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Beware the Delaware Choice of Law

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Delaware has long been one of the jurisdictions most friendly to the interests of corporations and is the state of incorporation for a significant majority of corporations. While that trend does not seem likely to change, a new Delaware Chancery Court decision should give pause to choice of law decisions of Delaware corporations with multi-jurisdictional work forces and operations in states other than Delaware.

Recent Ascension Case

In *Ascension Ins. Holdings, LLC v. Underwood*, C.A. No. 9897-VCG, 2015 Del. Ch. LEXIS 19 (Del Ch. Jan. 28, 2015) (unpublished), the Delaware Court of Chancery recently ruled that, despite a Delaware choice-of-law and venue provision contained in a non-compete agreement, California law applied to the agreement and under California law the agreement was void as a matter of law. In this case, the plaintiff (Ascension) sought an injunction against a former employee (Underwood) for violating a non-compete provision in an employment agreement entered into around the same time Ascension purchased Underwood's business under an asset purchase agreement.

When Underwood terminated his employment relationship with Ascension, the five-year non-competition period under the asset purchase agreement lapsed. However, the separate non-compete provision of Underwood's employment agreement provided a two-year tail at the end of the employment, which Ascension argued was specifically contemplated during the negotiations when acquiring Underwood's business.

Ascension was incorporated in Delaware, but headquartered in California which is also where Underwood worked. In the employment agreement, parties selected Delaware law to govern. Delaware law generally enforces employee non-competition agreements if reasonable in scope and duration and if they advance a legitimate economic interest of the employer. California, in contrast, has a specific statute that renders a covenant not to compete unenforceable against an employee unless made in connection with his or her sale of substantially all of the assets and goodwill of a business non-competition agreements (Cal. Bus. & Prof. Code Sections 16600, 16601).

Choice of Law Analysis

The Chancery Court conducted a choice-of-law analysis to determine whether Delaware or California law would apply. The court found that the parties' relationship was centered in California, the various contracts were negotiated and entered into

there, and the territory in which the defendant employee would be restricted was located there. The court acknowledged that "[u]pholding freedom of contract is a fundamental policy of [Delaware]" but rejected the plaintiff employer's argument that Delaware's interest in that policy trumped California's interest in not burdening its citizens with non-competition covenants. The Delaware court acknowledged that under the applicable California statute the non-compete in the asset purchase agreement would be enforceable to protect the acquired goodwill, but reasoned that the covenant in the employment agreement was directed to a different employer interest; concluding that the restriction in the employment agreement would be prohibited under California law. It held that "allowing parties to circumvent state policy-based contractual prohibitions through the promiscuous use of [choice-of-law] provisions would eliminate the right of the default state to have control over enforceability of contracts concerning its citizens." On this basis, the Chancery Court denied the employer's motion for preliminary injunction.

Practical Considerations

For Delaware corporations with employees in many states, this case presents a conundrum:

- While there is clearly a value to having a single state law govern its relationship with employees in many states, and Delaware law is comparatively employer-friendly with respect to restrictive covenants, there is a risk that the law of each employee's home state will control unless the corporation has a meaningful connection to Delaware.
- Similarly, a Delaware corporation headquartered in a state with laws on restrictive covenants that are in the middle of the spectrum (enforceable but narrowly construed or with high proof thresholds) might opt for Delaware law because it is more favorable. But in that situation the employer should evaluate the risk that in reaching for the more friendly laws of Delaware it may lose the benefit of even the modestly friendly provisions of its home state and become subject to laws of each employee's state which may render non-competition restrictions completely unenforceable or in other respects may be less favorable that those of the employer's home state.
- In mergers and acquisitions and similar transactions involving the sale of a business, acquirers commonly require restrictive covenants in both the sale agreement and in separate employment agreements. Acquirers should balance the risk that a court in any particular state may reject the choice-of-law provision that selects Delaware compared with the law of the state in which the acquirer has meaningful contacts.

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