

For Compete's Sake! Delaware Court Declines to Enforce Sale-of-Business Restrictive Covenants

The Bottom Line

- Courts around the country subject non-competition agreements and other restrictive covenants to increasingly strict scrutiny in employment contracts.
- Courts applying Delaware law may also limit enforcement of restrictive covenants executed in the sale-of-business context to the extent necessary to protect a buyer's legitimate business interests.
- Goodwill acquired in the purchase of a business is a legitimate economic interest, but purchasers should ensure that restrictive covenants included in their transactions are drafted narrowly to protect that legitimate interest.

"Courts disfavor restrictive covenants." This statement has become axiomatic in employment law, and it has never been truer. In the past several years, judges in various jurisdictions have cast an increasingly critical eye on agreements that purport to restrict employees' ability to work elsewhere once they leave their jobs. It has also been clear that courts will more readily enforce restrictive covenants that a company owner signs in connection with the sale of their business. A recent decision by a Delaware court, however, seems to undermine this latter truism.

The Foundation: Key Facts

In *Kodiak Building Partners, LLC v. Adams*, Philip Adams was the general manager and a stockholder of Northwest, a roof truss company. Kodiak is a company that acquires and then operates construction and remodeling businesses, including the sales of lumber and building materials, gypsum, construction supplies and kitchen interiors. Kodiak purchased all of Northwest's assets and stock, acquiring all Adams' shares in the process. As part of the acquisition, Adams signed a restrictive covenant agreement (RCA) that included non-competition and customer non-solicitation provisions. Not long after the sale, Adams resigned from Northwest and went to work for a competing roof truss company, Builders FirstSource (BFS). After losing a construction job to BFS, Kodiak sued Adams for breaching his RCA, seeking an injunction against him.

Demolition: The Court Strikes Down the Covenants

Delaware courts have a reputation of being friendly to employers and corporations, and a history of enforcing contracts. For this reason, among others, companies often select Delaware law to govern their transactions, as Kodiak – a Delaware limited liability company – did here. Kodiak probably liked its chances in seeking enforcement of Adams’ restrictive covenants in Delaware. In this case, however, the Delaware Court of Chancery declined to enforce the company’s RCA.

In reviewing the RCA, the court held that the agreement’s non-competition and non-solicitation provisions were overly broad and not tailored to protect a legitimate business interest. The court confirmed that a purchaser has a legitimate interest in protecting goodwill purchased from a business’ seller. The covenants in Adams’ RCA, however, purported to restrict him from competing with *all* of Kodiak’s other businesses, and from soliciting *all* of those businesses’ customers, not just Northwest’s or even those of Kodiak’s other lumber and building materials companies. As the court explained, “Kodiak’s legitimate economic interest supporting a restrictive covenant binding a Northwest employee and stockholder does not extend to goodwill and competitive space acquired in other transactions with other Company Group members in other industry segments.” The court would not enforce covenants seeking to restrict Adams in that other competitive space.

The Annexes: Two More Notable Points

The court’s decision included two additional significant holdings.

First, the RCA included a waiver provision purporting to have Adams agree that the restrictive covenants were reasonable and promise not to challenge them in litigation. The court held that this commonly included provision was unenforceable because it violated Delaware public policy.

Second, Kodiak asked the court to “blue-pencil” the covenants, revising and limiting them to make them enforceable. Delaware courts have been willing to blue-pencil overly broad agreements in the past. The *Kodiak* court refused to do so, however, citing the inequity that would result by creating a “no-lose” situation for companies seeking to impose overbroad covenants, rewarding those companies for overreaching with the knowledge that a judge might partially enforce even a very broad covenant.

Drawing Up Your Plans: Carefully Tailor and Review Restrictive Covenants

Kodiak aligns with many recent cases that continue to hold that restrictive covenants are proper only to protect a business' legitimate interests, including protecting the goodwill it has purchased and preventing the unauthorized use of competitively sensitive information or other unfair competition. This decision extends that principle to evaluating the enforceability of covenants a seller signs in connection with the sale of its business. Covenants in that context have long been subject to a lower standard of review than those included in employment contracts. *Kodiak* suggests that, at least under Delaware law, courts will limit the enforceability of covenants even in the sale-of-business context, enforcing them only to the extent necessary to protect specific, legitimate business interests of the buyer.

For More Information

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