NY, Del. May Be Trending Against Noncompete Enforceability

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Noncompetes are an ongoing hot topic, and we've witnessed a nationwide change in temperament with respect to enforcement of employee noncompete covenants. Several states have taken legislative action to rein in employee noncompetes — Massachusetts, Illinois and California being the most notable ones. Under statutes in those states, noncompetes are either near-entirely prohibited or restricted.

And, of course, throughout 2023 we saw administrative pronouncements from the Federal Trade Commission[1] and the National Labor Relations Board[2] proposing limits on the enforceability of noncompetes.

Some employers have tried to select Delaware law as a choice of law for noncompetes, especially in connection with equity plan awards, presumably because Delaware is the state of incorporation for the employer who will issue the equity award, and it has been known to have a robust common law that favors enforcement of contracts entered freely between two parties.

At least, that's what the employers thought. While New York and Delaware do not yet have statutory restrictions on noncompete provisions, there is a wide body of case law drawing the lines of enforceable restrictions on post-employment activities.

Of particular interest to us and our clients are trends that we see in the New York and Delaware courts regarding the enforcement of restrictive covenants in both equity award agreements and employment agreements.

New York Employers Beware

For New York-based companies and executives, two sets of agreements typically apply to competitive activities — an employment agreement and an equity award or grant linked to a robust incentive plan or limited liability partnership agreement. With employment agreements, a company headquartered or having a primary office in New York often selects New York law to govern the terms of that agreement and disputes are handled by those courts.

With regard to the equity agreement, however, New York companies incorporated in Delaware often choose Delaware as the governing law and forum for enforcement. This twofold situation creates complications when a departing executive accepts a job with a competitor — legislative and court trends in both states must be considered when evaluating risk mitigation and enforcement strategies.

While ideally, an employer would select one document strategy — either in a separate agreement or embedded as part of an equity award — and one state, either New York or Delaware, the fact is that sometimes the documentation gets garbled, and the same employee is subject to provisions that don't match.

It's already difficult enough to advise a client on the enforceability of these covenants, but with a situation where multiple agreements cover similar territory, it might be near impossible for a lawyer to provide clarity so that a business can arrange its contractual affairs in an orderly manner.

In New York, the Legislature passed a sweeping bill in 2023[3] that would have banned nearly all noncompete covenants for New York-governed employees, but at the last minute it was vetoed by the governor.

The legislation did not include an exception for highly paid workers or for the sale of a business. After months of intense lobbying, by both worker groups and employer advocates, New York Gov. Kathy Hochul vetoed this legislation.

She explained: My top priority was to protect middle-class and low-wage earners, while allowing New York's businesses to retain highly compensated talent. New York has a highly competitive economic climate and is home to many different industries. These companies have legitimate interests that cannot be met with the Legislation's one size-fits-all approach.[4]

New York businesses and employees have not heard the last of this noncompete ban. We expect that new legislation will be introduced in the 2024 session, taking into consideration sticking points that include minimum salary thresholds, incentive compensation forfeiture and sale of business exception.

Without a legislative fix, noncompetes in New York will continue to be evaluated in accordance with state common law, which is quite robust in New York.

Noncompete Enforceability in New York

As a general rule in New York, restrictive covenants entered into voluntarily in connection with employment, even at-will employment, will be enforced where the covenant is reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee.[5]

The determination of whether a restrictive covenant is enforceable is a case-specific inquiry.[6] New York courts have discretion to "blue pencil" or modify an agreement to delete unenforceable provisions.[7]

The circumstances of the employee's termination are important. New York courts apply the employee choice doctrine, which means that a noncompete will be enforced if an employee who resigns or voluntarily terminates their employment has a choice between complying with the noncompete and receiving compensation from the employer, i.e., severance pay or equity awards, or competing and forfeiting that compensation.[8]

On the contrary, if a company terminates the employee without cause, then this doctrine does not apply and New York courts, in general, will evaluate whether forfeiture of the compensation is reasonable[9] or may hold that the noncompete is per se unenforceable.[10]

In sum, while case law on noncompetes in New York continues to develop, there have been no big surprises in court in recent years. This is not the case in Delaware.

