

Delaware Limited Partnership Law Update

January 30, 2024

***Cantor Fitzgerald, L.P. v. Ainslie*: Delaware Supreme Court Upholds Validity of Forfeiture-for-Competition Provisions in Limited Partnership Agreement Based on Freedom of Contract Principles**

In *Cantor Fitzgerald, L.P. v. Ainslie*, C.A. No. 9436 (Del. Jan. 29, 2024), the Delaware Supreme Court reversed a prior ruling by the Delaware Court of Chancery and found that provisions of a limited partnership agreement authorizing a partnership to withhold distributions otherwise owed to former partners who compete with the partnership (forfeiture-for-competition provisions) are enforceable. The Court distinguished forfeiture-for-competition provisions in a partnership agreement from restrictive non-competition covenants and liquidated damages provisions used to enforce such covenants. While restrictive non-competition covenants and related liquidated damages provisions are generally subject to scrutiny for reasonableness under Delaware law, the Court held that absent unconscionability, bad faith, or other extraordinary circumstances, forfeiture-for-competition provisions in a partnership agreement are not subject to reasonableness review. Instead, the Court found that the express and stated public policy of the Delaware Revised Uniform Limited Partnership Act of giving effect to the principle of freedom of contract and the enforceability of partnership agreements supported enforcing a forfeiture-for-competition provision without regard to reasonableness.

The dispute at issue in the opinion arose out of the limited partnership agreement (the "Agreement") of Cantor Fitzgerald, L.P. (the "Partnership"). The Agreement included provisions that denied certain deferred distributions of capital account balances and grant amounts (the "Conditioned Payments") to former limited partners if such former partners engaged in competitive activities within four years after ceasing to be limited partners. The plaintiffs, a group of former limited partners of the Partnership, withdrew from the Partnership, resigned from their employment with an affiliated entity, and began working for various competitors. After their withdrawal, the Partnership determined that the former partners breached their non-competition obligations by engaging in competitive activities, and the Partnership withheld the Conditioned Payments in amounts ranging from roughly \$100,000 to over \$5 million. The plaintiffs subsequently filed suit in the Delaware Court of Chancery, alleging breach of contract claims and, among other things, that the forfeiture-for-competition provisions were unenforceable. In January 2023, the Delaware Court of Chancery ruled in the plaintiffs' favor, noting that Delaware's public policy has a "distaste for liquidated damages provisions that restrain trade by requiring employees to pay former employers if they compete," and held that forfeiture-for-competition provisions are subject to review for reasonableness.

In a decision rendered on appeal on January 29, 2024, the Delaware Supreme Court reversed the Court of Chancery's holding. The Court reviewed the public policy considerations associated with non-competition provisions and related liquidated damages provisions and compared them to the public policy considerations associated with forfeiture-for-competition provisions. In analyzing



whether to enforce the forfeiture-for-competition provisions, the Court distinguished between a restrictive non-competition covenant that prevents an individual from working in a specific field (which may be subject to injunctive relief) and a forfeiture-for competition provision that allows an individual to work but imposes a cost for doing so (which is not subject to injunctive relief). The Court also noted that 6 *Del. C. § 17-306* permits partnership agreements to contain consequences that are not available in other commercial contracts, such as penalties and forfeitures, and that the Delaware Revised Uniform Limited Partnership Act has a stated policy "to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." While recognizing that freedom of contract is not unbounded, the Court found that the public policy interest that is present when a court reviews the reasonableness of a restriction on working in a specific field is much stronger than the public policy interest in preventing employees from forfeiting benefits for choosing to compete. As a result, the Court found that the forfeiture-for-competition provisions in this case are not subject to review for reasonableness.

The Court's opinion in *Cantor Fitzgerald* highlights that, in the context of Delaware limited partnerships, Delaware courts (i) recognize a strong public policy of freedom of contract, and (ii) absent some form of bad faith or unconscionability, will generally preserve contractual flexibility and hold parties to their bargained-for agreements.

Whitestone v. Pillarstone: Delaware Court of Chancery Holds Adoption of Poison Pill Breaches Implied Covenant of Good Faith and Fair Dealing

In *Whitestone REIT Operating Partnership, L.P. v. Pillarstone Capital REIT, C.A. 2022-0607-LWW* (Del. Ch. Jan. 25, 2024), the Delaware Court of Chancery held that the general partner of a limited partnership breached the implied covenant of good faith and fair dealing when it adopted a shareholder rights plan (the "Rights Plan") that effectively thwarted a limited partner from exercising the unfettered contractual redemption right it obtained in connection with its investment in the partnership. In ruling for the limited partner, the Court found that the limited partner's redemption right contained a corresponding implied condition that the general partner not frustrate the exercise of the redemption right by taking self-interested actions to force the limited partner into an economically unfavorable position. As a result, the Court held that the Rights Plan was unenforceable as to the limited partner.

