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Employment

In Reversal, Delaware Supreme Court Enforces "Forfeiture for Competition" Conditions in Partnership Agreement

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The Delaware Supreme Court recently reversed a Chancery Court decision involving important issues related to "forfeiture for competition" provisions in partnership agreements. Such provisions are often used by fund managers and others to structure deferred compensation arrangements and disincentivize senior personnel from departing and competing. In *Cantor Fitzgerald, L.P. v. Ainslie* (*Ainslie*), the Supreme Court reversed and remanded the decision we reported on in March 2023, ruling that when sophisticated parties, in a contract governed by the Delaware Revised Uniform Limited Partnership Act (DRULPA), "agree that a departing partner will forfeit a specified benefit should he engage in competition with the partnership, [Delaware] courts should, absent unconscionability, bad faith, or other extraordinary circumstances, hold them to their agreements." In doing so, the Supreme Court wrote favorably of the employee-choice doctrine but did not expressly adopt it as part of Delaware law.

This article discusses the key holdings of the Supreme Court's decision, as well as updated practical considerations for fund managers in light of the reversal.

For the authors' previous article on the Chancery Court's decision, see "Delaware Chancery Court Strikes Down Employee Restrictive Covenants in a Partnership Agreement" (Mar. 16, 2023).

Background

The *Ainslie* case involved six former Cantor Fitzgerald employees who were also partners under a limited partnership agreement (LPA) with Cantor. The LPA contained two interrelated mechanisms designed to discourage former partners from competing with the partnership following their departures. Both mechanisms implicated a departing partner's deferred compensation, which otherwise would be payable in four equal annual installments.

The first mechanism involves restrictive covenants, including a prohibition lasting up to two years on engaging in "Competitive Activity," which is defined to include competition and solicitation of

employees and customers. A breach of the restrictive covenants – or, more precisely, a determination by the partnership's managing general partner that a former partner breached such covenants – entitles the partnership to:

- forfeit the former partner's deferred compensation; and
- seek injunctive relief to enforce the restrictive covenants to prevent ongoing breaches.

Under the second mechanism, referred to as the "Conditioned Payment Device," a departing partner's deferred compensation is forfeited if the former partner either:

1. breaches the restrictive covenants (referred to in the decision as the "No Breach Condition"); or
2. engages in Competitive Activity (referred to as the "Competitive Activity Condition").

Unlike a breach of the restrictive covenants, a failure to satisfy the Competitive Activity Condition does not give rise to a claim for injunctive relief, but it does entitle Cantor to declare the deferred compensation forfeited.

Following Cantor's determination that the six plaintiffs engaged in Competitive Activity, Cantor withheld deferred compensation from them, in amounts ranging from about $100,000 to more than $5 million. Cantor did not, however, seek injunctive relief to enforce the restrictive covenants. The six former partners subsequently sued Cantor to obtain the withheld payments.

See our two-part series: "D.C. and Illinois Restrictive Covenant Reforms Threaten Fund Managers' Non-Compete Arrangements" (Jan. 18, 2024); and "Restrictive Covenant Laws at the Federal and State Level Increase Challenges of Enforcing Non-Compete Agreements" (Feb. 1, 2024).

The Lower Court's Decision

The Chancery Court subjected the No Breach Condition to the standard applicable to the enforceability of restrictive covenants imposed on employees, including a review for reasonableness. The Chancery Court found the restrictive covenants facially overbroad and void as against public policy and thus unenforceable and not capable of triggering the No Breach Condition. In so finding, the court noted:

- the worldwide geographical scope of the restrictions;
- their application to all of Cantor's affiliates;
- the broad scope of the restrictions; and
- the fact that a breach could occur not only through actual competition but also by Cantor's managing general partner determining that a breach has occurred.

As to the Competitive Activity Condition, commonly known as a "forfeiture for competition" provision, the Chancery Court applied the standard applicable to a sale of a business, under which the review is the same as applied to restrictive covenants imposed on employees, but the inquiry is "less

searching." The Chancery Court found that even that more lenient standard was not met, and the Competitive Activity Condition therefore also was not satisfied. Although the scope of the Competitive Activity Condition was narrower than the No Breach Condition, the Chancery Court found the length of the restricted period – four years – unreasonable, especially given the shorter period applicable to the No Breach Condition (up to two years). The court found that "[n]early any legitimate interest [Cantor] had in the scope of the Restrictive Covenants in years one and two is stale by years three and four."

