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Feeling Competitive: The Reasonableness of Forfeiture-for-Competition Provisions

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In 2024, employers rushed to track the twists and turns of the Federal Trade Commission's (FTC) noncompete ban, which attempted to limit the enforceability of agreements that restrict employees from working for a competitor following employment. Though the FTC's ban has since fizzled out, the commotion around noncompetes also led to conversations about "forfeiture-for-competition" clauses — a similar, but distinct type of agreement.

Unlike a noncompete, which prohibits an employee from competing, a forfeiture-for-competition provision allows the terminating employee to work for a competitor (*i.e.*, compete), but the employee will forfeit any post-employment compensation and benefits which were conditioned upon compliance with the non-compete, whether or not such benefits have already been paid. In other words: you can choose to compete, but it may cost you. This is sometimes referred to as the "employee choice doctrine."

In many states, courts assess noncompetes under a reasonableness standard — meaning, if the agreement is reasonable under applicable state law considerations, it is enforceable. For years, courts have grappled with the appropriate standard for forfeiture-for-competition clauses. Should a reasonableness standard also apply?

In 2024, the Delaware Supreme Court declined to extend the reasonableness standard to a forfeiture-for-competition clause contained in a limited partnership agreement where all parties were sophisticated and experienced in contract law. This year, in January, the U.S. Court of Appeals for the Seventh Circuit likewise ruled in *LKQ Corporation v. Rutledge,* applying Delaware law, that forfeiture-for-competition clauses are not subject to judicial review of reasonableness (as is typically utilized for analysis of noncompetes), even if the parties are unsophisticated.

In *LKQ*, a former plant manager received restricted stock units (RSU) subject to a forfeiture-for-competition provision. The company later attempted to claw back the employee's RSUs after he resigned and began working for a competitor. The employee argued the clawback was unreasonable and unenforceable. Relying on the 2024 Delaware ruling, the company argued that the reasonableness standard did not apply. Siding with the company, the Seventh Circuit held that, under Delaware law, forfeiture-for-competition provisions are not subject to a reasonableness review, regardless of the type of agreement at issue (*e.g.*, partnership agreement, RSU agreement, or otherwise) or the sophistication of the parties involved. Importantly, the court left room for a potential exception to this rule where a provision is "so extreme in duration and financial hardship that it precludes employee choice by an unsophisticated party."

Though not all states recognize the employee choice doctrine, agreements subject to the Delaware law may include forfeiture-for-competition provisions as a possible alternative to noncompete agreements, with, potentially, a greater chance of enforceability against employees and a lower standard of review by the courts. Following the decision in *LKQ*, other courts (and other states) may take up similar questions in the future to further flesh out the enforcement considerations for forfeiture-for-competition clauses, such as the adequacy of supporting consideration for such clauses, the enforceability of these provisions against an employee who was involuntarily terminated, or the scope of any exceptions. In the meantime, employers should review their agreements containing employee restrictions to ensure the greatest chance of enforceability under applicable state law.

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