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COVENANT NOT TO COMPETE

Restrictive covenants: an employer's best friend

by Lauren E. Moak

Restrictive covenants include agreements by employees not to compete, disclose confidential information, or solicit an employer's clients. Based on a recent decision from Delaware's Court of Chancery, these agreements are more valuable than ever. Deciding a novel issue in Delaware, the court held that absent a provision to the contrary, restrictive covenants are assignable from one employer to another so long as both employers are engaged in the same business. That means when businesses merge, employees who are already subject to restrictive covenants with the acquired business don't have to execute new agreements with the acquiring business. In addition, the court reminds us that contracts defining the employer-employee relationship are the only way to prevent a competitor from poaching employees in an at-will- employment state such as Delaware.

Facts

The background in this case is one that will be familiar to many employers. Three businesses were competing in the surprisingly cutthroat world of third-party fundraising (selling fundraising materials to nonprofit organizations that then sell the items to their communities to raise money). Two of the businesses, Great American Opportunities, Inc. (GAO), and Kathryn Beich, Inc. (KB), merged, leaving GAO as the surviving business.

At the same time, a third business, Cherrydale Fundraising, saw an opportunity to expand its market presence by hiring several of KB's sales

reps. After the merger was complete, GAO discovered what was going on and attempted to prevent Cherrydale from picking off any more employees. But GAO was in a difficult position.

To KB's credit, it had been a careful employer, and almost all of its employees were subject to the trifecta of restrictive covenants: noncompetition, nondisclosure, and nonsolicitation contracts. However, GAO wasn't a party to any of the contracts. Faced with a complicated situation, it filed a lawsuit alleging that Cherrydale wrongfully interfered with the contractual relationship between GAO and its employees, leaving the court to sort out the details.

Discussion

Before it could address Cherrydale's poaching, the court had to decide if there was any formal relationship between GAO and KB's employees as a result of the merger. Cherrydale argued that Delaware's at-will-employment doctrine prohibits a claim of wrongful interference with a contractual relationship. In essence, it argued that there is no contractual relationship between employers and employees under Delaware law. An employer can fire an employee for any or no reason at all, and an employee is free to quit for any or no reason at all.

The court rejected that argument, noting that while there can be no wrongful interference without a contract, KB's employees *were* subject to contracts. Almost all of its employees had signed noncompetition, nondisclosure, and nonsolicitation agreements. And when a contract exists, there can be wrongful interference with that contract.

After establishing that at-will employment doesn't prohibit a claim for wrongful interference with contractual relations, the court had to determine whether KB could lawfully assign GAO its rights under the employees' restrictive covenants in conjunction with the sale of the business. Surprisingly, it was an issue that hadn't been thoroughly analyzed under Delaware law.

Adapting the general rule that contract rights may be assigned absent a provision prohibiting assignment, the court held that an employer's rights under a restrictive covenant may be assigned in conjunction with the sale of a business so long as the former employer and the current employer engage in the same type business. *Great American Opportunities, Inc. v. Cherrydale Fundraising, LLC*, C.A. No. 3718-VCP (Del. Ch. Ct., Jan. 29, 2010).

Bottom line

If you employ workers with specialized skills, restrictive covenants, including noncompetition, nondisclosure, and nonsolicitation contracts, are as important as ever. In an at-will state like Delaware, restrictive covenants are the only thing preventing your competitors from poaching your employees and their valuable know-how. But restrictive covenants are now

even more valuable because they can be assigned from one employer to another in a merger or asset sale. So if your employees aren't currently subject to restrictive covenants, now is the time to consider whether these contracts may be right for your business' circumstances.

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