In so finding, the Chancery Court refused to apply the employee-choice doctrine, which is described below. It likened forfeiture-for-competition provisions to liquidated damages provisions of which Delaware law is skeptical. Further, the Chancery Court refused to apply a more lenient standard to LPAs, noting that "Delaware courts . . . make no exception for restrictive covenants in the partnership setting."

The Chancery Court also refused to "blue-pencil," or revise, the restrictive covenants to make them reasonable, noting that when non-compete or non-solicitation agreements are unreasonable in part, "Delaware courts are hesitant to 'blue pencil' such agreements to make them reasonable" – even if the agreement includes a "blue-pencil" provision.

The Supreme Court's Decision

Freedom of Contracts and Deference to LPA Provisions

In reversing and remanding the Chancery Court's decision, the Delaware Supreme Court balanced "the relevant policy interests differently." It emphasized that the DRULPA, which governs the LPA at issue in the case, is expressly designed "to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." The Supreme Court stressed, "The emphatic policy statement in DRULPA corresponds with our tradition of ensuring freedom of contract . . . in order to facilitate commerce. We uphold the freedom of contract and enforce as a matter of *fundamental public policy* the voluntary agreements of sophisticated parties."

The Supreme Court nonetheless noted that freedom of contract is not absolute. "For instance, contracts that offend public policy or harm the public are deemed void, as opposed to voidable. But, given our strong interest in freedom of contract, covenants not to compete subject to Delaware law do not fall into this category," it explained.

In addition, the Supreme Court relied on the fact that the Competitive Activity Condition in the applicable LPA did not actually forbid competition or provide a basis for injunctive relief to prevent it, thus putting it "on different footing than underlies non-competition covenants such as the Restrictive Covenants underpinning the No Breach Condition." The Supreme Court explained that "if the former partner wishes to compete with Cantor Fitzgerald during the relevant time, Cantor Fitzgerald need not confer the deferred benefit on the former partner, who has agreed to forfeit that benefit upon engaging in competition."

The Supreme Court also rejected the Chancery Court's analogy to liquidated damages, which it felt was at "the heart" of the Chancery Court's decision, emphasizing that the Competitive Activity Condition was a condition precedent to Cantor's duty to pay the conditioned amounts. The Supreme Court stated, "This distinction is significant; liquidated damages, by definition, are a remedy for breach of contract and are not recoverable for a failure to meet a condition precedent."

Lastly, the Supreme Court disagreed with the Chancery Court's stance that "the common law's disfavor of forfeitures extends to [LPAs]" referring to DRULPA §17-306, which "permits partnership agreements to contain consequences that would be unavailable in a standard commercial contract, most notably penalties and forfeitures." The Supreme Court ruled that "forfeitures in [LPAs] should enjoy this court's deference on equal footing with any other bargained-for-term in a[n] [LPA]."

The Supreme Court concluded its ruling as follows:

> To sum up, we disagree with the Court of Chancery's conclusion that forfeiture-for-competition provisions like the one at issue here are restraints of trade subject to review for reasonableness. When sophisticated parties agree in a limited partnership agreement that a partner, who voluntarily withdraws from, and then competes with, the partnership, will forfeit contingent post-withdrawal financial benefits, public-policy considerations weigh in favor of enforcing that agreement.

The Employee-Choice Doctrine

As noted above, the Chancery Court refused to adopt the employee-choice doctrine, which, as described by the Delaware Supreme Court, "assumes that an employee who elects to leave a company makes an informed choice between forfeiting a certain benefit or retaining the benefit by avoiding competitive employment." The Supreme Court noted that the employee-choice doctrine appears to be the majority approach.

Although the Supreme Court did not expressly adopt the employee-choice doctrine – deciding the case instead on the freedom of contract afforded under the DRULPA – it agreed with the reasoning of those jurisdictions that have adopted such doctrine:

> The distinction between a restrictive non-competition covenant that precludes a former employee from earning a living in his chosen field and an agreement that allows a former partner to compete but at the cost of relinquishing a contingent benefit is, in our observation, significant. In the restrictive-covenant context, the former employee is effectively deprived of his livelihood and, correspondingly, exposed to the risk of serious financial hardship. This gives rise to the strong policy interest that justifies the review of unambiguous contract provisions for reasonableness and a balancing of the equities, two exercises typically foreign to judicial review in contract actions. By contrast, however, forfeiture-for-competition provisions, which, unlike restrictive covenants, are not enforceable through injunctive relief, do not prohibit employees from competing and remaining in their chosen profession, and do not deprive the public of the employee's services, present no such concern. The policy interest that preponderates in the former

> case is diminished – if it does not vanish – in the latter. To put it another way, the interest to be vindicated when evaluating a covenant that prohibits competition and that might even preclude gainful employment is significantly weakened when competition – often (as in this case) highly remunerative – is permitted. That diminished interest is insufficient to override DRULPA's directive to "give maximum effect to the principle of freedom of contract and the enforceability of partnership agreements."

