Update on the Enforceability of Restrictive Covenants Against a Terminated Employee

Balancing Free Competition With Protection of Employers’ Legitimate Interests

by James J. Ferrelli and John P. Kahn

There is an inherent tension in the law relating to restrictive covenants. On the one hand, the law recognizes an employer’s legitimate business interest in protecting trade secrets, confidential business information, and client relationships. The protection of these interests, however, is at odds with the public interest in free competition in the marketplace, and in affording every person the ability to earn a livelihood in his or her chosen profession or trade. The proper balance of these competing interests in any particular case—as in most cases heard in the Chancery Division—turns on a close examination and analysis of the particular facts in the case at bar.

In New Jersey, the seminal case setting forth the delicate balancing necessary to enforce restrictive covenants is Solari Industries, Inc. v. Malady. Solari sets forth the basic principle that restrictive covenants are enforceable only to the extent that they are reasonable under the circumstances. Generally, the court considers three factors to determine whether a restrictive covenant is reasonable: whether the agreement 1) is necessary to protect the employer’s legitimate interests; 2) causes undue hardship on the former employee; and 3) impairs the public interest. Courts applying the Solari test balance the competing interest found in the first and second prongs of the test, and weigh the impairment of the public interest, if any, in the resolution of the dispute.

In 2013, the New Jersey Assembly considered legislation aimed at altering the calculus set forth in Solari. The proposed law, A-3970, introduced on April 4, 2013, would invalidate any non-compete, non-solicitation, and/or non-disclosure agreement with an unemployed individual who is eligible to receive unemployment benefits. The bill would allow an unemployed individual, not only the right to compete, but also to solicit and disclose his or her former employee’s proprietary business information. The Assembly’s purpose, it appears, is to eliminate barriers to employment faced by unemployed individuals caused by restrictive covenant agreements with former employers. This law would tip the balancing scale under Solari in favor of unemployed former employees to advance the public interest of lower unemployment and more robust competition, to the detriment, potentially, of employers and businesses.

As this article goes to press, A-3970 remains just a proposal, not the law of New Jersey. Although well within the prerogative of the Legislature, it is debatable whether laws such as A-3970 are necessary or beneficial as a matter of policy, in light of the mandate of Solari and the availability of courts in the Chancery Division to fashion appropriate remedies that are specifically suited to the facts and case at bar. After an overview of the basic principles of the law of restrictive covenants, this article examines two 2013 cases that demonstrate the flexibility and efficiency of the Solari analysis.

Restraints on Protecting Confidential Proprietary Information—The Basics

As in virtually all states, the protection of trade secrets and confidential information in New Jersey is well settled. To prevail on a claim for misappropriation of trade secrets under
New Jersey law, a party must establish: “(1) the existence of a trade secret; (2) communicated in confidence by the plaintiff to the employee; (3) disclosed by the employee in breach of that confidence; (4) acquired by the competitor with knowledge of the breach of confidence, and (5) used by the competitor to the detriment of the plaintiff.”

The party who asserts the trade secret bears the burden of proving the information is a secret and not a matter of general knowledge in the industry. The New Jersey Supreme Court has relied upon the Third Circuit’s reference to the Restatement of Torts, which states:

> A trade secret may consist of any formula, pattern, device or compilation of information which is used in one’s business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers.

New Jersey courts recognize that employers have a legitimate interest in protecting client relationships. The courts also acknowledge employers’ legitimate interests in protecting trade secrets and confidential business information.

### Restraints on Employment and Competition—Hardship on the Employee

In evaluating whether a restrictive covenant imposes a hardship on the employee, courts will generally focus on two aspects of the restraint: 1) its geographic scope, and 2) the time period for which the restraints will be in effect.

### Geographic Scope of Restriction

In considering whether the geographic scope of a non-compete agreement imposes an undue hardship, courts consider “the likelihood of the employee finding work in his field elsewhere” and whether the employee ended the employment relationship, thus bringing the hardship on him or herself. A showing of personal hardship alone is insufficient to establish undue hardship. While there is no per se rule on the permissible geographic scope of a covenant, limited restraints will generally be enforceable if reasonable.

### Duration of the Restriction

As a general matter, New Jersey courts have considered post-employment restrictions with a duration of two years or less as reasonable.

