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Delaware Chancery Court Invalidates Restrictive Covenants and Forfeiture Provision In Partnership Agreement As Unreasonable

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The Delaware Chancery Court recently invalidated restrictive covenants in a limited partnership agreement, finding the covenants to be "facially overbroad" and declining to "blue pencil" those provisions. Significantly, the Court also applied Delaware's reasonableness test to invalidate a provision which subjected a return of capital and deferred compensation to forfeiture if the employee violated their restrictive covenants or competed with the employer. Employers with non-compete and non-solicitation agreements or so called "forfeiture-for-competition" provisions that apply Delaware law should carefully consider the scope of their agreements and consult with counsel for the best approach.

A Careful Look at the Scope of Restrictive Covenants and Forfeiture-For-Competition Provisions:

Delaware law concerning restrictive covenants is often considered favorable to employers. A recent ruling demonstrates, however, that Delaware courts will carefully review such provisions to ensure they satisfy the standards for enforceability.

In *Ainslie v. Cantor Fitzgerald, L.P.*, No. 9436-VCZ, 2023 WL 106924 (Del. Ch. Jan. 4, 2023), the Court reviewed two mechanisms in Cantor Fitzgerald's limited partnership agreement designed to "discourage[] former partners" from competition: restrictive covenants and a forfeiture-for-competition clause.

Cantor Fitzgerald's restrictive covenants included a one-year non-compete provision and a two-year non-solicitation provision. Under Cantor Fitzgerald's limited partnership agreement, a limited partner "will breach a Restrictive Covenant only when the Partnership's Managing General Partner makes the good faith determination that the partner has done so."

Under the forfeiture-for-competition clause, Cantor Fitzgerald agreed to pay limited partners their capital accounts and earned compensation over a period of four years, unless the partners engaged in competitive activity. In such a case, the clause allowed Cantor Fitzgerald to deem those payments forfeited.

At issue in *Ainslie* was Cantor Fitzgerald's decision to forfeit payments ranging from approximately $100,000 to over $5 million to six former limited partners after each partner was determined to have engaged in competitive activity. In response, the six former limited partners sued Cantor Fitzgerald

seeking the payments, as well as a declaration rendering the forfeiture-for-payment clause unenforceable.

To determine whether the forfeiture clause was enforceable and therefore whether the former partners were entitled to their money, the Court explained, it "must evaluate whether the Restrictive Covenants are enforceable under Delaware law." In doing so, the Court held the restrictive covenants were "unreasonable and therefore unenforceable."

The *Ainslie* analysis of the restrictive covenants provides important insight for employers into the Court's current and future stance regarding the permissible scope of non-compete and non-solicitation agreements.

At the outset, the Court cited a prior decision from October 2022, stating, "Delaware courts are hesitant to 'blue pencil' such agreements to make them reasonable." *Kodiak Bldg. P'rs, LLC v. Adams*, 2022 WL 5240507, at *4 (Del. Ch. Oct. 6, 2022). Further, the Court rejected the argument that a stipulation as to the reasonableness of the covenants found in the agreement "insulate[d] the agreement from a reasonableness review under Delaware law."

The Court found the restrictions unreasonable for a number of reasons. First, it held that the worldwide geographic scope was unreasonable under the circumstances. Second, the Court stated the covenants were "most patently unreasonable" in the scope of whom the covenants protected, in part because they covered activities competitive with any affiliated entity of Cantor Fitzgerald.

Third, the Court addressed the agreement's definition of "prohibited solicitation," stating the definition "includes acting in concert with others to attempt to 'solicit, induce, or influence' a consultant to terminate 'other business arrangements' with Cantor Fitzgerald, and inducing a customer or employee of a Cantor Fitzgerald affiliate to 'adversely affect their relationship' with an affiliate." The Court also mentioned other prohibited activities in the covenants, including "assisting others in becoming 'connected with[] any Competing Business' of an affiliate and taking 'any action that results directly or indirectly in revenues or other benefit for that Limited Partner or any third party that is *or could be considered* to be engaged in such Competitive Activity.'"

In holding these restrictions to be overly broad, the Court expressed concern that, given the language of the agreement, "it is highly possible a partner could unknowingly engage in a Competitive Activity."

The "overbreadth [of the Agreement,]" the Court said, "is exacerbated by how the LP Agreement defines whether it has been breached." The Court noted that the breach provision expanded "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 believed in good faith that the employment was a Competitive Activity."

Take-Away and Next Steps:

The Court's holding in *Ainslie* provides valuable guidance to employers seeking to ensure the validity of their non-compete and non-solicitation agreements, as well as those seeking to protect legitimate business interests through forfeiture-for-competition provisions. Employers should work with counsel to draft narrowly tailored agreements that are reasonable in the scope of geographic location and protected activity.

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