Hedge Fund Law Report

Delaware Chancery Court Strikes Down Employee Restrictive Covenants in a Partnership Agreement

By Lance J. Gotko, Asaf Reindel and Yaara Shchori-Ben Harush, *Friedman Kaplan Seiler Adelman & Robbins LLP*

Restrictive provisions in employment contracts have been getting a lot of attention of late. For example, in January 2023, the Federal Trade Commission (FTC) released a proposed rule that would severely restrict the use of non-compete clauses. The same month, the Delaware Chancery Court issued its decision in *Ainslie v. Cantor Fitzgerald, L.P.* (*Ainslie*). That decision is a cautionary tale for employers that might believe Delaware's general pro-business slant makes it a friendly environment for the enforcement of non-competes and other restrictive covenants – including those imposed on employees via partnership agreements. In *Ainslie*, the court held that non-competition and non-solicitation restrictions, as well as a four-year forfeiture-for-competition provision, contained in a partnership agreement were unenforceable due to their unreasonable scope and duration.

This article discusses the key holdings in *Ainslie*, as well as practical considerations for fund managers.

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).

Background

In *Ainslie*, six Hong-Kong-based former employees were parties to a limited partnership agreement with Cantor that contained several in-

terlocking provisions designed to prohibit or discourage competition after the end of their employment:

- one-year non-compete provision; and
- a two-year ban on solicitation of Cantor's customers and employees.

The partnership agreement essentially defined "competitive activity" as breaching the restrictive covenants or otherwise engaging in any activity that competes with any of the businesses of Cantor or its affiliated entities. There was no geographic limitation to the restrictive covenants, which therefore were worldwide in their scope. Cantor (the limited partnership's managing general partner) was granted the exclusive, final and binding power to determine, in good faith, whether a former partner had violated the restrictive covenants.

In addition, the partnership agreement provided that some of a withdrawing partner's compensation would be held back – and paid out over four years – on the conditions that the individual must not breach the restrictive covenants (No Breach Condition) and must not otherwise engage in competitive activity during the four-year period (No Competitive Activity Condition). If a former partner violated either or both conditions, that person would forfeit any held-back sums not already paid. The partnership was formed under Delaware law, and the partnership agreement selected Delaware courts as the forum for all disputes.

The six employees left Cantor and, shortly thereafter, went to work for a competitor. Cantor determined that the former employees violated the No Breach Condition and the No Competitive Activity Condition and therefore forfeited their held-back sums, which ranged among the individuals from about $100,000 to almost $5.5 million. The former employees sued Cantor in the Delaware Court of Chancery for (among other things) breach of contract, claiming that the forfeiture-for-competition provision and the restrictive covenants were invalid.

Cantor sued – and lost – in Hong Kong to enforce the restrictive covenants in the former employees' employment agreements, but, in the Delaware action, Cantor did not seek enforcement of the restrictive covenants contained in the partnership agreement. Accordingly, the core issue presented was whether the forfeiture-for-competition provision for breach of the restrictive covenants or otherwise engaging in competitive activity was enforceable. After a couple of years of discovery, all the parties moved for summary judgment.[1]

See "Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements" (Nov. 23, 2011).

Restrictive Covenants and No Breach Condition Are Unenforceable

No Exception for Partnerships

In its brief, Cantor cited authority from the Delaware Supreme Court, the Court of Chancery and the Delaware Revised Uniform Limited Partnership Act for the broad proposition that the partnership agreement should be enforced pursuant to its clear terms. The *Ainslie* court was not swayed by this argument. Instead, the court declared that Delaware courts do not mechanically enforce non-compete or non-solicit agreements – and "they make no exception for restrictive covenants in the partnership setting."

Having decided that the provisions at issue were not entitled to leeway just because they were in a partnership agreement, the *Ainslie* court proceeded to apply the standard applicable to enforceability of restrictive covenants imposed on employees. Namely, such covenants must:

1. be reasonable in geographic scope and temporal duration;
2. advance a legitimate economic interest of the party seeking their enforcement; and
3. survive a balancing of the equities.

The Court's Scope Analysis

The *Ainslie* court held that the restrictive covenants' worldwide geographic scope was unreasonable. It noted that "the absence of a geographic limitation does not render [a] restrictive covenant unenforceable *per se*: it can be enforceable if the restriction is narrowly tailored to serve the employer's interests in the circumstances of the case." But, the court found insufficient Cantor's "conclusory argument" that it is a global business and therefore, a global restrictive covenant was necessary.

The court also found the non-compete provision was "most patently unreasonable" because it protected not only Cantor but also all of its affiliates. In addition, the court emphasized the broad scope of the restrictive covenants, which (among other things) prohibited:

- assisting others in becoming connected with any competing business; and
- taking any action that results directly or indirectly in revenues or other benefit for a former partner that is "*or could be*

considered" to be engaged in competitive activity (emphasis in the original).

