

Court of Chancery Strikes Down Restrictive Covenants Designed to Protect Private Equity Investments Beyond the Target

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Recently, the Delaware Court of Chancery issued a decision regarding restrictive covenant agreements that will likely have an immediate impact on the scope of restrictive covenants in private equity transactions. In the decision, the court completely struck down a restrictive covenant that prevented sellers from competing, not only with the target of the transaction, but also with the private equity fund's other operating companies that were not part of the transaction. The court found that such a restrictive covenant was broader than necessary to protect the buyer's legitimate business interest in the target, and as a result, completely struck down the provision. The decision cautions private equity funds to limit the scope of their restrictive covenant provisions in purchase agreements to the business carried on by the target, and instead to seek to prevent competition with its other businesses through alternate means, such as employment agreements.

The noncompetition provision at issue in *Kodiak Building Partners, LLC v. Adams* was one that has become boilerplate in many of today's business sale agreements. Kodiak Building Partners, LLC (Kodiak), a private equity firm that frequently acquires construction-based businesses, purchased Northwest Business Components (Northwest), an Idaho manufacturer and distributor of lumber-based building products. As part of the transaction, members of Northwest management that received consideration signed noncompetes. One manager's noncompete extended 2.5 years from closing, and promised not to compete with *any of Kodiak's portfolio companies in Washington, Idaho, or within a 100-mile radius of another Kodiak company's location*. The noncompete was not limited to competition with the target's business. As part of the noncompete, the manager acknowledged the provision as reasonable and necessary to protect Kodiak's business interests and waived his right to challenge its reasonableness. In the months following the Kodiak-Northwest transaction, this manager took a job with a direct Northwest competitor within 100 miles of Northwest's headquarters. Shortly after, Kodiak filed a suit for a preliminary injunction against the manager.

The court denied the motion and struck down the noncompete. The court acknowledged that in Delaware, noncompetition provisions in the sale-of-business context, as opposed to those in the employment context, are more likely to be upheld as reasonable given that they are the result of a heavily negotiated bargain in which the sellers often reap substantial financial benefits. While context matters, noncompetition provisions must be reasonable in geography, time, and scope, and they must advance the buyer's legitimate economic interests. The noncompete at issue in this case failed to meet these standards, despite being in the more favorable sale-of-business context, because the provisions' attempt to prevent competition with the private equity fund's other businesses went beyond its legitimate business interests. The fact that Kodiak invested in other industries did not mean it could prevent individuals from working in those industries as part of this transaction. Such a restriction,

both geographically and in scope, does not protect Kodiak's legitimate economic interests in the acquisition itself. In so ruling, the court refused to blue-pencil the provision to limit its scope to an enforceable extent, declined to enforce the provision purporting to waive any challenge to the noncompete, and struck the noncompete down entirely.

Several lessons can be gleaned from this decision, but most importantly, this case solidified private equity buyers' need to appropriately tailor restrictive covenant agreements. While buyers may be tempted to protect their investments in companies other than the target, they must remember that only the subject of the transaction in question is relevant for determining whether a noncompete is reasonable in scope. Moreover, the once-standard provisions by which sellers acknowledged the reasonableness of their restrictive covenants and waived their right to challenge them will not be mechanically enforced in Delaware.

Overall, the decision counsels private equity buyers to limit the scope of their restrictive covenant provisions in purchase agreements to the business carried on by the target, rather than extending them to their other operating companies. Private equity buyers can attempt to separately prevent competition with their businesses, other than the target, through other agreements, such as employment agreements or stockholder agreements, with sellers that become employees or owners of the private equity fund post-closing.

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