



A Robinson+Cole Legal Update

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Buyer Beware: Delaware Court of Chancery Declines to Blue-Pencil Restrictive Covenant in M&A Transaction

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On October 6, 2022, in *Kodiak Building Partners, LLC v. Philip D. Adams*, C.A. No. 2022-0311-MTZ (Oct. 6, 2022), the Delaware Court of Chancery found that a restrictive covenant entered into in connection with an asset purchase agreement was unenforceable.

While legislatures and courts across the country have seemingly grown increasingly hostile towards non-compete agreements in the employment context, such restrictive covenants are generally enforced against sellers in connection with an acquisition of a target company.[1] Buyers often select Delaware law in these transactions with the expectation that restrictive covenants will be enforced—even if portions of the covenants are found to be unenforceable.[2]

The Court of Chancery's decision declining to blue-pencil the restrictive covenant in *Kodiak Building Partners* serves as a cautionary tale for buyers that fail to narrowly tailor non-compete and non-solicitation provisions in the asset purchase agreement or other documentation of the transaction.

Background

Plaintiff Kodiak Building Partners, LLC is a Delaware limited liability company in the business of purchasing and operating small companies in the construction industry. Over the course of several years, it has acquired at least nineteen wholly owned subsidiaries. It operates four lines of business: (1) lumber and building materials; (2) gypsum; (3) construction supplies; and (4) kitchen interiors.

Defendant Adams was the former general manager and stockholder of Northwest Building Components, Inc., a roof truss company. Northwest had a single business location in Rathdrum, Idaho.

On June 1, 2020, Kodiak and Northwest entered into a stock purchase agreement. In the transaction Kodiak acquired all Northwest's assets, including its goodwill and Adams's 8.33 percent interest in Northwest. In connection with the acquisition, each of the four Northwest stockholders entered into a restrictive covenant agreement (RCA) with Kodiak. The RCA included both non-competition and non-solicitation provisions. In the RCA, Adams explicitly acknowledged the reasonableness and necessity of the RCA and waived any defense based on the reasonableness of the covenants.

Shortly after the closing, Adams resigned and began working for Builders FirstSource, Inc. (BFS), a neighboring roof truss and lumber business. BFS is located in Spokane, Washington, approximately 24 miles from Northwest's business location. Kodiak then sued Adams for breach of the restrictive covenant and sought a preliminary injunction.

Court of Chancery's Decision

Under Delaware law, non-compete agreements must (1) be reasonable in geographic scope and temporal duration, (2) advance a legitimate economic interest of the party seeking its enforcement, and (3) survive a balancing of the equities.

While the Court of Chancery acknowledged that "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," the Court went on to deny Kodiak's request for a preliminary injunction enforcing the covenant, determining instead that the RCA was unenforceable.

First, the Court found that the RCA's waiver provision did not preclude the Court from reviewing the restrictive covenants for reasonableness. The Court held it can "discount contractual waivers of defenses when public policy demands it." In this case, the Court found that public policy requires Delaware courts to evaluate non-competition contracts for reasonableness and "an employee's promise not to challenge the reasonableness of his restrictive covenant cannot circumvent this Court's mandates to review those covenants for reasonableness."

Second, the Court found that the RCA does not advance a legitimate business interest. The Court agreed that, in the context of the sale of a business, Kodiak had a legitimate economic interest in protecting what it had purchased—the goodwill and assets of Northwest and its investors. The Court, however, found that "Delaware law has not affirmatively recognized a legitimate business interest in protecting all the acquirer's preexisting goodwill that predated the acquirer's purchase of the target." Therefore, the Court found that the RCA went too far because it not only sought to protect the assets of Northwest, but also Kodiak's pre-existing assets, including its other subsidiaries and all their respective businesses.

Third, the Court also found that the RCA was geographically overly broad because it prohibited competition in geographic areas around Kodiak subsidiaries other than Northwest.

Finally, while acknowledging that the balancing of the equities "is far less important where the covenant not to compete is part of a contract for the sale of a business, rather than an employment agreement," the Court found that the balance of the equities in this case favored Adams. Significantly, the Court declined to "blue pencil" the RCA. Delaware courts have modified, or blue penciled, restrictive covenants viewed as overly broad restrictions by ignoring the unreasonable portions and enforcing only the valid provisions.[3] Similarly, Delaware courts have imposed limitations on otherwise overly broad restrictive covenants to render them reasonable and enforceable.[4] Notwithstanding, the Court found that "Delaware courts are hesitant to 'blue pencil' such agreements to make them reasonable." The Court's decision is especially surprising because the Court acknowledged that Adams appears to have violated those portions of the RCA that are supported by Kodiak's legitimate business interests.

Takeaways

Moving forward, purchasers in M&A transactions should not assume courts applying Delaware law will automatically blue-pencil otherwise overly broad restrictive covenants in M&A deals. Instead, buyers should ensure that restrictive covenants are narrowly tailored to protect from competition only the assets and goodwill that are being purchased in the transaction. Additionally, while there is no harm in including them, general waivers of the reasonableness defense provisions relating to the enforceability of the restrictive covenants will not have an impact if the rationale of this decision holds.

ENDNOTES

[1] *Faw, Casson & Co. v. Cranston*, 375 A.2d 463, 465 (Del. Ch. 1977) (greater scrutiny is given to restrictions in employment contracts than to restrictions in contracts for the sale of a business or stock).

[2] *Hammermill Paper Co. v. Palese*, C.A. No.7128, 1983 WL 19786, at *6 (Del. Ch. June 14, 1983) (observing that blue penciling is permissible under Delaware law in connection with the review of restrictive covenants).

[3] See, e.g., *Delaware Exp. Shuttle, Inc. v. Older*, C.A. No. 19596, 2002 WL 31458243, at *13 (Del. Ch. Oct. 23, 2002) (ignoring provision purporting to restrict conduct that is "similar to" that of the employer because it is overbroad and unenforceable but enforcing provision restricting conduct that is "competitive with" the employer).

[4] See, e.g., *RHIS, Inc. v. Boyce*, C.A. No. 18924, 2001 WL 1192203, at *7 (Del. Ch. Sept. 26, 2001) (reducing temporal scope of a covenant not to solicit to one year, rather than two); *Norton Petroleum Corp. v. Cameron*, C.A. No. 15212-NC, 1998 WL 118198, at *4 (Del. Ch. Mar. 5, 1998) (reducing geographical scope of restrictive covenant to 20 miles, rather than 100); *Gas Oil Products, Inc. of Delaware v. Kabino*, C.A. No. 9150, 1987 WL 18432, at *2 (Del. Ch. Oct. 13, 1987) (enforcing an agreement without an express territorial scope and establishing a reasonable geographical limitation where there was none contained in the covenant not to compete).

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