

PUBLICATION

Delaware Invalidates a Selling Stockholder's Non-Compete Covenant:

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In drafting restrictive covenants, acquiring companies should be aware that courts may not necessarily uphold, or even "blue pencil" (revise overbroad restrictive covenants), restrictive covenants imposed on sellers in an acquisition.

As an example, the Delaware Chancery Court in *Kodiak Building Partners, LLC v. Philip D. Adams* invalidated a non-compete covenant agreed to by Philip Adams, the selling company's former general manager and minority stockholder, in connection with the sale of the company for which he had worked for 17 years.

On June 1, 2020, Kodiak Building Partners (Kodiak) purchased the Idaho company Northwest Building Components (Northwest), which had one line of business – the manufacture, sale, and delivery of roof trusses – pursuant to a Stock Purchase Agreement. In connection with the acquisition, Northwest's selling stockholders, including Adams, entered into restrictive covenant agreements (RCAs), which restricted these stockholders from competing with any business in Kodiak's broad portfolio of construction-related companies (which included companies that produce roof trusses and lumber, drywall, steel construction supplies, and kitchen interiors) for a period of 30 months. The RCAs also restricted the stockholders from soliciting any client or customer of Kodiak and its affiliates and defined "confidential information" to include information relating to the other business lines under Kodiak's umbrella. The RCAs were governed by Delaware law.

Almost four months after the closing, Adams joined a company that, similar to Northwest, supplied building materials for roof trusses. However, Adams's new employer also provided building materials not related to roof trusses, such as lumber, and provided design services for roof trusses, all of which was outside the scope of business of Northwest. Adams's new employer had two locations in Spokane, Washington, with one being 24 miles from Northwest's location in Idaho. Approximately six months after the closing, Kodiak learned it had lost a job to Adams's new employer. Kodiak later brought suit in Delaware's Chancery Court against Adams, seeking a preliminary injunction for breaching his obligations under the RCA.

Consideration of Reasonableness or Business Justification

The Delaware court was unreceptive to Kodiak's position. As an initial matter, the court rejected Kodiak's argument that the court should not consider the reasonableness or business justification for the non-compete based on Adams's acknowledgment in the RCA that the restrictions were reasonable and justified by business necessity. The court noted that even if the parties have willingly entered into an agreement such as the RCA, the court will not enforce contractual provisions that are against public policy, adding that "[p]ublic policy requires Delaware courts to evaluate non[-]competition and non-solicitation contracts holistically, carefully, and nonmechanically, with an eye towards reasonableness, equity, and the advancement of legitimate business interests" (*Kodiak Bldg. Partners, LLC v. Adams*, No. 2022-0311-MTZ, 2022 WL 5240507 at *6 (Del. Ch. Oct. 6, 2022)).

The court went on to note that "[m]echanically enforcing additional language describing the covenants as reasonable would insulate the covenants from judicial review, gutting the work Delaware courts are charged with doing to effectuate the public policy of this State." This position made it clear that despite the commonly included language in restrictive covenant agreements where the party being restricted acknowledges both the

reasonableness of the restriction and the business necessity for it, parties seeking to enforce such agreements may still be required to establish that the restrictions are reasonable in geographic and temporal scope and in the scope of restricted activities, and that such restrictions protect a company's legitimate business interest and are not merely included in an effort to eliminate competition or restrict job mobility.

Consideration Whether Restrictions Advance Legitimate Business Interest

With that issue resolved, the court then examined whether the restrictions in the RCA "advance a legitimate business interest," such as securing the goodwill of a business and the protection of its confidential information from misuse. The court recognized that in the context of the sale of a business, the acquiring party "has a legitimate economic interest with regard to the assets and information it acquired in the sale" (*Kodiak*, 2022 WL 5240507 at *8). After all, the purchaser has typically paid a large amount of money for the business and has a need to exclude the seller from the competitive space to give the purchaser time to realize success with its newly acquired company (*Kodiak*, 2022 WL 5240507 at *10).

In this case, the court found that Kodiak's RCA restrictions went "too far" by seeking to protect not only the goodwill of Northwest, but also that of other portfolio companies within Kodiak's company group. The court noted that "[t]he buyer's valid concerns about monetizing its purchase do not support restricting the seller from competing in other industries in which the buyer also happened to invest in prior to the acquisition." Delaware law does not recognize a "legitimate business interest in protecting all the acquirer's preexisting goodwill that predated the acquirer's purchase of the target." Kodiak's attempt to protect its lines of business that were unrelated to Northwest, the court found, was overbroad. In other words, Kodiak's RCA was not sufficiently tailored to protect a legitimate business interest related to the transaction.

