COVINGTON

# Delaware Chancery Court Declines to Enforce Noncompete in California Despite Choice of Law Provision

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Corporate

In *Ascension Ins. Holdings, LLC v. Underwood* (January 28, 2015),[1] the Delaware Chancery Court declined to follow an explicit Delaware choice of law provision and denied a Delaware limited liability company's request for preliminary injunctive relief to enforce a noncompete provision against a California resident and former employee.

## Background

In 2008, the defendant-employee participated a sale of assets to the plaintiff-employer that was governed by an asset purchase agreement (the "APA"). At the time, the parties expressly contemplated the defendant's subsequent investment in the plaintiff but, notably, the parties did not discuss whether a restriction on competition would be a part of that contemplated agreement. The parties subsequently entered into an employee investment agreement (the "EIA") under which the defendant agreed, among other things, to refrain from competing with the plaintiff for two years after leaving employment with the plaintiff's subsidiary. In the EIA the parties also agreed to both Delaware venue and Delaware choice of law.

The plaintiff sought injunctive relief in the Court of Chancery to enforce the noncompete.

## Noncompetition Covenants

Delaware public policy generally allows contractual agreements not to compete. In California, Section 16600 of the Business and Professions Code prohibits noncompetition covenants. Such prohibition is subject to narrow statutory exceptions such as Section 16601, which permits a person who sells the assets and goodwill of a business to be subject to a noncompetition covenant.

## Delaware Law on Choice of Law Provisions

In *Ascension*, the plaintiff argued that the non-compete should be enforced under Delaware law, as provided in the EIA choice of law provision. Delaware follows the Restatement (Second) of Conflict of Laws. Section 187 of the Restatement provides that a choice of law provision should not be enforced in a way that circumvents the fundamental public policy of the state that would otherwise control the contract if that state has a materially greater interest in the matter than the state elected in the choice of law provision.

[1] 2015 Del. Ch. LEXIS 19, *17-18 (Jan. 28, 2015).

The Vice Chancellor determined that California law applied notwithstanding the choice of law provision in the EIA. First, the Vice Chancellor determined that California was the state with the strongest contacts to the contracts and that absent the choice of law provision, California law would apply to the contract. Next, he noted that California's public policy against noncompete provisions is stated unequivocally by statute. Finally, while he considered the argument that Delaware strongly favors freedom of contract, the Vice Chancellor found that California had a materially greater interest in the question of whether the contract at issue should be enforced or not. In determining that California's specific interest was materially greater than Delaware's, he noted that: (1) the APA and EIA were entered into in California, (2) the APA and EIA were negotiated in California, (3) the non-compete provision was limited almost exclusively to California by virtue of the geographic scope of the plaintiff's business and (4) the defendant's state of residence and the plaintiff's principal place of business were both in California. The Vice Chancellor stated that "[t]he entire purpose of the Restatement [choice of law] analysis is to prevent parties from contracting around the law of the default state by importing the law of a more contractarian state, unless that second state also has a compelling interest in enforcement."

The plaintiff argued that, even if California law applied, the exception in Section 16601 allowed enforcement of the non-compete. The Vice Chancellor, applying California law, determined that the exception did not apply because there was no evidence that at the time the parties entered the APA they had contemplated a non-compete would be included in the EIA, and therefore the non-compete in the EIA was not a negotiated part of the asset purchase transaction. The Vice Chancellor noted that the purpose of the Section 16601 exception is to enforce a "post-acquisition" non-compete in order to protect a purchaser's interest in capitalizing on acquired goodwill for a limited period, as distinguished from a "post-employment" non-compete such as the one in this case, which is targeted at an employee's fundamental right to pursue a profession.

**Conclusion**

This case serves as a reminder that a non-California choice of law provision is not a guarantee that a noncompetition covenant that would be void under California law will be enforced, even by non-California courts. Employers seeking noncompetes against California employees (or where other California contacts are present) should not rely on choice of law provisions to render an unenforceable noncompete enforceable.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Corporate practice group:


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