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Enforcing Del. Choice-of-Law Provisions in Restrictive Covenant Agreements

ALERT | September 25, 2019

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It is well-settled that California has a strong public policy against the enforcement of restrictive covenants against employees. Because of this, there has been a recent trend where employers have sought to circumvent California's public policy by invoking Delaware law in restrictive covenant agreements with their employees. However, in a number

of recent opinions, the Delaware Court of Chancery has resisted those efforts, instead choosing to invalidate the Delaware choice-of-law provisions and apply California law to void the restrictive covenants.

Indeed, despite the fact that Delaware is typically a contractarian state, the Court of Chancery has reasoned that, unless one or more conditions (summarized below) are met, California-based companies will not be permitted to effectuate an end run around California's strict public policy by invoking Delaware law in contracts with their employees. Furthermore, although not directly addressed by the Court of Chancery's recent decisions, it is likely, based on the Court's reasoning in these decisions, that Delaware courts will apply California law to void noncompetition and nonsolicitation provisions within an agreement between employers with their principal places of business *outside of California* and their employees that *live and work primarily in California*, notwithstanding the existence of a Delaware choice-of-law provision.

California Public Policy

California's strict public policy against the enforcement of restrictive covenants, which is embodied within its Business and Professions Code, provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Cal. Bus. & Prof. Code § 16600. California also recently amended its Labor Code to prevent employers from requiring their California-based employees to enter into contractual provisions that: "(1) [r]equire the employee to adjudicate outside of California a claim arising in California; or (2) [d]eprive the employee of the substantive protection of California law with respect to a controversy arising in California." Cal. Lab. Code § 925(a). Likewise, such choice-of-law and choice-of-forum provisions in contracts entered into prior to January 1, 2017 can be found voidable, if said contract is modified, amended, or changed after that date.

California's prohibition on non-competition agreements is subject to certain exceptions. For instance, California law will not automatically void restrictive covenants imposed upon a person who is a direct or indirect owner of a business being sold to a buyer. Cal. Bus. & Prof. Code § 16601. Likewise, California law allows enforcement of a partner's restrictive covenants with a California partnership in anticipation of the dissolution of the partnership or the partner's disassociation from the partnership. Cal. Bus. & Prof. Code § 16602. Moreover, California's statutory prohibition against enforcement of non-California forum-selection and choice-of-law provisions will "not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an

agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice of law to be applied." Cal. Lab. Code § 925(e).

Delaware's Enforcement of California Public Policy

Delaware courts have taken note of a recent trend in which employers have attempted to circumvent California's public policy by invoking Delaware law in restrictive covenant agreements with their employees rather than seeking to satisfy one of the statutory exceptions to California's public policy. However, in a number of recent decisions, the court has rebuffed those efforts, instead choosing to invalidate the Delaware choice-of-law provisions and apply California law to void restrictive covenants between employers and their employees.

In conducting this analysis, the court follows section 187 of the Restatement (Second) of Conflict of Laws. Under the Restatement, the first question a court must decide in determining whether to enforce a Delaware choice-of-law provision is whether, absent that provision, California law would apply. Second, if the answer to the first question is yes, then the court must determine whether the enforcement of the covenant would conflict with a "fundamental policy" of California law that is materially greater than Delaware's interest in the dispute. If each of these questions is answered in the affirmative, California law will apply notwithstanding the choice-of-law provision.

The seminal case applying this framework to restrictive covenants imposed by California-based companies is *Ascension Insurance Holdings, LLC v. Underwood*, 2015 Del. Ch. LEXIS 19, at *6-8 (Del. Ch. Jan. 28, 2015). In that case, the Court of Chancery addressed a covenant not to compete in an employee investment agreement that contained Delaware forum-selection and choice-of-law provisions. The agreement was entered into between the plaintiff, a Delaware limited liability company with its principal place of business in California, and the defendant, a former employee of the plaintiff who resided and worked in California. Because it is well-established that "California public policy disallows contractual agreements not to compete," and because California law would apply in the absence of the Delaware choice-of-law provision, the court held that the employee investment agreement was governed by California law despite the Delaware choice-of-law provision. As such, the court found the covenant not to compete to be void and unenforceable under California law.

