Delaware Supreme Court Endorses Broad Application of the "Employee Choice" Doctrine

December 23, 2024

Last week, the Delaware Supreme Court in *LKQ Corp. v. Rutledge* clarified how forfeiture-for-competition provisions are treated under Delaware law.[1] The Court held that its prior endorsement of the "employee choice" doctrine in *Cantor Fitzgerald, L.P. v. Ainslie*[2]—under which forfeiture-for-competition provisions are enforced as a matter of contract and are not subject to reasonableness review—applies to a range of agreements, including restricted stock unit ("RSU") agreements, not just to limited partnership agreements.[3] This decision will be a welcome start to 2025 for employers because the import of the decision is that an employee who voluntarily leaves and competes can be required to forfeit (or return) previously granted benefits subject to a forfeiture-for-competition provision without additional judicial scrutiny of the provision's reasonableness. The deterrent effect of the potential for forfeiture or clawback should provide many employers with a useful retention tool in the current environment of greater scrutiny of restrictions on worker mobility.

Background. Earlier this year, the Delaware Supreme Court in *Cantor Fitzgerald* held that forfeiture-for-competition provisions in limited partnership agreements were not akin to noncompetes and thus not subject to a reasonableness analysis. In that case, limited partners (i.e., investment professionals of a presumably relatively high level of financial sophistication) voluntarily left Cantor Fitzgerald to join a competitor. Because the firm's partnership agreement had a forfeiture-for-competition provision, Cantor Fitzgerald withheld distributions from the former partners' capital accounts and incentive payouts, which would have otherwise paid out over a four-year period. (The Delaware Chancery Court, reversed by the higher court, had applied a reasonableness test applicable to traditional noncompetes, finding the provisions overbroad and unenforceable.[4]) The Delaware Supreme Court ultimately found that the provisions did not restrain trade, as the provisions were agreed to by sophisticated parties in a limited

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[1] See *LKQ Corporation v. Robert Rutledge*, No. 23-2330, slip. op (Del. Dec. 18, 2024).

[2] *Cantor Fitzgerald v. Ainslie*, 312 A.2d 674 (Del. 2024).

[3] Under the employee choice doctrine, a former employee bound by a forfeiture-for-competition provision may either refrain from competing and retain their post-employment compensation and benefits, or choose to compete and thereby forfeit those benefits.

[4] *Ainslie v. Cantor Fitzgerald, L.P.*, No. 9436-VCZ, 2023 WL 106924, at *22 (Del. Ch. Jan. 4, 2023).

partnership agreement. The decision was based in part on the statutory language of the Delaware Limited Partnership Act, which left uncertainty about whether the holding would extend beyond the limited partnership context.

The New Decision. In the Seventh Circuit case certified before the Delaware Supreme Court, *LKQ Corporation v. Robert Rutledge*,[5] an employee who worked as a plant manager received grants of RSUs through his company's equity incentive program, which required the employee to sign RSU agreements and restrictive covenant agreements that included overlapping nine-month post-termination noncompetes. When the employee voluntarily resigned and began working for a competitor within five days of his departure, the company sought to recover, via a clawback mechanism, eight years' worth of sales proceeds the employee had received from selling shares of common stock acquired on settlement of the RSUs.

After evaluating the forfeiture-for-competition provisions in the employee's RSU agreement, an Illinois federal district court, relying on the Court of Chancery's decision in *Cantor Fitzgerald* (which had not yet been reversed), concluded that the restrictions were unenforceable under Delaware law as unreasonable restraints of trade. On appeal, the Seventh Circuit, uncertain of the application of the Delaware Supreme Court's decision in *Cantor Fitzgerald* outside of the limited partnership context, certified for the Delaware Supreme Court's consideration the questions as to whether the holding should be limited to partnership agreements, and if not, when it should apply.[6]

Last week, the Delaware Supreme Court responded with a broad reading of *Cantor Fitzgerald* and embrace of the employee choice doctrine, writing that its holding extends beyond forfeiture-for-competition provisions in limited partnership agreements to those in other agreements—including RSU agreements.

