The court found that the geographic scope of the non-compete at issue, which restricted Eastman's employment "anywhere in the world," was too broad, especially when considering that Alchemy only provides national services. "The incongruity between the geographic scope of the covenant and that of Alchemy's business" led the court to conclude that the non-compete was unreasonably broad. Although an argument could be made that Eastman may have engaged in competitive activities after the acquisition (Eastman became an investor and member of the board of directors of a company founded by his son, which advertised itself as being crafted from the "ground up using the know-how and experience of the founders of Alchemy Systems"), because of the unreasonable breadth of the restrictive covenants, the court ruled them to be completely unenforceable.

Like in *Ainslie v. Cantor Fitzgerald*, the court refused to blue pencil the restrictive covenant in this instance. The court asserted that "revising the non-compete to save Intertek — a sophisticated party — from its overreach would be inequitable."

General Trend

These decisions in Delaware reflect a national trend of cracking down on restrictive covenants. In January 2023, the Federal Trade Commission announced that it took legal action against three companies and two individuals, forcing them to drop restrictive covenants that affected thousands of employees and marking the first time that the FTC has ever sued to halt non-compete restrictions. In the same month, the FTC also announced a Notice of Proposed Rulemaking that would prohibit employers from imposing non-compete clauses on employees. The FTC is expected to vote on the final version of its proposal in April 2024.

On May 30, 2023, the general counsel of the National Labor Relations Board, Jennifer Abruzzo, issued a memo positing that non-compete provisions in employment contracts and severance agreements violate the National Labor Relations Act. While Abruzzo acknowledged that a non-compete provision might not violate the NLRA if it was narrowly tailored to special circumstances (*i.e.*, it clearly restricts only individuals' managerial or ownership interest in a competing business or true independent-contractor relationships), she stated that her view was that the general desire to avoid competition from a former employee is not a legitimate business interest that could support a special circumstances defense. While the memo does not constitute binding law, it does indicate what the general counsel intends to prosecute moving forward. In addition, this memo was issued shortly after the NLRB's decision in April in *McLaren Macomb*, 372 NLRB No. 58 (2023), holding most non-disparagement and confidentiality clauses signed by employees covered by the NLRA void as a matter of policy.

At the state level, these types of restrictive covenants have also been under increased scrutiny. In the past year, many states have been pushing legislation to limit non-compete provisions. In May 2023, Minnesota became the latest state to enact restrictions on non-compete agreements as Governor Tim Walz signed into law a near-total total ban on non-compete agreements that restrict an employee from working in a specified geographical area or from working for another employer after termination of employment.

Moving Forward

These decisions substantially change how a party seeking to obtain restrictive covenants should think about these provisions. At least in Delaware, it is no longer safe to seek the broadest protection that can be negotiated and rely on blue-pencil provisions or stipulations as to reasonableness to protect against overreach. Also, providing that the party benefiting from

restrictive covenants can resolve related factual issues in its discretion may now do more harm than good. Parties should give careful consideration to ensure that the geographic and temporal scope of restrictive covenants, along with the scope of the restricted activities, are each tailored to protect their legitimate economic interests. Not only should business parties keep the impact of these cases in mind as they enter into transactions and agreements in the future, but it could be worth re-examining existing restrictive covenants to determine if such restrictive covenants might be overly broad and, if so, whether to amend those provisions to enhance their enforceability.