Articles + Publications | August 13, 2025

Delaware Court of Chancery Invalidates Noncompete Provision Found in Typical Sponsor Equity Documents

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In *Weil Holdings II, LLC, v. Jeffrey Alexander, DPM*, the Delaware Court of Chancery struck down a noncompete provision contained in the LLC agreement of a sponsor-backed portfolio company, finding the provision unreasonable in both duration and geographic scope. The decision is notable because the term of the provision (*i.e.*, for the ownership period plus a two-year tail period) is common in the private equity space, suggesting that, pending the outcome of an appeal to the Delaware Supreme Court, a reformulation may be advisable.

Background

In 2023, as part of a broader transaction, Dr. Jeffrey Alexander (defendant) purchased an ownership interest in Weil Holdings II, LLC (plaintiff), a holding company that owns multiple companies that operate in the podiatry industry, including Weil Foot and Ankle Institute (WFAI) and executed the plaintiff's LLC agreement, which contained a noncompete provision that prohibited him from competing against the plaintiff or an "affiliate practice" within the "restricted territory" for so long as the defendant held an ownership interest in the company and for two years afterwards. The restricted territory covered WFAI's 16 locations and additional locations of WFAI's affiliates, including two states where the defendant had never worked. The language of the LLC agreement also allowed for the restricted territory to expand as the plaintiff opened new locations. Later in 2023, WFAI terminated the defendant's employment and the defendant subsequently began practicing podiatry at an alleged competing practice. The plaintiff brought suit, seeking, among other things, to enforce the noncompete.

Analysis

Delaware courts will not mechanically enforce noncompetes, as they are restrictive of trade. Under Delaware law, a noncompete must (i) be reasonable in geographic scope and temporal duration, (ii) advance a legitimate economic purpose of the enforcing party, and (iii) survive a balance of the equities. As part of its analysis, the court distinguished between noncompetes within the employment context, where the court must balance the enforcement of contractual promises against the need to avoid oppressive restrictions that may arise from unequal bargaining power, and noncompetes within the sale of business context, where there is generally less disparity in bargaining power amongst the parties.

The plaintiff argued that the provisions within an LLC agreement should not receive the same level of scrutiny that noncompetes receive in employment agreements. The plaintiff also highlighted that the defendant willingly entered into the LLC agreement as an investor and made standard representations that he was a sophisticated investor capable of evaluating the merits and risks of the investment. Despite the level of scrutiny applied, the court

nevertheless held that the scope of the noncompete was unreasonable and that it was “not a close call.”

According to the court, the duration of the noncompete was potentially indefinite, rendering it invalid, because the LLC agreement did not afford members a mandatory redemption right. While the LLC agreement gave the plaintiff the option to repurchase the defendant’s ownership interest, this did not matter for purposes of the court’s analysis because the defendant did not have the power to divest himself of his ownership interests and therefore start the clock on the two-year tail period. With respect to the geographic scope of the noncompete, the court stated that preventing the defendant from practicing podiatric medicine in four states, including two where the defendant had never practiced, is not appropriately tailored to protecting the plaintiff’s legitimate business interests. The court was also concerned that the restricted territory could change because it was tied to affiliate practices as the defendant expanded the location of its practices or opened entirely new practices. Under this arrangement, the defendant could be working in an area that is not within the restricted territory but nonetheless find himself in breach of the noncompete if the defendant decided to open a new practice in that location. Consistent with recent cases from the Delaware Court of Chancery, the court declined to blue-pencil the noncompete provision.

Takeaways

This decision serves as a cautionary tale for sponsor-backed companies to potentially re-evaluate the scope of their restrictive covenants outside the sale of business context, both with respect to duration and geography. While it is standard practice to require members, including employees, to sign onto LLC agreements with noncompetes, these restrictions must still be reasonable in both duration and geographic scope, otherwise the restrictions are likely to be invalidated completely if challenged. If the durational scope of the provision is tied to the member’s ownership of interests in the company, the member must be able to divest their interest to start the clock on the noncompete tail. This could be accomplished with a put right that requires the company to repurchase the ownership interest upon termination of the employment relationship at a stated price depending upon the circumstances. If the noncompete is tied to a geographical area, those areas should ideally not be subject to change and should only prohibit competition in areas necessary to protect the company’s legitimate business interests. We note that the decision is on appeal to the Delaware Supreme Court and, as such, any final practical takeaways and drafting considerations may change.

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