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Seventh Circuit Decision Highlights Distinction Between Traditional Non-Compete and Forfeiture-for-Competition

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A recent decision by the U.S. Court of Appeals for the Seventh Circuit allowed an employer to enforce a "forfeiture-for-competition" against a former plant manager. The Court explained that, under Delaware law, forfeiture-for competition is not subject to the same reasonableness standard as a traditional non-compete clause. The case is *LKQ Corporation v. Robert Rutledge*, No. 23-2330 (7th Cir. Jan. 22, 2025).

Background

A former plant manager received restricted stock unit (RSU) awards as part of his compensation over several years. Each RSU award was governed by Delaware law and stated that the employee would forfeit his RSUs if he went to work for a competitor within 9 months after leaving the company. The company sought to enforce the forfeiture after the employee resigned and joined a competitor.

In June 2023, a federal District Court in Illinois held that the forfeiture provision was unenforceable because it failed a standard reasonableness test based on geographic and temporal scope, protecting a legitimate business interest, and a balancing of the equities. On appeal, the Seventh Circuit noted that the Delaware Supreme Court had distinguished between forfeiture-for-competition and a traditional non-compete, holding that a forfeiture-for-competition provision was not subject to the reasonableness test; but the forfeiture provision in that case was contained in a limited partnership agreement that had been negotiated by sophisticated parties. The Delaware Supreme Court had not addressed whether reasonableness would be required for a forfeiture clause in an agreement between employer and employee that had been subject to little or no negotiation.

The Seventh Circuit certified the open question to the Delaware Supreme Court and the Delaware Supreme Court responded that its prior decision was not limited to the limited partnership context. The Delaware Supreme Court explained that, unlike a traditional non-compete clause, a forfeiture-for competition provision "does not restrict competition or a former employee's ability to work." The Delaware Supreme Court cautioned, however, that there could be circumstances where the forfeiture is "so extreme in duration and financial hardship that it precludes employee choice by an unsophisticated party and should be reviewed for reasonableness."

Applying the Delaware Supreme Court's explanation, the Seventh Circuit held that the circumstances of the case were not so "extreme in duration and financial hardship" as to require a reasonableness review. Although the plant manager's annual salary was only $109,000, he was not unsophisticated and had voluntarily accepted RSU awards that were available only to "key persons"—a designation reserved for less than 2% of the company's workforce. The Seventh Circuit also determined that, though substantial, forfeiting RSUs valued between $130,000 and $340,000 did not reach the level of "extraordinary hardship" that might require a reasonableness review. Accordingly, the Seventh Circuit reversed the District Court and remanded for further proceedings.

Implications

Although non-compete provisions are almost always subject to some version of a reasonableness test (and prohibited altogether in some states), many states apply a looser standard to forfeiture-for competition provisions. The principle is that, while it might be unreasonable to restrict competition or to prevent someone from taking another job, it is fair to condition incentive compensation on honoring a non-compete. Employers should remain mindful, however, that there is some limit on the cost that can be imposed for breaching a non-compete. The details will vary by jurisdiction and the court's assessment of the equities. Proskauer's Restrictive Covenants, Trade Secrets & Unfair Competition Group can help with strategies for your specific circumstances.

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