

Restrictive Covenants in Connection With a Sale of a Business Cannot be Overbroad

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Business owners and transaction lawyers who view non-compete agreements as standard in connection with the sale of a business should be careful not to overreach in imposing restrictive covenants on sellers in purchase agreements and related deal documents. That is the lesson of the Delaware Court of Chancery's recent decision, *Kodiak Building Partners, LLC v. Philip D. Adams*, which limits the use of non-compete agreements in connection with the sale of a business. The decision makes clear that courts, even in Delaware, will not rubber-stamp post-closing non-compete agreements.

Relevant Facts

In *Kodiak Building Partners*, the buyer sought to impose a post-closing noncompete on the seller's largest shareholder-employees, including Mr. Adams. It is universally recognized that buyers have a legitimate interest in protecting the goodwill associated with the business they are purchasing to ensure that key stakeholders do not compete with the business and consequently diminish the company's value. Delaware courts have historically upheld non-compete agreements in connection with the sale of a business and have given them a less-searching inquiry than they give post-employment non-compete agreements.

Here, the non-compete agreement at issue had two notable provisions: (1) a clause in which the employee conceded that the non-compete agreement was reasonable, valid, and necessary; and (2) a provision restricting the employee from competing in all of the buyer's other, unrelated businesses (referred to as the "Company Group").

When Adams resigned from his employment with the buyer to work for a business that was not directly competitive with the seller's business but was

competitive with other businesses in the Company Group, Kodiak sued Adams to enforce the non-compete agreement.

Waiving a Party's Ability to Challenge the Reasonableness of the Non-Compete Agreement

Before analyzing the scope of Adams' non-compete agreement, the court found that the language in the agreement in which the employee waived his right to challenge the reasonableness of the agreement did not preclude the court from actually considering the agreement's reasonableness. The court reasoned that an attempt to contractually declare an agreement reasonable seeks to "circumvent [the] court's mandate to review those covenants for reasonableness" and will not "insulate the covenants from judicial review." In other words, the right to challenge the enforceability of a non-compete is not something this court found could be waived.

Scope of the Non-Compete Agreement

Upon reviewing the scope of the non-compete agreement, the court found that the agreement was overbroad and unenforceable. As noted, it is typical for buyers to require key stakeholders of the seller to sign a post-closing non-compete to protect the company's goodwill and confidential information. However, here, the court found that the non-compete restrictions were too broad because they prevented Adams from competing not only with the seller's actual narrow manufacturing business but also from competing with those businesses under Kodiak's broader Company Group, which included other construction businesses. The court held that a non-compete agreement in connection with the sale of a business can only prevent an employee from competing with those businesses in which the selling company actively participated.

Delaware Court Declined to Blue Pencil

The court's opinion was also notable because of its refusal to blue-pencil the agreement. Historically, Delaware courts have been willing to blue pencil, or rewrite, an overly broad non-compete agreement to make the agreement enforceable. The *Kodiak* court, however, declined to blue pencil the overly broad restrictions and observed that Delaware courts will be "hesitant" to blue pencil agreements. The court explained that blue penciling has created an incentive for employers to impose overly broad agreements with the expectation that, if the matter goes to court, the court will narrow the scope of any overly aggressive drafting. The court warned employers not to expect that they will be able to get away with imposing overly restrictive terms. Thus, those working on corporate transactions should be aware that Delaware courts may decline to blue-pencil an overly broad provision in a non-compete agreement and may instead opt to strike the provision entirely.

Key Lessons From the Court's Decision for Buyers:

- Do not impose a non-compete that is any broader than necessary.
- Be sure to properly define the business as of the closing date, not the buyer's broader business.
- Do not assume a court will blue-pencil and fix your agreement, as the court may decline to enforce it at all.

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