

Delaware OKs forfeiture-for-competition in partnership agreements

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In *Cantor Fitzgerald, LP v. Ainslie*¹ the Delaware Supreme Court upheld a forfeiture-for-competition provision in a partnership agreement which authorized the partnership to withhold distributions otherwise owed to a partner who voluntarily withdraws from, and then competes with, the partnership under circumstances where a traditional restrictive covenant would be unenforceable.

The decision reversed the Court of Chancery's ruling that forfeiture-for-competition provisions should be subject to the same scrutiny for reasonableness applied to restrictive employment covenants.

The Delaware Supreme Court, relying more heavily on the Delaware policy permitting sophisticated parties to avail themselves of the contractual flexibility embodied in the Delaware Revised Uniform Limited Partnership Act, ruled that Delaware courts should, absent unconscionability, bad faith, or other extraordinary circumstances, hold the parties to the terms of the partnership agreement.

The opinion makes clear that when it comes to Delaware partnership agreements, "parties have a right to enter into good and bad contracts; the law enforces both."

Cantor Fitzgerald, L.P. is a global financial services company formed under Delaware limited partnership law.

Cantor Fitzgerald maintains a capital account for each of its partners that, by default, is to be paid out in annual installments over four years following a partner's withdrawal. In addition, Cantor Fitzgerald partners can earn partnership units, referred to as "grant units," which are not held in the partner's capital account. The value of the grant units is also paid out in four equal installments over four years following a partner's departure.

The Cantor Fitzgerald partnership agreement contains a so-called "forfeiture-for-competition" provision designed to discourage competition by former partners. The partnership agreement expressly conditioned the obligation to pay the four annual payments on such partner having not engaged in any competitive activity prior to the date of such payment. Therefore, to remain eligible to receive the future annual payments, a former partner must refrain from competitive activity.

This financial disincentive for engaging in competitive activity is in place for the four years during which the former partner is eligible to receive payments from the partnership. So, for example, a partner who refrains from competitive activity for two years will

receive distributions during the period but, upon commencement of competition in the third year, forfeits distributions thereafter through the fourth year.

This financial penalty for competing following withdrawal as a partner is distinguishable from a traditional covenant not to compete in several key respects.

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The partnership agreement explicitly states: "each partner acknowledges that this Article ... is intended solely to reflect the economic agreement between the partners with respect to amounts payable upon a partner's bankruptcy or termination. Nothing in this Article ... shall be construed or interpreted as restricting the ability of a former partner in any way from engaging in a competitive activity, or in any other employment of any nature whatsoever"

The competitive activity condition does not restrict competition or a former partner's ability to work, nor does competition support injunctive relief. But if the former partner wishes to compete with the partnership during the relevant time, the partnership need not confer the deferred benefit on the former partner, who has agreed to forfeit that benefit upon engaging in competition.

This case arose when six partners of Cantor Fitzgerald voluntarily resigned from employment, withdrew from the partnership, and went to work for competing firms. Cantor Fitzgerald refused to pay the four annual distributions, totaling more than \$9 million, claiming the former partners were ineligible because they had engaged in competitive activity and the condition precedent to the partnership's payment obligation was not satisfied.

The former partners filed suit against Cantor Fitzgerald in the Court of Chancery asserting breach of contract claims related to the partnership's enforcement of the partnership agreement and requesting a declaration that the four-year restriction on competition provision is not appropriately limited in time and space,

fails to protect a legitimate interest of Cantor Fitzgerald, and is oppressive and therefore unenforceable.

The former partners' legal claims track an employee's customary defenses to an employer's efforts to enforce a traditional covenant not to compete. Delaware, like most states, is reticent to enforce a covenant not to compete because of public policy disfavoring restraints of trade and allowing individuals to freely pursue their profession of choice.

The Chancellor observed a split among the courts of other jurisdictions regarding whether forfeiture-for-competition provisions should be treated as restraints of trade to be evaluated for reasonableness or as a financial consequence attending a withdrawing partner's decision to compete.

