



Delaware is Moving Away from Broadly Enforcing Non-Competition Restrictions

Mar 15, 2023

Categories:

[Blogs](#)

[Private Equity Industry](#)

[Blog](#)

Authors:

[Edward W. Moore, Jr.](#)

[David J. Zylka](#)

[Jack Griffith](#)

This article was originally published in [Reuters Legal News \(March 13, 2023\)](#).

Delaware courts are joining a growing list of legislative, judicial, and regulatory bodies that view restrictive non-competition covenants unfavorably. In three recent Chancery Court opinions, Delaware courts reflect an evolution in jurisprudence regarding restrictive covenants' interpretation. Other notable regulatory developments may also impact treatment of such covenants.

In January 2023, the U.S. Federal Trade Commission (FTC) issued a proposed rule that would effectively ban all employers from imposing non-compete agreements on their workers, which includes a *limited* exception for non-competition agreements between a seller and buyer of a business; however, the exception is only available where the party restricted by the non-compete clause is an owner, member, or partner holding at least a 25% ownership, and also restricts non-solicitation and other non-competition provisions.

Buyers and sellers shouldn't assume that Delaware law will apply to determine if such restrictions are enforceable pursuant public policy.

Even when applied, the restrictions must be reasonable on their face or the courts won't reform them for enforcement. Buyers and sellers shouldn't rely on Delaware courts to reform or "blue pencil" restrictive covenants to a reasonable and enforceable level or scope.

Delaware law will not always be applied

In the February 2023 case of *Hightower Holding, LLC v. John Gibson* that Court denied an action seeking enforcement of restrictive covenants that were subject to Delaware law pursuant to its

deference to the law and prevailing public policy of Alabama law.

The determination of a different applicable law of the restrictions, rather than accepting the agreed governing law, results in a blanket rejection of non-competition and non-solicitation restrictive covenants.

John Gibson was employed as a partner and financial advisor at a financial advisory firm that was subsequently acquired by Hightower Holding, LLC. Gibson and other partners entered an agreement (the "Protective Agreement") subject to Delaware law containing restrictive covenants subject to an essentially five-year restricted period prohibiting Gibson from: owning any interest in, managing, controlling, participating in, consulting with, or becoming engaged or involved with any person engaged in or to engage in the "Business" of Hightower within the U.S. or any other jurisdiction in which Hightower does business (the "Territory"); or making any investment (whether equity, debt or other) in, lending or providing money or assets, or providing any guaranty or other financial assistance to any person engaged or to engage in the Business in the Territory.

Gibson also agreed to Hightower's Amended and Restated Limited Liability Company Agreement (the "LLC Agreement") subject to Delaware law that contained restrictive covenants subject to a restricted period of more than six years (the "LLC Agreement Restricted Period"), prohibiting engaging in substantially similar activities as described in the Protective Agreement.

Gibson resigned from Hightower after establishing his own investment fund entity (formed under Delaware law), and fund management and investment entities (formed under Alabama law), prior to his resignation (collectively, the "Gibson Entities").

These recent decisions and related proposals are critical for drafters of acquisition agreements to understand so restrictive covenants may be enforced against sellers of businesses, departing key employees or management team members with equity interests.

The increasing frequency of the Delaware Chancery Court's refusal to enforce these types of restrictions now includes merger and

acquisition transactions, not merely discrete restrictive employment agreements. The holdings in these recent cases provide a new analytical approach that directly impacts private equity and venture capital transactions and any transaction with non-compete or non-solicit covenants.

While still subject to potential appeal, these decisions serve as a warning that buyers with diversified portfolios and lines of business must take care to narrowly tailor restrictive covenants to only those activities germane to the business of the target and avoid expanding restrictions to other holdings. The courts have limited the interpretation of terms such as “Restricted Territory,” and lines of business that can be defined as a “Restricted Business.”

The Court ruled that Alabama, not Delaware, was the default state for determining applicable law; the restrictive covenants conflicted with Alabama policy, and Alabama’s interests outweighed those of Delaware.

Delaware follows the Restatement (Second) of Conflicts of Laws (the “Restatement”), which provides that a contractual choice of law will generally control, unless an exception applies. The Court noted that in certain circumstances the exception allows for the law of the default state (the state with the most significant contacts and compelling public policy interest) to govern if enforcement of the covenant would conflict with a “fundamental policy” of the default state’s law and the default state “has a materially greater interest in the issues” of the contract at hand.

Since the relevant agreements were negotiated, executed, and performed in Alabama, the acquired investment advisory firm was located there, and Gibson’s alleged breaches centered in Alabama as Gibson and Gibson Entities were all either domiciled/formed, operated, and/or registered in Alabama, the Court determined that “[t]he heavy weight of Alabama’s relationship to this matter indicates that its law would apply absent the parties’ selection of Delaware law.”