Regarding both aspects of the “undue hardship” inquiry, courts focus on the specific facts of the particular case, and the evidence presented with respect to undue hardship on the employee. However, as demonstrated by recent decisions, the court also takes into account the particularized showing of legitimate interest by the employer that is the basis for the restriction on the employee. These cases make it clear that under a Solari analysis, courts will not enforce restrictive covenants unless the specific evidence presented weighs in favor of enforcing the restriction against the former employee in order to protect legitimate, actual interests of the employer that are demonstrated by the evidence presented.

### A Look at Truong, LLC v. Tran

This case involved a dispute concerning manicurists at a nail salon who entered into a restrictive covenant, left their positions for three- to four-month breaks and returned to the job. The question presented was whether the break in service rendered the restrictive covenant unenforceable and whether the two-year restriction found in the agreement was reasonable under the circumstances.

Defendant Le was hired by plaintiff Truong for his nail salon in May 2005, and defendant Tran was hired in April 2009; both were manicurists. Upon hiring by the nail salon, both employees signed a restrictive covenant that barred them from working within 25 miles of the municipalities in which the plaintiffs’ salons were located for two years from the date of termination. Le ceased working for the plaintiff for a period of four months—June to Sept. 2006—in order to help his girlfriend move to Missouri. Le then returned to his position with the nail salon. Although Le attempted to paint his return to the nail salon as unexpected, the court ruled that the break in service was not a termination because “Le did not obtain a lease or professional license in Missouri, did not enroll in college there, left belongings in New Jersey, and did not testify [that] he quit.” Le resigned from the nail salon in Aug. 2011, and opened a competing nail salon in May 2012.

The court viewed defendant Tran’s “interruption in service” differently than Le’s. In Sept. 2009, Tran left the nail salon and began working for a nail salon within the 25-mile radius restricted by the agreement. Upon learning of Tran’s employment with a competitor, the plaintiff threatened legal action. In response to the legal dispute, Tran accepted an offer to return to the plaintiff’s nail salon. Upon returning to the salon after an absence of approximately four months, Tran was not asked to sign a new employment agreement. Tran then left the salon in May 2012, to join Le’s new business.

The first issue the Appellate Division addressed was whether the restrictive covenants expired prior to May 2012—the date Le opened the competing salon—because of the earlier breaks in service. Although the facts relating to the breaks of service were disputed, the Appellate Division found there was enough credible evidence to support the
trial judge’s findings.

With respect to Tran, the trial court determined that although she terminated her employment with the plaintiff, the prior employment agreement remained legally in force upon her return. The Appellate Division disagreed, ruling that once Tran terminated her employment in Aug. 2009, the restrictive covenant expired under its own terms in two years, or by Aug. 2011. The court ruled that “absent a new agreement, Tran’s return to work later in 2009 is of no moment.” The court cited to authority for the proposition that once a fixed-term employment agreement expires, an at-will contract is created and the original agreement has no effect. As a result, since the agreement expired in Aug. 2011, the restrictive covenant no longer applied to Tran.

With respect to Le, the Appellate Division declined to disturb the trial court’s ruling that the nature of Le’s break in service did not terminate his employment agreement. Nonetheless, the court found the restrictive covenant was unenforceable under the Solari/Whitmeyer test because the court determined that the two-year scope of the agreement was unreasonable based on the nature of the business at issue.

The Truong court affirmed the principles of Solari. A restrictive covenant is reasonable if it “simply protects the legitimate interests of the employer, imposes no undue hardship on the employee, and is not injurious to the public.” The reasonableness of the covenant is determined case by case, based on its duration, geographic limits, and the scope of activities prohibited. And each of the factors are narrowly tailored to ensure the covenant is no broader than necessary to protect the employer’s interests.”

The court should consider the inherent characteristics of the client-relationship that the employer seeks to protect.”

The court may also consider the relevant lifespan of a trade secret or other protectable information. The plaintiff has the burden to establish the reasonableness of the covenant. The court guards against any overbroad restriction that prevents competition, distinguished from a restriction that protects an employer’s legitimate interest.

