Articles + Publications | March 29, 2024

Noncompete Covenants in Deferred Compensation Plans: Proceed with Caution

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SYNOPSIS: Supplemental executive retirement plans (SERPs) and other forms of deferred compensation plans sometimes incorporate certain post-employment restrictive covenants for covered employees into the plan. Those covenants may take the form of a separate noncompete agreement with a full range of potential employer remedies for breach — including a court injunction to stop the prohibited conduct — or may simply be a condition for the payment of plan benefits that results in forfeiture of benefits in case of breach — referred to as a "forfeiture for competition" provision. A recent Delaware Supreme Court decision, *Cantor Fitzgerald v. Ainslie*, looks favorably on such forfeiture for competition provisions. But other states, especially California, continue to pass laws that create legal risks when incorporating restrictive covenants into compensation arrangements. And the FTC proposed (but has not yet adopted) a nationwide ban on many noncompetes. This Insight article explores these recent developments and suggests steps employers should consider when incorporating restrictive covenants into their SERPs or other deferred compensation plans.

Use of Restrictive Covenants in Deferred Compensation Plans

Employers often desire to restrict certain conduct by key employees after they terminate employment. These restrictions typically take the form of covenants made by the key employee to refrain from certain conduct for a specified period after termination of employment — broadly referred to as restrictive covenants. The prohibited conduct may include agreeing not to engage in competition with the employer's business, such as by taking a job with a competitor or starting up or funding a new competitive business — referred to as a noncompete. The prohibited conduct may also include agreeing not to solicit the employer's customers for business or the employer's employees to leave employment — referred to as customer or employee nonsolicits.

Employers with SERPs or other deferred compensation plans with employer-provided benefits often include noncompete or nonsolicit requirements as part of the plan. The methods by which the restrictive covenants are incorporated in the plan vary. Some deferred compensation plans may condition participation in the plan on the employee first entering a separate, stand-alone restrictive covenants agreement with the employer.[1] Other deferred compensation plans may include the restrictive covenants in the deferred compensation plan itself. The deferred compensation plan may include a specific forfeiture requirement related to breach of covenants or may indirectly provide for such forfeiture by including breach of covenants as part of a definition of termination of employment for "cause" that results in forfeiture.

There have been several recent developments that throw the spotlight on the interaction between restrictive

covenants in compensation arrangements like SERPs and other deferred compensation plans and potential challenges to the enforceability of those restrictive covenants. This article explores key recent developments and suggests actions that employers should consider regarding restrictive covenants included in their deferred compensation plans.

Forfeiture for Competition vs. True Noncompete

Restrictive covenants used in deferred compensation plans may be characterized as either a "forfeiture for competition" or a "true noncompete," distinguishable as follows:

- A forfeiture for competition provision refers to a clause in a deferred compensation plan that conditions payment of plan benefits on the participant's continued compliance with any applicable restrictive covenants. The clause does not allow the employer to enforce the restrictive covenants through a court-ordered injunction preventing the employee from engaging in competition or soliciting customers or employees. Rather, the clause solely serves as a contractual condition to payment, which if not met, results in the payment not being made. In other words, the participant may take a job with a competitor or solicit the employer's customers, but by choosing to do so, the participant gives up the right to the deferred compensation payment.

- A true noncompete refers to a restrictive covenant that not only serves as a contractual condition to payment, but also may result in the employer requiring the employee to cease and desist from the prohibited conduct. The employer may do so by seeking a court-ordered injunction, in which case the participant will be barred from accepting employment with the competitor or from communicating with the specified customers or employees.

These two approaches to incorporating restrictive covenants into compensation arrangements are often blurred into a single concept, but there can be important legal differences between the two depending on the relevant jurisdiction.