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Noncompete Enforceability in Delaware

Until recently, many employers viewed Delaware as an employer-friendly forum to ensure enforcement of noncompetes. The Delaware Court of Chancery began declining to enforce noncompetes with individual employees and taking a strong stance against blue-penciling in 2022 with Kodiak Building Partners LLC v. Adams[11] — a trend that has continued through the November 2023 Sunder Energy LLC v. Jackson decision.[12]

In Kodiak, Vice Chancellor Morgan Zurn noted that while "covenants not to compete in the context of a business sale are subject to a 'less searching' inquiry than if the covenant 'had been contained in an employment contract,'" a covenant not to compete in the sale of a business must still be limited to the "purchased asset's goodwill and competitive space that its employees developed or maintained."[13]

Shortly thereafter, Vice Chancellor Zurn refused to enforce a noncompete in Ainslie v. Cantor Fitzgerald LP in January 2023, involving a noncompete and a "forfeiture-for competition" provision.[14]

The latter is not usually held to the same reasonableness standard as a noncompete, because, as the argument goes, the employee is still free to provide services in competition with his former employer, even though she would forfeit compensation by doing so, so such a "forfeiture-for-competition" provision does not unduly restrain trade.[15]

The Ainslie court, however, analyzed the "forfeiture-for competition" using the typical reasonableness standard — weighing the restraint on the employee against the legitimate interests of the employer — and, surprisingly to some, declined to enforce the forfeiture provision.[16]

Vice Chancellor Zurn noted 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."[17]

This trend against enforcement continued a month later with HighTower Holding LLC v. Gibson,[18] Vice Chancellor Lori Will refused to honor the parties' selection of Delaware as the choice of law, concluding that another state — Alabama — had a more significant relationship to the dispute.[19]

As such, the court concluded that "[t]he noncompete provisions are likely void under Alabama law" and declined to blue-pencil the provision.[20]

How Executives May Negotiate Such Covenants

The Delaware Chancery Court ended 2023 with Sunder Energy LLC v. Jackson, in which Vice Chancellor Travis Laster announced a general rule — not just a preference as in the earlier cases — that unreasonable covenants with individual employees will be invalidated rather than modified.

This rule, in part, reflects the court's recognition of "imbalances in bargaining power and repeat-player experience that exist between businesses and individuals."[21] The court outright rejected the notion that highly compensated executives are on an equal footing as corporations when it comes to bargaining power.[22]

Finally, we highlight Vice Chancellor Laster's words of caution about the increasingly large number of noncompete cases brought in Delaware Chancery Court by companies that operate exclusively outside of Delaware.

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Sunder filed suit here — in Delaware — because Sunder is a Delaware LLC and its lawyers deployed the now widespread legal technology of inserting restrictive covenants into an internal governance document. Businesses and their lawyers do that so they can invoke Delaware's contractarian regime and argue that it should override how other jurisdictions regulate restrictive covenants….

For Delaware courts to address these matters is problematic because the Delaware franchise depends on other states deferring to Delaware law to govern the internal affairs of the entities that Delaware charters.

Delaware risks jeopardizing that deference if Delaware accommodates efforts to use the internal governance documents of its entities to override the law of other states on issues of great importance to them.[23]

These are cautionary words that companies should seriously consider when drafting noncompetes that contain Delaware choice of law and forum selection clauses.

On the Horizon

We expect that the legal issues involving noncompetes in New York and Delaware will continue to present challenges and intriguing fact patterns. We note, for instance, that the Chancery Court granted an interlocutory appeal in Sunder Energy, which is now pending before the Delaware Supreme Court.[24]

This quickly changing landscape will require companies and their counsel to continue monitoring these developments in the legislature and judiciary.

References

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[7] BDO Seidman v. Hirschberg, 93 N.Y.2d 382, 391-93 (1999).
[8] See, e.g., Morris v. Schroder Capital Mgmt. Int'l, 7 N.Y.3d 616, 620-21 (2006).
[9] Morris, 7 N.Y.3d at 621; Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 48 N.Y.2d 84, 89 (1979).
[10] Lucente v. International Business Machines Corp., 310 F.3d 243, 254-55 (2d Cir. 2002); Arakelian v. Omnicare, Inc., 735 F. Supp. 2d 22, 41-42 (S.D.N.Y. 2010); SIFCO Indus., Inc. v. Advanced Plating Technologies, Inc., 867 F. Supp. 155, 158 (S.D.N.Y. 1994).
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[14] Ainslie v. Cantor Fitzgerald L.P., 2023 WL 106924 (Del Ch. Jan. 4, 2023).
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[19] HighTower, 2023 WL 1856651, at *4.
[20] HighTower, 2023 WL 1856651, at *5-6.
[21] Sunder Energy, 2023 WL 8166517, at *49.
[22] Sunder Energy, 2023 WL 8166517, at *49 note 66.
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