The court stressed that, under these standards, "it is highly possible" that a partner could unknowingly engage in a competitive activity. The court posited a hypothetical in which a former Cantor partner in Hong Kong takes a position as an accountant at a large international accounting firm that provides service to a European entity, which Cantor determines could be considered to be assisting others in indirectly competing with a Cantor affiliate. The court found that Cantor had not provided a convincing rationale why such a "broad and vaguely defined scope" was necessary to protect its good will, customer relationships or any other legitimate business interest (including protection of "any kind of information – proprietary or otherwise – that would warrant that restriction").

Although the court acknowledged that Delaware courts have enforced outright non-competes of five-year durations – and even longer "for more tailored restrictive covenants" – it held that the four-year forfeiture-for-competition provision was unreasonable in light of the partnership agreement's "broad and vaguely defined provisions." The court also held that the restrictive covenants' overbreadth was exacerbated because they could be breached not only through actual competition but also by Cantor deciding they had been breached, thus expanding their scope to activities that did not harm any legitimate Cantor interests.

The court considered the balance of equities, including Cantor's arguments that:

- it was not seeking to prohibit the former employees from obtaining competitive employment;
- the former employees knowingly entered into the partnership agreement, fully aware of its terms;
- they profited from the enforcement of those provisions against other withdrawing partners; and
- to deny enforcement of the restrictive covenants would deny Cantor and its other partners the benefit of their bargain.

The *Ainslie* court, however, found that those considerations were outweighed by the amounts the former employees stood to lose; the fact that Cantor relied on its decision to forfeit those amounts rather than establishing they had actually breached the agreement before a factfinder; and that the restrictions themselves are so broad that it appears it would be difficult – and so vague that it would be risky – for former Cantor partners to find employment in, or adjacent to, the financial services field. Having found the restrictive covenants invalid, the court also invalidated the No Breach Condition.

See "District Court Decision Suggests That Overly Broad Restrictive Covenants Will Not Be Enforced in Employment Agreements in the Wealth Management Industry" (Apr. 26, 2012).

No "Blue Pencil"

In addition, the court refused to re-write or "blue-pencil" 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 when an agreement expressly provides that unenforceable contractual terms may be revised as necessary to make them enforceable.

No Competitive Activity Condition Is Unenforceable

After invalidating the No Breach Condition, the *Ainslie* court then turned to consider the validity of the No Competitive Activity Condition.

The Court Rejected the Employee Choice Doctrine

In defending the No Competitive Activity Condition, Cantor urged the court to apply the "employee choice" doctrine, which views forfeiture-for-competition provisions not as restrictive covenants but as financial disincentives that come into play when an employee chooses to quit to work for a competitor. Under that doctrine, forfeiture-for-competition provisions are not reviewed for reasonableness.

Noting that "[o]ther courts have stated that employee choice is the majority approach," the *Ainslie* court nevertheless decided it was "more consistent with Delaware law" to refuse to apply the doctrine. The court explained that decision by noting that:

> forfeiture-for-competition provisions may still meaningfully deter or prevent employees from seeking other employment in a manner that is disproportionate to the employer's interest. In my view, to embrace the employee choice doctrine wholesale would be to turn a blind eye to these concerns that Delaware law has prioritized. Applying the reasonableness standard to forfeiture-for-competition provisions can weed out abusive and harmful forfeiture provisions while still permitting employers to discourage competition insofar as their interests warrant it.

In connection with this analysis, the court likened forfeiture-for-competition provisions to liquidated damages provisions to which Delaware law extends skepticism, and reasoned that:

> it is only a small step to move from a liquidated damages provision requiring a former employee to pay amounts to a former employer if the employee competes, to a forfeiture-for-competition provision excusing the employer from paying amounts if the employee competes. Like liquidated damages provisions based on competition, forfeitures are disfavored because of their potential to cause unjust outcomes.

In addition, the court observed that even if Delaware law were agreeable to adopting the employee choice doctrine, the No Competitive Activity Condition was a "poor fit for it," because forfeiture could occur regardless of the reason an individual ceases to be a partner, while the employee choice doctrine requires the employee to have quit voluntarily.

The Court Applied a Sale of Business Reasonableness Review

Having refused to apply the employee choice doctrine, the court concluded that Delaware law supported the state "joining the ranks of jurisdictions that review forfeiture-for-competition provisions for reasonableness as restraints on trade." The court held, however, that the fact former Cantor partners are "still free to compete justifies scaling the review back to the more lenient or employer-friendly review Delaware affords restrictive covenants in the sale of a business as compared to an employment agreement." That review is the same as the one applied to covenants imposed on employees, but the inquiry is "less searching."

