

# Cautionary Tale from Delaware: Restrictive Covenants Binding Sellers Must Be Narrowly Tailored

**October 27, 2022**

A recent decision from the Delaware Court of Chancery in the case of [Kodiak Building Partners, LLC v. Philip D. Adams](#) (Del. Ch. Oct. 6, 2022) should give pause to buyers seeking to impose upon sellers non-competition and related restrictive covenants that go beyond the specific business of the target company. The decision makes clear that more can indeed be less—and sometimes even nothing at all.

The dynamic faced by Kodiak Partners—the buyer in this case—is a common one. Buyers usually wish to limit the ability of the sellers to compete with the business they have just sold. Moreover, where the buyer is itself engaged in the same or a similar business, and particularly when a seller is expected to continue as an employee of the business following closing, the buyer often will want restrictive covenants to apply to the entirety of the combined business, including activities in which the target did not engage and geographies in which it did not operate before closing. Even where the buyer acknowledges some uncertainty regarding its ability to enforce restrictions that go beyond the scope of the business being acquired, it often considers the risk well worth taking, on the basis that the existence of the restriction may have *in terrorem* effects and a view that, in the unlikely event of litigation, the worst that can happen is that the covenant might be narrowed by the court.

The selling stockholder in the *Kodiak Building Partners* case did not fear the covenant. When the buyer brought suit to enforce it, the court, rather than narrowing the covenant, held it unenforceable in its entirety on the grounds that its scope, by going beyond the business conducted by the target to include the buyer's own business, was unreasonable. Ironically, it appears that the selling stockholder's conduct would have breached even a narrow restriction, limited to the pre-closing business of the target, and that the broader covenant was in this instance unnecessary. Nonetheless, for want of a narrower scope, the entire covenant was lost.

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## BACKGROUND

The case involved the sale of Northwest Building Components, Inc., a small manufacturer of roof trusses (“Northwest”), to Kodiak Building Partners, a much larger construction business (“Buyer”). Philip Adams (“Adams”) was the general manager and 8% shareholder of Northwest. In connection with the sale, Adams entered into a restrictive covenant agreement having a 30-month term, which included non-competition and non-solicitation covenants for Buyer’s benefit. Adams agreed not to engage in any activity that competed with the “Business” and not to solicit any customers or clients of Northwest or any other member of the “Company Group,” which included Buyer, its subsidiaries and their respective affiliates. “Business” was defined broadly, encompassing more services than Northwest actually offered, while the geographic scope of the covenant also extended beyond Northwest’s operations: it restricted any competition by Adams within 100 miles of any location where a Company Group member sold products or services in the year prior to closing. In the agreement, Adams acknowledged that the covenants were reasonable in scope and agreed that he would not contest them. Approximately 16 months following closing, Adams resigned from Northwest, and two months later joined a competing company, located in a different state but less than 25 miles from Northwest’s operations. Buyer sued to enforce the restrictive covenant.

## COURT’S ANALYSIS

### **Provisions Limiting a Party’s Right to Contest Reasonableness of Restrictive Covenants Violate Public Policy**

At the outset, the court held that neither the waiver by Adams of his right to contest the scope of the restrictive covenant nor his acknowledgement that the covenant was reasonable precluded him from challenging the covenant or the court from considering its reasonableness. The court stated that “mechanical submission to an employee’s promise not to challenge a restrictive covenant would fly in the face of the public policy that compels [the court to] review that covenant” and that the court cannot “decline to apply a common law test simply because one party stipulates the test is not necessary.”

### **Scope of Restrictive Covenants Held Unreasonable**

Finding that both the scope of the restricted activities and the geographic scope were overly broad, the court held that the restrictive covenants were unenforceable against Adams. In reaching its conclusion, the court acknowledged that buyers have a legitimate interest in protecting the goodwill of businesses they acquire. However, the restrictive covenants in dispute went far beyond that objective, attempting to protect the goodwill of Buyer and the other members of the Company Group, in addition to

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that of Northwest. This, the court held, was not permitted under Delaware law. “Restrictive covenants in connection with the sale of a business legitimately protect only the purchased asset’s goodwill and competitive space that its employees developed or maintained.”

### **“Blue Pencil” Provisions Won’t Save an Overly Broad Covenant**

The court declined to “blue pencil” the covenant—despite the parties’ agreement that “any provision of [the] Agreement deemed invalid or unenforceable by a court of law [...] shall be considered to be automatically deleted from this Agreement; any such deletion [to] apply only to that portion of any provision so adjudicated”—holding that to do so would be inequitable. The court cited multiple Delaware cases declining to reform overly broad restrictive covenants. The court reached this decision despite its acknowledgment that portions of the agreement were supported by Buyer’s legitimate business interests and that Adams appeared to have breached those provisions.

### **KEY TAKEAWAYS / PRACTICE POINTS**

Because restrictive covenants entered into in connection with the purchase of a business are generally subject to less exacting judicial scrutiny than those contained in employment agreements, Buyers often prefer to make such covenants as broad as possible, often covering business activities of the buyer, in addition to those of the target. However, the *Kodiak Building Partners* decision makes clear that restrictive covenants given in consideration for the sale of a business may be held unenforceable in their entirety if their scope goes beyond the business actually carried on by the acquired company. Moreover, common provisions, such as a waiver of the right to contest the scope of the restrictive covenant or an agreement that the covenant is reasonable are, per *Kodiak Building Partners*, largely ineffective as a means to protect the covenant.

Some buyers may still seek a broader restriction, perhaps because they believe that the seller will not risk breaching the covenant, that a future employer will not risk a claim for tortious interference with it, or that a future court, including the Delaware Supreme Court, will not agree with the Court of Chancery’s decision in *Kodiak Building Partners*. A more conservative approach, though, would be to limit the scope of the restrictive covenant agreement to the business carried on by the target. If a seller has a post-closing employment relationship with or equity interest in the buyer, the agreements governing those relationships—such as an employment agreement or a stockholders agreement—could include restrictive covenants applicable to activities carried on by the buyer. While restrictions agreed to in those contexts may be subject to greater judicial scrutiny than those given as consideration for the sale of a business, bifurcating the restrictive covenants in this manner will avoid the risk that the restrictions applicable to

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the target's business will fall victim to the desire to get the enforceability benefits of a seller non-compete for activities not engaged in by the seller. While some buyers may consider an overbroad covenant to be a "no-lose" proposition, *Kodiak Building Partners* demonstrates that, at least in Delaware, this is not necessarily the case.

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Please do not hesitate to contact us with any questions.

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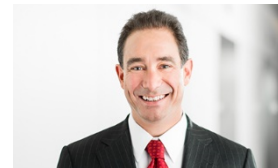
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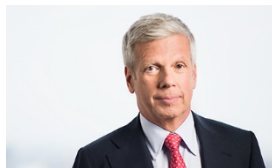


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