The Supreme Court noted that the Conditioned Payment Device operates regardless of whether the employment and partnership is voluntarily or involuntarily terminated. However, the Supreme Court focused on the consequences of a partner's departing voluntarily, as was the case here.

In January 2023, the Federal Trade Commission (FTC) proposed a rule that would severely restrict the use of non-compete provisions. For more on the FTC's proposed rule, see "What Fund Managers Should Know About the FTC's Proposed Ban on Non-Compete Provisions" (Feb. 16, 2023).

Practical Considerations for Fund Managers

The Delaware Supreme Court's decision in *Ainslie* restores the view that fund managers have extensive latitude in constructing LPA provisions designed to discourage competition and solicitation in connection with deferred compensation arrangements. Unlike its jurisprudence regarding restrictive covenants in a purely employer-employee relationship, the Supreme Court declined to analyze the reasonableness of the forfeiture-for-competition conditions contained in an LPA.

As a result, *Ainslie* demonstrates that the restricted period applicable to forfeiture-for-competition provisions in an LPA could be longer than an ordinary non-compete. In *Ainslie*, the restricted period for the No Breach Condition in the LPA was four years, as compared to the restricted period applicable to the employees' Competitive Activity Condition of up to two years.

Because of the similarity between the provisions of the DRULPA relied on by the Supreme Court and the parallel provisions of the Delaware Limited Liability Company Act, it seems likely that similar deference would be given by a Delaware court to such provisions if included in a limited liability company (LLC) agreement.

Nevertheless, as to restrictive covenants that apply to employees and are not part of deferred compensation-related conditions in an LPA, the Chancery Court's decision in *Ainslie* may well stand as a guide in crafting such arrangements. The Delaware Supreme Court did not reject the Chancery Court's reasonableness analysis but rather ruled that it should not have been applied to the LPA's forfeiture-for-competition condition precedent. Until more post-*Ainslie* case law is developed, the Chancery Court's finding that the specific restrictive covenants in *Ainslie* were unreasonable and unenforceable should still be considered when drafting and assessing restrictive covenants.

In addition, the Delaware Supreme Court's decision focused on the Competitive Activity Condition (the forfeiture-for-competition provision) and found Cantor was entitled to rely on it to withhold the conditioned payments. It seems that having made such finding, the court did not need to analyze and did not make a similar finding as to the No Breach Condition (the alternative condition

precedent in Cantor's Conditioned Payment Device). Because the forfeiture-for-competition provision was the Supreme Court's focus, fund managers wishing to disincentivize competition and solicitation by former partners should consider including forfeiture-for-competition provisions in their LPAs and LLC agreements, rather than relying exclusively on conditions triggered by the breach of a restrictive covenant contained in an employment agreement.

It is also notable that the Chancery Court refused to "blue pencil" the restrictive covenants, an issue the Supreme Court did not address in its holding. Thus, fund managers should bear in mind that a Delaware court may not come to the rescue if a restrictive covenant is overbroad.

Therefore, fund managers would still be well advised to assess, with their counsel and in light of the Chancery Court's analysis:

- the scope of the prohibited activities, including any application to affiliates;
- their geographical and temporal scope;
- who decides whether a breach has occurred;
- whether inconsistencies exist among the restrictive covenant provisions; and
- the potential financial consequences of any restrictive provisions.

At the same time, fund managers should review and construct forfeiture-for-competition provisions in LPAs and LLC agreements designed to discourage competition and solicitation under the standard set forth in *Ainslie*: absent unconscionability, bad faith or other extraordinary circumstances, a Delaware court would analyze such provisions under the fundamental public policy of freedom of contract – without regard to their reasonableness, especially when the limited partners are sophisticated parties.

See "How NY-Based Investment Managers Can Craft Enforceable Non-Competes That Do Not Provide for Post-Employment Compensation" (Sep. 5, 2019).

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