An Overview of Recent Delaware Case Law on Noncompete and Forfeiture-for-Competition Provisions

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Restrictive noncompetition covenants have frequently been the subject of judicial review in Delaware and regulatory scrutiny nationwide in recent years. While the Delaware judiciary has often been reluctant to enforce noncompetes, a number of recent decisions from the Delaware Supreme Court and the Delaware Court of Chancery have provided helpful guidance to employers, business partners, and transaction planners on the key components of reasonableness review, the courts' "blue penciling" authority, and a potential alternative mechanism for protecting business interests: forfeiture-for-competition provisions.

Noncompetes typically restrict individuals from working in their chosen field within a geographic region for a specified period of time, and are often implemented via employment agreements, entity organizational documents, or as post-closing covenants in sale agreements. Decisions addressing challenges to noncompetes invariably involve weighing competing policy interests: on the one hand, the desire to promote free trade and an employee's right to work; on the other, Delaware's reverence for freedom of contract. When a party seeks to enforce a noncompete, Delaware courts will assess the terms of the provision for reasonableness, focusing primarily on the geographic scope and temporal duration of the restriction, as well as the extent to which the restriction advances the legitimate economic interest of the party seeking enforcement.

Although Delaware has not established a brightline rule regarding enforceable geographic or temporal limits of a noncompete, a court will consider how both components operate together under the circumstances. Generally speaking, the broader the scope of the restriction, the higher the burden will be for the party seeking enforcement. Recently, in *Payscale v. Norman*, the Delaware Court of Chancery explained that a restriction's geographic scope and temporal duration are inversely related for purposes of the court's reasonableness analysis, such that a longer temporal restriction will be more reasonable if the geographic scope is comparatively limited, and a broader geographic scope will be more reasonable if the temporal restriction is comparatively limited. Despite this, if either the geographic scope or the temporal restriction is found to be broader than necessary to protect the party's legitimate business interests, a court will not enforce the restriction.

Payscale and other recent decisions have also emphasized the importance of precision when defining the competitive activity to be restricted and the entities the restriction is seeking to protect. In this regard, it is important to avoid vague language and for the restriction to encompass only the services actually provided by an employee during their term of employment with the underlying company. For example, in *Hub Group v. Knoll*, the Court of Chancery held that a noncompete was unenforceable in part because it restricted the former employee from doing anything "substantially the same as" what he did when he was employed. Relatedly, in *Payscale*, the Court of Chancery deemed a noncompete "unreasonably vague" for lack of specificity with respect to the line of business operated by the underlying entities.

In *Sunder Energy v. Jackson*, the Supreme Court confirmed that the Delaware courts have the discretionary authority to blue pencil (or revise) a noncompete provision if it is found to be unreasonable or overbroad, but it also declined to adopt a brightline rule that would require blue penciling. While they may have the authority to blue pencil

noncompetes, Delaware courts have been reluctant to do so in more recent cases. Indeed, we have identified only two instances of the Court of Chancery blue penciling a noncompete over the past two decades (*Delaware Express Shuttle v. Older* and *DGWL Investment v. Giannini*). Rather than blue penciling, Delaware courts have recently been more likely to invalidate noncompetes that it finds unreasonable or overbroad in their entirety, citing concerns such as an unwillingness to "rescue a sophisticated party from its own unenforceable contract" (*Intertek Testing Services NA, v. Eastman*) and a reluctance to create a "no lose scenario in which employers receive the benefits of an overbroad covenant, and on those occasions when enforceability is challenged, gain the benefit of a lawful restriction through blue-penciling" (*Sunder Energy* Court of Chancery opinion). Thus, to stand the best chance of surviving reasonableness review, parties should draft unambiguous and narrowly tailored noncompete restrictions in the first instance rather than relying on judicial blue penciling to save intentionally overbroad restrictions.

Other recent decisions—including, most notably, *Cantor Fitzgerald v. Ainslie, LKQ v. Rutledge*, and *Fortiline v. McCall*—have drawn a meaningful distinction between noncompetes and so-called forfeiture-for-competition provisions. Unlike traditional noncompetes that restrict competitive activity outright, forfeiture-for-competition provisions provide that employees will lose some contingent benefit or right (such as future compensation or their ownership interests in the entity) if they engage in restricted competitive activity. These provisions effectively give employees the choice to compete but impose a clear contractual cost on them for doing so.

In *Cantor Fitzgerald*, the Supreme Court opined that the same policy interest justifying reasonableness review did not apply to forfeiture-for-competition provisions because they do not outright restrict competition, and such provisions should therefore be analyzed and enforced using general contract principles. The Supreme Court proceeded to uphold the terms of a limited partnership agreement that authorized a partnership to withhold consideration that otherwise would have been owed to former partners who competed with the partnership. In *LKQ v. Rutledge*, which involved a forfeiture-for-competition provision in an equity award agreement, the Supreme Court further clarified that the same analysis in *Cantor Fitzgerald* would be applied by Delaware courts outside of the limited partnership context as well. Most recently, in *Fortiline v. McCall*, the Court of Chancery explained the application of reasonableness review is not dictated by the remedy sought by the enforcing party, but rather by what the provision demands of the individual against whom enforcement is sought—if the provision restricts competition, reasonableness review will apply. But if the provision simply provides a penalty in the form of forfeiture of contingent benefits in the event of competition, it will not. Despite the Delaware courts' general shift away from applying reasonableness review to forfeiture-for-competition provisions, in *LKQ*, the Supreme Court acknowledged that reasonableness review could still be appropriate in circumstances where the provision "is so extreme in duration and financial hardship" as to preclude the employee choice.

Given the number of recent impactful decisions in this area, existing noncompetes should be carefully reviewed to determine whether they are clear and narrowly tailored enough to withstand reasonableness review. Contract drafters should also consider whether their legitimate business interests can be protected through the use of forfeiture-for-competition provisions that may be less likely to be subject to reasonableness review by Delaware courts than a traditional noncompete.

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