Reasonableness of Restrictions on Competition and Solicitation

The court analyzed the reasonableness of the RCA restrictions on competition and solicitation and, consistent with its earlier finding, concluded that they were unreasonable in both their geographic scope and the scope of the restricted activities. The court acknowledged that what is considered reasonable in the context of the sale of a business may be significantly broader than reasonableness in the context of an employment agreement not connected with a business transaction, but, as the court made clear, purchasers do not have a blank check in terms of post-sale restrictions on solicitation and competition.

The geographic restriction for competition in the RCA prohibited Adams from competing "anywhere in the states of Idaho and Washington, and within a 100 mile radius of any other location outside of those states in which [Northwest, MCI] or any member of the Company Group have sold products or provided services within the 12 months prior to Closing." Adams was restricted from soliciting customers from "any other member of the Company Group . . . for purposes of providing products or services to such customers that are competitive with the products or services provided by [Northwest, MCI], [Kodiak], any other member of the Company Group, or the Business as of any such time." The court found the scope of these provisions overbroad because they exceeded the goodwill and competitive space that Kodiak purchased from Northwest and the market served by Northwest, particularly since Adams only had business relationships with Northwest customers, not the customers of companies within Kodiak's larger portfolio.

The court also found that the scope of restricted business activities, which purported to prevent Adams from working for businesses engaged in "manufacturing, marketing, selling, distributing, installing and/or delivering . . . floor and stair components; framing; siding and other building materials and supplies, and providing services with respect thereto, including design, engineering, turn-key solutions, project management and trade coordination services," was also overbroad and unnecessary to protect the goodwill that Kodiak had purchased in its acquisition of Northwest.

It is also worth noting the court declined to blue-pencil (rewrite) the RCA to make the restrictions narrower, despite explicit language in the RCA directing a court to do so. The court observed in a footnote that Delaware courts had regularly exercised the discretion not to blue-pencil an overbroad agreement and instead to strike the overbroad provision in its entirety, citing the assertion in a law journal article that "many [overbroad non-compete agreements], perhaps most, reflect the incentives the law has created for employers: ask for as much as possible, with the expectation that you will get at least what you're entitled to should the matter go to court" (*Kodiak*, 2022 WL 5240507 at *5 n. 49). This somewhat cynical observation seems to be reflected in the court's entire analysis of the RCA in this case.

At another point in its opinion, the court observed that "Delaware law contemplates denying injunctive enforcement of an overbroad restrictive covenant because of the power dynamic between an employer and employee at the time of signing," quoting a 2011 Delaware Chancery opinion in *Del. Elevator, Inc. v. Williams*, 2011 WL 1005181, at *10 (Del. Ch. Mar. 16, 2011)), that states: "It is trite and naive to suggest that low[-] to mid-level employees freely agree to restrictive covenants. Disparities in resources, bargaining power, and access to information undercut that overly simplistic notion"

What Does This Opinion Mean for Your Business?

Parties who have reflexively selected Delaware choice of law provisions in their non-competition and non-solicitation agreements due to the perceived friendliness of Delaware courts to business and the willingness of those courts to enforce such restrictions with little judicial scrutiny – particularly in the context of the sale of a business – should be given pause by this opinion and take the following into consideration.

- The *Kodiak* case indicates that Delaware courts may only support restrictive covenants that apply to the goodwill and competitive space of the acquired company and in the market the acquired company serves and may decline to enforce a restrictive covenant that extends to all industry spaces held by a buyer before the acquisition.
- Buyers should not rely on a Delaware court to blue-pencil overly broad restrictive covenants, even where a contract expressly allows a court to do so. This means buyers and their counsel should carefully review the restrictive covenants in their transaction documents and associated employment agreements to ensure that these are narrowly tailored to the interests that the buyer needs to protect based on the geographic scope and sphere of activities in which the seller realistically operated.
- Consider selecting a choice of law provision from a state where courts have exercised less scrutiny of restrictive covenant provisions – even if this means the RCA has a different choice of law provision than the asset or stock purchase agreement itself.
- Let this decision be a reminder to draft restrictive covenants thoughtfully and to select choice of law provisions carefully.

Should you have any questions or need additional information, please contact [Martha Boyd](#), [Tyler Saenz](#), or [Gabby Haddad](#), or your Baker Donelson [Business and Corporate](#) Group attorney.