Notably, in a transcript ruling issued in July 2019, *Avaya Holdings Corp. v. Haigh*, C.A. No. 2019-0344-JRS (Del. Ch. July 2, 2019), the Court of Chancery extended the reasoning set forth in *Ascension* to void restrictive covenant agreements between a California-based company incorporated in Delaware *and an employee who neither lived in nor physically worked primarily in California*. There, the employee, who worked for the California-based company virtually from his home in North Carolina and was responsible for a sales territory that included Delaware, signed various equity award agreements that contained restrictive covenants and a Delaware choice-of-law provision. The employee later left the company to work virtually for another California-based employer, where he also would be performing at least some services physically within California. The court reasoned that applying California law was still warranted in this case, despite the presence of the Delaware choice-of-law provision, because "California's fundamental public policy prohibiting noncompetition provisions extends not only to California residents, but also to nonresidents who seek employment with a California-based employer with the expectation that the employee will provide services or perform functions within California." On that basis, the court voided the employee's restrictive covenants under California law.

Even more recently, in August 2019, the Court of Chancery held that the reasoning set forth in *Ascension* and *Avaya* applies not only to noncompetition provisions with California companies, but also nonsolicitation provisions imposed by California companies. *Nuvasive, Inc. v. Miles*, 2019 Del. Ch. LEXIS 325 (Del. Ch. Aug. 26, 2019). The Court of Chancery has also extended the reasoning set forth in Ascension to restrictive covenants imposed by companies based in other states that have a strong public policy against the enforcement of noncompetition and nonsolicitation provisions. *Cabela's LLC v. Wellman*, 2018 Del. Ch. LEXIS 511 (Del. Ch. Oct. 26, 2018) (applying Nebraska law to invalidate a noncompetition agreement despite the presence of a Delaware choice-of-law provision).

The Court of Chancery has been clear, however, that where one or more of the exceptions to a state's public policy against enforcement of restrictive covenants is met, the court will uphold the Delaware choice-of-law provision and enforce the restrictive covenants in accordance with Delaware law. For example, in *NuVasive, Inc. v. Miles*, 2018 Del. Ch. LEXIS 329 (Del. Ch. Sept. 28, 2018), the Court held that, based upon the passage of section 925 of California's Labor Code (discussed above), applying Delaware law to restrictive covenant agreements would not offend California's fundamental policy when the employee was represented by counsel when he or she agreed to the restrictive covenants and Delaware choice-of-law provision before signing the agreement. In other words, the court held that, when California public policy does not per se void the

restrictive covenant agreements in question, Delaware choice-of-law provisions in those agreements will be enforced and the restrictive covenants will be enforced consistent with Delaware law.

Takeaways

The bottom-line takeaways from these decisions is as follows: When California has the most significant relationship with a dispute, Delaware courts will apply California law to void noncompetition and nonsolicitation provisions within an agreement between a California-based company and one of its employees, *even when* the company is incorporated in Delaware, the employee does not primarily live or work physically in California, and the contract in question contains a Delaware choice-of-law provision, *unless* one of the following conditions is met:

1. The employee was advised by counsel regarding the effect of the noncompete and Delaware choice-of-law provision (*see* Cal. Lab. Code § 925(a)).

2. The employee agrees to the noncompetition and nonsolicitation provisions as a condition to the sale of a business of which the employee was an owner (*see* Cal. Bus. & Prof. Code § 16601).

3. The noncompetition provision is signed in anticipation of a partner's dissociation from a partnership or dissolution of the partnership (*see* Cal. Bus. & Prof. Code § 16602).

4. The employee is not a resident of California and does not—and will not with his or her new employer—perform services within California.

Although there are no Delaware cases directly addressing this point, it is also likely—given the reasoning of the Court of Chancery opinions discussed above and California's enactment of Cal. Lab. Code § 925(a)—that Delaware courts will apply California law to void noncompetition and nonsolicitation provisions within an agreement between employers with their principal places of business *outside of California* and their employees that *live and work primarily in California*, notwithstanding the existence of a Delaware choice-of-law provision.