This is the case despite noteworthy differences in the facts of the two cases. The LKQ employee was a middle manager earning a relatively modest salary, while the Cantor Fitzgerald partners were sophisticated and highly compensated; LKQ sought to recover eight years of stock sale proceeds, while Cantor Fitzgerald attempted to withhold not yet received distributions.

In both cases, the Court found, as a critical distinction, that the forfeiture-for-competition provisions did not restrict competition or a former employee's ability to work; the provisions simply withheld a conditional payment if the employee chose to

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5 *LKQ Corporation v. Robert Rutledge*, 96 F.4th 977 (7th Cir. 2024).

6 Prior to this week's decision in *LKQ Corporation v. Rutledge*, the Court of Chancery had limited the application of the Supreme Court's decision in *Cantor Fitzgerald* in *Hub Grp, Inc. v. Knoll*, 2024-0471-SG, 2024 WL 3453863 (Del. Ch. July 18, 2024).

compete. RSU agreements, the court notes, are more akin to a deferred benefit than to a noncompetition covenant.[7] And the clawback provisions are better viewed as "returning a supplemental benefit for breaching the terms of a bargain" than as a penalty for working for a competitor.[8]

Implications for Employers. Employees should leverage Delaware law, if possible. Employers who choose Delaware as the governing law of their equity and deferred compensation arrangements gain an advantage, as forfeiture-for-competition provisions are now clearly supported by Delaware precedent, even for corporate entities beyond limited partnerships.

However, courts may still examine whether Delaware law has a legitimate nexus to the agreement. Without a proper nexus to Delaware, a choice-of-law provision may be disregarded, and another state's law with a stronger connection to the parties may be applied.[9] Other states continue to vary in whether they will view forfeiture provisions as restraints of trade and apply a reasonableness test (such as Maryland), or whether they will align more closely with Delaware and embrace the employee choice doctrine (such as New York). Delaware has itself signaled a desire not to become a haven for noncompete litigation by choosing to apply the laws of other states in recent decisions.

Where Delaware law applies, the court's ruling in *LKQ Corporation* makes clear that there are multiple instances in which forfeiture-for-competition provisions will be upheld without a reasonableness review, even where the financial benefit being forfeited is already paid out, and where the employee subject to the forfeiture is not a highly paid executive. However, the court left open the possibility that a forfeiture-for-competition provision imposing a clawback "so extreme in duration and financial hardship that it precludes employee choice by an unsophisticated party" would be reviewed for reasonableness.[10] As such, employers should continue to use reasoned judgment when drafting such provisions.

It is also important to note that the Delaware Supreme Court in its opinion defines the employee choice doctrine as applying only when the employee voluntarily terminated employment. The Court did not address a situation where an employer sought to

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[7] *LKQ Corp. v. Robert Rutledge*, No. 23-2330, slip. Op at 13 (Del. Dec. 18, 2024) (citing *Cantor Fitzgerald*, 312 A. 3d at 689).

[8] *W. R. Berkley Corp. v. Dunai*, 2021 WL 1751347, at *2 (D. Del. May 4, 2021) (discussing a non-competition provision in a stock grant agreement).

[9] *Hightower Holding v. Gibson, C.A.*, No. 2022-0089-LWW, 2023 WL 1856651 (Del. Ch. Feb. 9, 2023); *Swipe Acquisition Corp. v. Krauss*, No. 2019-0509-PAF, 2021 WL 282642 (Del. Ch. Jan. 28, 2021).

[10] *LKQ Corp.* at *17.

inforce a forfeiture-for-competition provision where the employee was involuntarily terminated.

There will also be many situations where this new tool will not be useful—for example, for employees without equity; or for employers whose equity is out of the money; or where the forfeiture amount is so low that a new employer can make the employee whole for the forfeiture via a sign on bonus or replacement equity award.

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