Don’t let your reach exceed your grasp

In the October 2022 case of *Kodiak Building Partners, LLC v. Philip D. Adams*, Kodiak Building Partners LLC, a Delaware LLC, purchased Philip Adams' and other stockholders' shares in building and roof trusses materials company Northwest Building Components Inc., a Washington corporation with a location in Idaho.

The transaction included an agreement that specifically included: non-competition; non-solicitation; confidentiality; non-interference; and non-disparagement restrictive covenants (collectively, the "Restrictive Covenants"). The Restrictive Covenants were applicable for 30 months from the date of closing, included acknowledgment by Adams and the waiver of any right to challenge the reasonableness and necessity of the Restrictive Covenants.

Adams took employment within 30 months with a national roof truss producer. Kodiak sought to enjoin him from continuing in that position. The Delaware Court of Chancery noted the purpose of Restrictive Covenants, and in particular the non-competition clauses, in the context of transactions involving the sale of a business, are meant to protect an acquirer's *legitimate* economic interests in a purchased asset (in this case, Northwest's business and not Kodiak's).

The Court asserted it mandated, under public policy, to review non-competition covenants for reasonableness regardless of the intent at the time of agreement and struck the non-competition covenant, determining that: it would be inequitable to enforce the non-competition covenant against Adams since Kodiak's legitimate economic interest could support restraining Adams' employment only in the goodwill and competitive space of Northwest and in the market Northwest serves (i.e., not that of Kodiak's subsidiaries); and the waiver by Adams of his right to challenge the reasonableness of the non-competition covenant was immaterial in light of the Court's underlying obligation to comply with Delaware law and to review the Root Cause Analysis (RCA) for compliance with public policy before granting an injunction.

The Court declined to "blue pencil" the restrictive covenant to a reasonable level and instead struck the covenant in its entirety.

“[W]here noncompete or nonsolicit covenants are unreasonable in part, Delaware courts are hesitant to ‘blue pencil’ such agreements to make them reasonable.”

Restrictive covenants in governance agreement are at risk

On the heels of *Kodiak*, in the January 2023 case of *Ainslie v. Cantor Fitzgerald*, the Court delivered a subsequent, and similarly chilling, opinion refusing to enforce restrictive covenants created outside the employment agreement of an employee co-owner of a business.

The Court held that certain restrictive covenants, applicable to former partners who voluntarily left their partnership, were unreasonable and unenforceable due to their excessive scope and were unnecessary to the legitimate protection of the partnership’s goodwill and customer relationships.

Brad Ainslie, and five other former partners, (collectively, the “Former Partners”), brought suit against their former partnership, Cantor Fitzgerald, L.P., for enforcing unreasonable restraints of trade against buyers in Cantor’s limited partnership agreement (the “LP Agreement”) upon their voluntary withdrawal from the partnership.

Several provisions in the LP Agreement were drafted to prohibit the Former Partners from competing, soliciting clients or employees, or using the confidential information of the partnership following their withdrawal. They included a restrictive covenant prohibiting competition for one year and a restrictive covenant prohibiting solicitation of the clients or employees of Cantor for a period of two years (the “Restrictive Covenant Devices”); a conditioned payment device (the “Conditioned Payment Device”) that allowed Cantor to withhold otherwise earned payments from a Former Partner’s capital account (the “Conditioned Payments”) as a penalty for breaching any Restrictive Covenant Device in the LP Agreement (the “No Breach Condition”); and engaging in competitive activity within four years following withdrawal, even if it wouldn’t otherwise breach a Restrictive Covenant Device (the “Competitive Activity Condition”).

The Court held the provisions were conditions precedent, as opposed to penalties. While the No Breach Condition was triggered by a breach of the Restrictive Covenant Devices by the Former Partners, “for such breach to occur, the underlying promise must be enforceable” but such Restrictive Covenant Devices were “facially overbroad and void against public policy,” and could not serve as a basis for triggering the No Breach Covenant and Cantor’s subsequent exercise of the Conditioned Payment Device. The Competitive Activity Condition doesn’t depend upon a breach of the Restrictive Covenant Devices for its validity but is subject to a reasonableness determination considering Delaware public policy.

Upon application of such reasonableness test, the Court found the Competitive Activity Condition was invalid as contrary to public policy. Although the agreement lacked geographic restrictions, the agreement was not necessarily unenforceable. Still, a convincing rationale wasn’t provided by Cantor for enforcement of a broad and vaguely defined scope to protect goodwill and customer relationships.

The Court found the Competitive Activity Condition to be a “forfeiture-for-competition” provision.

“Delaware law is clear that imposing financial consequences on former employees for competitive circumstances that are not their fault, and in an amount that is untethered to the former employer’s loss, has an in terrorem effect and operates as an unreasonable restraint of trade.”

Kodiak, Ainslie, and Hightower demonstrate that recent and ongoing transactions must be scrutinized to be reasonably likely to comply with less enforcement by Delaware courts, regardless of the manner in which those courts decline to enforce such restrictive covenants.

For more information, contact any attorney with Frost Brown Todd’s [Private Equity](#) industry team.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.