In applying this less searching review to the No Competitive Activity Condition, the *Ainslie* court found that the scope of the prohibited activity was narrower than under the No Breach Condition:

- the definition of competitive activity did not include taking actions that "could be considered" competitive activity; and
- unlike with respect to the restrictive covenants, Cantor was not given the sole authority to determine whether the No Competitive Activity Condition had been met.

The court further noted, however, that the No Competitive Activity Condition restrained former partners for at least two years longer than the restrictive covenants, when nearly any legitimate interest Cantor had in the scope of the restrictive covenants in years one and

two is stale by years three and four. The court found that, even under this more lenient standard, nearly all of the reasons for concluding that the restrictive covenants are unreasonable apply, and "the [No] Competitive Activity Condition as a forfeiture-for-competition provision is unenforceable as an unreasonable restraint of trade."

In reaching this conclusion, the court observed that the amounts of the former employees' forfeitures were significant and not tethered to any competition that actually harmed the partnership. The court added that the breadth of "competitive activity" made it possible, if not likely, that a former partner could trigger it accidentally or unknowingly. The court emphasized that "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."

See "Trending Issues in Employment Law for Private Fund Managers: Non-Compete Agreements, Intellectual Property, Whistleblowers and Cybersecurity" (Nov. 17, 2016).

Practical Considerations for Fund Managers

The court's decision in *Ainslie* was clearly motivated by its sense that Cantor had overreached. The combination of the breadth of the restrictive covenants; the breadth and effect of the forfeiture-for-competition provision; and the fact that Cantor (not a court or jury) had the sole power to decide whether the restrictive covenants had been breached was just too much for the court. In light of this, when Delaware law applies, fund managers should consider whether adopting the kind of multi-layered approach the court condemned in *Ainslie* could do more harm than good.

Furthermore, fund managers and their counsel should bear in mind it is by no means certain that a court will come to the rescue if restrictive covenants are overbroad. As *Ainslie* demonstrates, even in jurisdictions where blue-penciling is available, the court may have discretion to refuse to re-write restrictive covenants it finds unreasonable.

Fund managers, working with their counsel, should also specifically review their restrictive covenants and forfeiture-for-competition provisions to:

- assess the scope of the prohibited activities, including the universe of affiliated entities to which the restrictions apply, and whether the provisions could cause a former partner or

employee to accidently or unknowingly engage in the prohibited activity. Fund managers should consider reducing applicability solely to what is truly needed to protect their legitimate business interests;

- assess the temporal scope of the covenants and whether the manager could articulate a legitimate business interest that would warrant the duration of the prohibitions;
- evaluate restrictive covenants that apply globally and consider confining them to specific geographic areas or, alternatively, specifically articulate in the covenants why worldwide restrictions are necessary to protect the manager's legitimate business interests (bearing in mind that "our business is worldwide" did not suffice in *Ainslie*);
- consider whether a breach could occur or a condition to payment will not be met even without actual competition, such as if the manager has the power to make an adverse determination;
- identify potential inconsistencies between provisions designed to discourage competition. For instance, in *Ainslie*, the court did not believe the four-year No Competitive Activity Condition could be justified by a legitimate business interest when the non-compete lasted just one year and the non-solicit expired after two years;
- consider the potential financial consequences of failure to satisfy a condition and its relationship to any actual potential loss to the partnership; and
- review any liquidated damages provisions used as enforcement devices for restrictive covenants through the lens of the *Ainslie* court's analysis of the enforceability of liquidated damages under Delaware law.

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

[1] On March 9, 2023, seven former employees/partners commenced a putative class action against Cantor and some of its affiliates in the U.S. District Court for the District of Delaware. Relying on and quoting the *Ainslie* decision, the plaintiffs allege that the one-year/two-year restrictive covenants and the four-year forfeiture-for-competition provision contained in Cantor's LPAs are unreasonably broad, unsupported by any legitimate business interest and unenforceable. The complaint defines the putative class as all persons who were LPs under any of Cantor's partnership agreements and who, after their employment with Cantor ceased, were denied payment of any of held-back sums.

Lance J. Gotko heads Friedman Kaplan's employment practice group and represents companies and individuals in the financial services and other industries in connection with a wide variety of employment-related matters. He provides advice and representation in disputes related to employment-related issues, separation agreements, group moves, compensation, misappropriation of trade secrets, breaches of noncompete agreements and fiduciary duties, and employment discrimination.

Asaf Reindel is a partner in the corporate and employment practices of Friedman Kaplan. He has a broad-based transactional and commercial practice, which includes representation of executives and senior employees, as well as employers, in the negotiation of employment and separation arrangements. He also represents investment funds in connection with investment transactions, employment and other corporate matters, as well as family offices and individuals in connection with their investments.

Yaara Shchori-Ben Harush is a foreign associate at Friedman Kaplan. Her corporate practice includes mergers and acquisitions; equity and debt financing; joint ventures; employment and separation agreements; and commercial contracts.