Delaware Supreme Court Affirms Interest Forfeiture Resulting From Partnership Agreement Non-Compete

Background

- We recently highlighted the Chancery Court decision in *Cantor* which invalidated certain provisions that mandated post-departure forfeiture of partnership benefits if the exiting partner competed
- The Delaware Supreme Court reversed the forfeiture part of the decision, finding that freedom of contract in an LPA under DE law overcame public policy interests disfavoring overbroad restrictive covenants

Court Findings

- Deference to Limited Partnership Agreements. The Delaware Revised Uniform Limited Partnership Act is intended "to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." The court held heightened deference was required because these provisions were in a DE partnership agreement
- Forfeiture Provisions Do Not Restrict Competition – Different Standard than Non-Compete. The Court also directly addressed the comparison between a forfeiture provision and a non-compete. Because the forfeiture provision (in practice and by explicit acknowledgement in the partnership agreement) did not restrict competition, it is evaluated on different standards than a non-compete. The court summed up its views on this difference in this excerpt:

> "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 … 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."

Takeaways

- "Forfeiture-for-competition" provisions that provide only economic consequences (and do not provide injunctive relief) could be attractive given this DE law and similar NY law, particularly if (a) there is enough held-back compensation to create the right incentives; and (b) the participant is not likely to simply be bought out by a competitor
- The DE Supreme Court is signaling that it will have more tolerance for restrictive covenants (however crafted) applicable to (a) partners vs. employees and (b) circumstances where the employee/partner quits voluntarily as opposed to being terminated

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