

Ruling: Forfeiture-for-Competition Provisions in Delaware Partnership Agreements Are Not Subject to a Reasonableness Review

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On January 29, 2024, in *Cantor Fitzgerald, L.P. v. Ainslie*, the Delaware Supreme Court reversed a decision of the Delaware Court of Chancery holding that a forfeiture-for-competition provision in a partnership agreement was a restraint of trade subject to review for reasonableness.

Noncompetition covenants — *i.e.*, affirmative obligations to refrain from engaging in competitive activities, and which are enforceable by injunction or for which monetary damages may be available — are not impacted by the Delaware Supreme Court’s decision and remain subject to review for reasonableness to the extent Delaware law applies.

Cantor Fitzgerald, L.P. operates under an agreement of limited partnership (the LPA). Limited partners agree to be bound by the LPA, which contains two separate mechanisms to discourage competition following a limited partner’s withdrawal from the partnership:

1. **A noncompetition covenant.**
2. **A forfeiture-for-competition provision**, under which a withdrawing limited partner forfeits, and Cantor Fitzgerald does not have to make, certain future payments in the event the withdrawing limited partner engages in competitive activities.

A limited partner’s breach of the noncompetition covenant will itself also trigger the forfeiture provision.

After six limited partners withdrew from the partnership, Cantor Fitzgerald determined that the former limited partners engaged in competitive activity and, as a result, forfeited their entitlements to certain future payments under the LPA.

The six former limited partners subsequently filed suit in the Court of Chancery, asserting breach of contract claims and challenging the enforceability of the noncompetition covenant and forfeiture-for-competition provision.

The court held that the noncompetition covenant in the LPA was unreasonable and unenforceable because the scope of activities it prohibited was overbroad. Turning to the forfeiture-for-competition provision, the court likened the forfeiture-for-competition provision to a liquidated damages clause that restrains trade. Such provisions are disfavored in Delaware.

Accordingly, the court determined that the forfeiture-for-competition provision, like the noncompetition covenant, should be reviewed for reasonableness. Having found the noncompetition covenant overbroad, the court held the forfeiture-for-competition covenant was also unenforceable.

Relying heavily on the mandate in the Delaware Revised Limited Partnership Act to honor freedom of contract in construing partnership agreements, the Delaware Supreme Court reversed and held that forfeiture-for-competition provisions contained in limited partnership agreements are not subject to the review for reasonableness standard that is imposed on affirmative obligations to refrain from competition.

Contrary to the Chancery Court’s holding, the Supreme Court found that forfeiture-for-competition provisions like those in the LPA are not akin to liquidated damages clauses, since forfeiture provisions serve as conditions precedent to a contractual obligation (whereas liquidated damages serve as a remedy to a breach of contract).

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The Delaware Supreme Court concluded that “forfeitures in limited partnership agreements should enjoy this court’s deference on equal footing with any other bargained-for-term in a limited partnership agreement.”

The Delaware Supreme Court’s decision:

- Is limited to forfeiture-for-competition provisions in partnership agreements under Delaware law.

- Does not impact the reasonableness standard applied to employee noncompetition covenants or other affirmative obligations not to compete outside of the partnership context.

However, the decision highlights that Delaware courts will give deference to what parties agree to in partnership agreements.