The Chancellor noted that some courts adopt the "employee choice" doctrine, under which courts do not review forfeiture-for-competition provisions for reasonableness so long as the employee voluntarily terminated her employment.

Delaware's distaste for liquidated damages provisions supported the conclusion that forfeiture-for-competition provisions must be reviewed for reasonableness as restraints on trade.

The Chancellor concluded that Delaware's emphasis on balancing an employer's ability to contractually protect its goodwill and customers against the public policy favoring free competition and employee mobility, and Delaware's distaste for liquidated damage provisions that restrain trade by requiring employees to pay former employers if they compete, support the conclusion that forfeiture-for-competition provisions should be reviewed under the standard test for reasonableness as restraints on trade.

The Chancellor relied heavily on Delaware law's treatment of liquidated damage provisions enforcing noncompete agreements, deciding that Delaware's distaste for liquidated damages provisions supported the conclusion that forfeiture-for-competition provisions must be reviewed for reasonableness as restraints on trade. The Chancellor concluded that the provision's four-year restriction on competition was facially overbroad and void as against public policy.

The Delaware Supreme Court reversed. The Supreme Court found the liquidated damages analogy to be misplaced. Liquidated damages, by definition, are a remedy for breach of contract and are not recoverable for a failure to meet a condition precedent.

The Delaware Supreme Court distinguished Delaware cases reviewing liquidated damage provisions enforcing noncompetition agreements contained in employment agreements whose underlying covenants are subject to a review for reasonableness.

The Supreme Court emphasized that the claims under review were not brought by an employer seeking to enforce a liquidated

damage provision for employee's breach of a restrictive covenant in an employment agreement; instead, this is a lawsuit filed by former partners against the partnership requesting that a forfeiture-for-competition provision be declared invalid under the same test as applied to traditional noncompete agreements.

The Supreme Court made clear that freedom of contract is not absolute and that contracts which offend public policy or harm the public are void.

The provision at issue in *Cantor Fitzgerald* is not a penalty enforced against an employee based on the breach of a restrictive covenant but rather a condition precedent that excuses the partnership from its duty to pay if the former partners fail to satisfy the condition to which they agreed to be bound in order to receive a deferred financial benefit.

The Supreme Court underscored that the considerations underlying a traditional noncompete, such as a restriction on freedom of employment, were absent from a provision calling only for a forfeiture of benefits.

In ascertaining the public policy of Delaware as it relates to the enforceability of the provisions of partnership agreements, the Supreme Court noted that the Delaware General Assembly explicitly declared that it is the policy of the Delaware Revised Uniform Limited Partnership Act "to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements,"² permitting partnership agreements to contain consequences that would be unavailable in a standard commercial contract, most notably penalties and forfeitures.

The Supreme Court made clear that freedom of contract is not absolute and that contracts which offend public policy or harm the public are void but given Delaware's strong interest in freedom of contract, covenants not to compete do not fall into this category.

The competitive activity condition does not restrict competition or a former partner's ability to work. But if the former partner wishes to compete with the partnership during the relevant time, the partnership need not confer the deferred benefit on the former partner, who has agreed to forfeit that benefit upon engaging in competition.

The Supreme Court focused on the distinction between a restrictive noncompetition covenant that precludes a former employee from earning a living in a chosen field and an agreement that allows a former partner to compete but at the cost of relinquishing a contingent benefit.

The Supreme Court ruled that in the restrictive covenant context, the former employee is effectively deprived of her livelihood and, correspondingly, exposed to the risk of serious financial hardship. This gives rise to the strong policy interest that justifies the review of contract provisions for reasonableness and a balancing of the equities.

By contrast, however, 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.

With the Supreme Court holding that the common law's disfavor of forfeitures does not extend to limited partnership agreements and that forfeitures in limited partnership agreements should enjoy

the Court's deference on equal footing with any other bargained-for-term in a limited partnership agreement, Delaware partnership law provides a powerful tool to create financial disincentive that discourages competition by former partners.

Notes

¹ 2024 WL 315193 (Del. Jan. 29, 2024).

² 6 Del. C. § 17-1101(c).

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