A recent Delaware Supreme Court decision, *Cantor Fitzgerald v. Ainslie*, Del., No. 162, 2023, 1/29/24, illustrates the potential significance of this distinction. The service providers in the case (who were partners in a limited partnership rather than employees) entered into various agreements that included both a true noncompete and a forfeiture for competition related to certain partnership capital account distributions and equity awards. The lower court[2] considered whether a forfeiture for competition clause should be analyzed under a more deferential, contract law standard that respects the mutual intent of willing, competent parties, or whether the public policy against noncompete agreements should apply, resulting in heightened scrutiny as to the reasonableness of the restriction. The lower court decided the latter — *i.e.*, that forfeiture for competition clauses are a form of true noncompete that must be reviewed for reasonableness. On the facts in the case and measured by that standard, the lower court found the clauses were unreasonable. But the Delaware Supreme Court disagreed. It found that "freedom of contract" represented a higher public policy interest in Delaware, and that a forfeiture for competition clause simply represents a contractual condition to a payment (in legal jargon, a "condition precedent"), not a restriction on future employment.[3] Under the so-called "employee choice" doctrine, the employee may freely choose to compete, thereby voluntarily relinquishing a claim to compensation that was expressly conditioned on not competing. The court held that, absent "unconscionability, bad faith, or other extraordinary circumstances," the willing contractual bargain of the parties should be respected.[4]

As a result, SERPs or other deferred compensation plans governed by Delaware law should have a strong argument that forfeiture for competition provisions included in the plan can be enforced. But if the plan includes a true noncompete, the reasonableness of the covenants, including temporal and geographic scope, the nexus with protecting confidential employer information, and the clarity of defined terms such as the definition of the employer's business, should be closely scrutinized.

Most other states apply some form of reasonableness review for restrictive covenants and may or may not have clearly distinguished between forfeiture for competition versus true noncompete provisions. There are some states, however, that appear to follow Delaware in respecting the employee choice doctrine when it comes to forfeiture for competition provisions, including New York and Pennsylvania, among others.[5]

Choice of Law

As the *Ainslie* case makes clear, the applicable state law for determining the enforceability of restrictive covenants, whether structured as a forfeiture for competition or true noncompete, is often critical to the outcome. A deferred compensation plan should include a clear statement as to the intended state governing law, and the selected state should bear a reasonable connection to the parties. That reasonable connection could include the state in which the employer is incorporated, the state where the employer is headquartered, or the state where the employee primarily performs services.

Whether the choice of law provisions in the deferred compensation plan will be respected depends on each state's rules. Courts follow the choice of law rules of the state where the lawsuit is filed. For example, if a deferred compensation plan with a forfeiture for competition provision has selected Delaware as the relevant governing state law, but an employee in another state (other than California — see below) sues in their home state, the choice of law rules applied by the employee's home state will control. Most states will respect the choice of law provision in the plan, however, so long as there is a substantial relationship or other reasonable connection between the selected state and the parties. In other words, in our example, the employee's home state may apply Delaware law based on the choice of law provision in the plan. Some states have not definitively decided this issue in this context. And then there is California …

California – Be Careful

California law for years has provided that, with limited exceptions (such as in connection with the sale of a business), post-employment restrictive covenants, including noncompete and nonsolicitation of customers, are void against public policy as impermissible restraints of trade.[6] Also, recent case law in California suggests that post-employment covenants related to nonsolicitation of employees may also be considered an impermissible restraint of trade.[7]

California's statutory provisions do not distinguish between a forfeiture for competition and a true noncompete. A 1965 court decision in California determined that a forfeiture for competition provision in a pension plan amounted to a penalty that acted as an impermissible restraint of trade.[8] Given this case and the strong expression by the California legislature as to the underlying public policy considerations for its laws, many employers choose to treat forfeiture for competition provisions the same as a true noncompete for California purposes.

For years, California law also has restricted the ability of employers to avoid these requirements through a choice of law provision. Generally, California law does not permit an employer to require an employee who primarily resides and works in California to waive California as a choice of law or forum. The one exception to this rule where California law may respect a choice of law provision in an agreement between employer and employee is when the employee was represented by counsel in negotiating the agreement.[9] Otherwise, in general, a non-California choice of law provision in a deferred compensation plan will not be respected by California courts.