The case arose out of a contribution agreement pursuant to which Whitestone REIT Operating Partnership, L.P. ("Whitestone") contributed real estate assets to Pillarstone Capital REIT Operating Partnership L.P. (the "Partnership") in exchange for roughly 80% of the partnership units of the Partnership. In connection with the transaction, Whitestone, as the sole limited partner, and Pillarstone Capital REIT ("Pillarstone"), as the general partner, entered into an amended and restated partnership agreement (the "Partnership Agreement"). The Partnership Agreement gave Whitestone a unilateral right to redeem its partnership units in exchange for cash or Pillarstone common shares. Several years after the parties entered into the contribution agreement, Whitestone and Pillarstone considered separating. During separation negotiations, Pillarstone learned that Whitestone might elect to redeem its partnership units rather than continuing with negotiations. In response to this perceived threat, Pillarstone's board adopted the Rights Plan in an apparent attempt to force Whitestone to continue the negotiations and to compromise its leverage. The Rights Plan provided that Pillarstone's shareholders (other than an "acquiring person") would be entitled to exercise rights for additional Pillarstone shares upon a person becoming a beneficial owner of at least 5% of

Pillarstone's shares. The Court noted that the Rights Plan was designed such that Whitestone did not "beneficially own" the shares it would be entitled to receive upon a redemption of its units of the Partnership prior to making a decision to have its units redeemed; however, it would beneficially own all of the Pillarstone shares it could receive upon a redemption immediately upon delivering a notice of redemption, regardless of whether Pillarstone chose to satisfy the redemption with cash or shares. If Whitestone became an "acquiring person" through such an acquisition, the exercise of rights by the other holders pursuant to the Rights Plan would result in significant dilution to Whitestone. Concluding that it could not exercise its contractual redemption rights without diluting the value of its redemption consideration, Whitestone filed suit against Pillarstone for breach of contract, breach of the implied covenant of good faith and fair dealing, and breach of fiduciary duty.

In its decision, the Court focused its analysis on the implied covenant of good faith and fair dealing. The Court explained that "[a]t its core, the implied covenant 'embodies the law's expectation that 'each party to a contract will act with good faith toward the other with respect to the subject matter of the contract'''" and, as a result, "parties to an agreement can hold one another accountable for violating implied 'contract [] terms that are so obvious ... that the drafter would not have needed to include the conditions as express terms in the agreement.'" The Court noted that "the implied covenant is 'a limited and extraordinary legal remedy'" that "cannot be used to rewrite an agreement or 'rebalanc[e] economic interests after events that could have been anticipated, but were not, that later adversely affected one party to [the] contract.'"

The Court framed its reasoning around the elements of proving a claim for breach of the implied covenant, which it described as (1) a specific implied contractual obligation, (2) a breach of that obligation, and (3) resulting damage. Addressing each of these elements in turn, the Court first found that the bargained-for terms of the Partnership Agreement clearly allowed Whitestone to redeem its partnership units at any time, and therefore implied a condition that Pillarstone could not frustrate Whitestone's exercise of the right. The Court explained that nothing in the record indicated that, at the time of negotiating the Partnership Agreement, Pillarstone might adopt a rights plan that could frustrate Whitestone's exercise of its redemption right, and therefore the implied condition was an obvious term and did not need to be expressly reflected in the Partnership Agreement. Next, the Court found that the Rights Plan was clearly enacted to impair Whitestone's redemption right and coerce it into negotiating separation terms favorable to Pillarstone. Despite Pillarstone's arguments that the Rights Plan was adopted in good faith and in response to credible takeover and fire sale concerns, the Court dismissed the arguments and found that Pillarstone's defensive actions "deprived Whitestone of the benefit of its bargain." In addressing the final damages element, the Court examined the technical aspects of the Rights Plan to ultimately determine that it produced an economic disincentive for Whitestone to redeem its partnership units, and that Whitestone should not be required to face "financial peril" for exercising a properly bargained-for right. Finding that the Rights Plan breached the implied covenant of good faith and fair dealing and dismissing the additional breach of contract and fiduciary duty claims as moot, the Court declared the Rights Plan unenforceable and allowed Whitestone to exercise its redemption right.

The Court's opinion in *Whitestone* serves as an important reminder that, although the implied covenant is a limited and extraordinary legal remedy, it is a factor that must be considered when analyzing whether a party's actions or omissions have violated the terms of a partnership agreement.