California recently raised the stakes on these issues by passing two new laws, effective January 1, that reinforce the existing prohibition on post-employment restrictive covenants. One of these new laws requires that employers provide written notice to certain California employees that any noncompete agreements they signed are void.[10] The other new law adds a civil liability for (1) presenting an employee with a provision that is void under the California Business and Professions Code (including post-employment noncompete provisions and customer nonsolicitation provisions), or (2) for enforcing or attempting to enforce these provisions, and allows employees to seek injunctive relief, damages, and attorneys' fees.[11] This new law also makes it clear that California's law prohibiting many restrictive covenants applies to employees who move to California, even if the agreements they entered were otherwise valid, or they earned benefits under the agreements, when the individuals lived and worked elsewhere.[12]

The punchline is that employers with employees located in California should exercise caution when incorporating post-employment restrictive covenants into deferred compensation plans. Those plan features should be closely reviewed with counsel, and there may need to be carve-outs that apply to employees located in California.

Other Legal Development Demonstrating Hostility Toward Restrictive Covenants

While California remains the most hostile jurisdiction for restrictive covenants, a significant number of other states have in recent years adopted their own laws intended to restrict the use of noncompetes.[13] Many of those laws, while clearly directed at true noncompetes, do not in the statutory language indicate whether they also are intended to apply to forfeiture for competition provisions. Some of the state laws, however, clearly do also apply to forfeiture for competition provisions.[14] A number of these state laws do not apply to highly paid employees with compensation over a specified level.[15] Participants in deferred compensation plans will likely have compensation levels in excess of those state law thresholds, especially given that deferred compensation plans should limit eligibility to a "select group of management or highly compensated employees" in order to qualify as a "top hat" plan under the Employee Retirement Income Security Act of 1974, as amended.

The FTC proposed its own rule in 2023 that would prohibit certain noncompete agreements in all states.[16] The proposed rule does not clearly indicate whether it would apply to a forfeiture for competition provision. It defines a noncompete provision as "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer" (emphasis added). The proposed rule also states that it applies to a "*de facto* non-compete clause because it has the effect of prohibiting the worker from seeking or accepting employment." It is not clear that a forfeiture for competition provision would meet that *de facto* test. The proposed rule does not include any exception for highly paid employees and would override less restrictive state laws but not more restrictive state laws (like California). It is unclear, however, if the FTC will move forward with the proposed rule, amend it, or abandon it given the number of objections and concerns raised when it was proposed. The FTC is

expected to issue its decision in the coming months.

Steps to Take Now

Employers that include restrictive covenants in their SERPs or other deferred compensation plans, whether directly or indirectly, should re-examine those provisions in light of the recent developments described above. Working with their legal counsel, employers should:

- Identify whether their plans include any restrictive covenant provisions, including by cross-reference to separate restrictive covenants agreements or as part of a termination for "cause" provision;
- Determine whether any such restrictive covenants are best categorized as a forfeiture competition provision versus a true noncompete;
- Review the relevant choice of law provision in the plan and consider how those restrictive covenants will be evaluated in that state;
- Identify the relevant states where eligible employees in the plan work or reside, and consider whether the choice of law provisions in the plan will be respected in those states;
- Consider whether the plan should include any carve-outs from the restrictive covenants, such as for eligible employees located in California, and further consider whether any additional state compliance requirements must be met, such as notice requirements that apply in some states; and
- Continue to monitor for additional legal developments, including new state laws, court cases interpretating existing laws, and the status of the FTC proposed rule.

In some cases, the evaluation process may suggest potential amendments to the deferred compensation plan provisions such as updates to the choice of law, clarifications as to whether the provisions are intended to operate solely as a forfeiture for competition, or the addition of possible carve-outs or other limitations based on applicable state laws.

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[1] For example, in the recent case, *Hankins v. Crain Automotive Holdings, LLC*, 2024 BL 51937, E.D. Ark., No. 4:23-cv-01040, 2/16/24, the employer sponsored a deferred compensation plan that included as a condition to the employer-provided benefits, a requirement that the participant enter a separate noncompete/nonsolicit agreement. The participant had not entered into any such agreement, and the employer attempted to use that fact as a reason not to pay the participant the $4.9 million benefit otherwise owed upon the participant's termination of employment. The court ruled for the participant, contending that the employer had operated the plan for over four years without ever raising the issue about an agreement not having been executed, and the employer could not then wait and raise the issue only after the participant terminated employment.

[2] *See Ainslie v. Cantor Fitzgerald*, CA. No. 9436-VCZ (Del. Ch. Jan. 4, 2023).

[3] While the facts in the case focused on limited partners providing services to a limited partnership and the decision cites certain features of the Delaware Revised Uniform Limited Partnership Act, the core reasoning articulated by the Delaware Supreme Court appears to apply more broadly and should encompass employer/employee service relationships.

[4] *See Cantor Fitzgerald v. Ainslie*, Del., No. 162, 2023, 1/29/24, at pg. 4. While the Court reversed the lower court's decision as to the applicable legal standard for reviewing forfeiture for competition clauses, it remanded the case to the lower court for a determination as to whether the relevant restrictive covenants at issue were in fact breached.

[5] For a good discussion regarding the employee choice doctrine, see *Ainslie v. Cantor Fitzgerald*, *supra*, at pages 55-57.

[6] *See* Section 16600 of the California Business and Professions Code.

[7] *See, e.g.*, *AMN Healthcare, Inc. v. Aya Healthcare Services, Inc.*, 28 Cal. App. 5th 923 (2018).

[8] *See Muggill v. Reuben H. Donnelley Corp.*, 62 Cal.2d 239 (1965).

[9] *See* Section 925 of the California Labor Code.

[10] *See* Section 16600.1 of the California Business and Professions Code, which became effective on January 1, 2024.

[11] *See* Section 16600.5 of the California Business and Professions Code, which became effective on January 1, 2024.

[12] *Id.*

[13] As the FTC notes in its January 2023 release accompanying their proposed national noncompete ban (see footnote 14 below), eleven states plus the District of Columbia have enacted statutes making noncompete clauses void or unenforceable based on the worker's earnings or a similar factor. See, *e.g.*: **Colorado**: Colo. Rev. Stat. §8-2-113; **District of Columbia**: Ban on Non-Compete Agreements Amendment Act of 2020, D.C. Code §§32-581.01 through 32-581.05; **Illinois**: Illinois Freedom to Work Act, 820 Ill. Comp. Stat. 90/1 to 90/97; **Massachusetts**: Massachusetts Noncompetition Agreement Act, Mass. Gen. Laws ch. 149, §24L; and **Washington**: Wash. Rev. Code §§49.62.005 to 49.62.900.

[14] *See*, *e.g.*, Illinois, *supra* ("'Covenant not to compete' also means an agreement between an employer and an employee that by its terms imposes adverse financial consequences on the former employee if the employee engages in competitive activities after the termination of the employee's employment with the employer."); and Massachusetts, *supra* ("Noncompetition agreements include forfeiture for competition agreements . . .").

[15] For example, the noncompete restrictions in the following states generally do not apply to employees with compensation over the following levels: **Colorado**: ($112,500 for 2023); **District of Columbia**: $150,000

($250,000 for certain medical specialists) as increased for inflation after 2022; **Illinois**: $75,000 (subject to $5,000 increases every five years); and **Washington**: $100,000 (in 2020, increased for inflation to $116,593 in 2023).

[16] *See* the FTC rulemaking page, including a link to the proposed rule, here: https://www.ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking.

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