Focusing on the facts with respect to Le, the court found that while the nail salon had a legitimate interest in its customer lists, there was insufficient evidence to support a restriction of a two-year bar of competition. Critical to the Appellate Division’s analysis, there was no evidence regarding the time to solidify new customer relationships with new employees and no evidence of the nature of the plaintiff’s customers and how long it takes for customer lists to become stale. The Appellate Division noted the case did not involve trade secrets. Further, it ruled a ban on competition was unnecessary if the goal was to protect against Le using private customer lists. The court stated “a ban on solicitation may adequately protect plaintiff’s interest in barring exploitation of confidential customer lists.”

Essentially, the employer did not present sufficient evidence of its interest in upholding the restriction on Le’s employment and the harm that would flow to the employer if the two-year restriction was not enforced. The Appellate Division, as a result, lifted the injunction imposed by the trial court.

A Look at Newport Capital Group LLC v. Loehwing

Similar to the analysis in Truong, the United States District Court for the District of New Jersey parsed the non-solicitation provision of a non-compete agreement and determined a covenant not to solicit prospective customers of a former employer was unenforceable. The court explained its decision based upon the public interest in free market competition: “Courts will not enforce a restrictive agreement merely to aid the employer in extinguishing competition, albeit competition from a former employee. Ultimately, the consuming public would suffer from judicial nurturing of such naked restraints on competition.”

The defendant in Newport was a financial advisor who solicited business from and marketed Newport’s services to prospective clients. During the defendant’s employment with Newport, he signed an agreement that precluded solicitation of any current and/or prospective clients of the company. The issue presented was whether the prohibition on solicitation of prospective clients was enforceable.

Citing Whitmeyer, the court ruled that while employers have a reasonable interest in protecting trade secrets and other proprietary information and customer relations, they have no legitimate interest in preventing competition. While the court found the non-solicitation agreement was enforceable to protect the employer’s current clients, it found the non-solicitation provision regarding prospective clients was overly broad, and that enforcing that portion of the agreement would significantly impair the public’s interest, in large part because it would “unduly burden Loehwing because it would have a deleterious effect on his ability to work as a financial advisor, in New Jersey or elsewhere.” Based upon the availability of public information concerning potential clients available to the defendant, the defendant would have to submit his prospective clients to the plaintiff for pre-approval if the court upheld the restriction on prospective clients, a situation the court described as “untenable, for obvious reasons.”

Another factor noted by the Loehwing court in determining whether the restrictive covenant is enforceable...
against prospective clients was the particular nature of the consulting business involved, which it described as “a personalized service giving rise to an interest in the public to choose among competing providers.” Indeed, the nature of the business involved may be critical. A related consideration is whether the restriction impedes “the rights of the public to have free access to the advice of professionals licensed by the state.”

Courts will consider the demand for services offered by the employee and the particular nature of the consulting business involved, which it described as “a personal service.”

**Conclusion**

Under New Jersey case law, as reaffirmed by Truong and Loehwing, the courts remain sensitive to the former employee’s interest in prospective employment, and the public’s interest in having a free and competitive marketplace. Proposed legislation such as A-3970 may just be a codification of what is already implemented by the courts. However, that notwithstanding, the proposed legislation may interfere with an employee’s freedom to contract in order to safeguard against misappropriation of proprietary information (including knowledge of customers and processes) in situations in which the court sitting in chancery may be the better arbiter of what is reasonable or unreasonable under the circumstances, based upon the specific facts and evidence presented.

**Endnotes**


2. Solari 55 N.J. at 585.

3. The text of the proposed bill is as follows: “An unemployed individual found to be eligible to receive benefits pursuant to the ‘unemployment compensation law,’ R.S.43:21-1 et seq., shall not be bound by any covenant, contract, or agreement, entered into with the individual’s most recent employer, not to compete, not to disclose, or not to solicit. This section shall not be construed to apply to any covenant, contract, or agreement in effect on or before the date of enactment of P.L., c. (C.) (pending before the Legislature as this bill).”


10. Id.

11. See Pathfinder, L.L.C. v. Luck, 2005 WL 1206848 (D.N.J. 2005) (holding that where a non-compete “was limited to clients, for a limited duration, it was not unreasonable merely because the geographical limits were open-ended”).


14. Id.

15. Id. at *3.

16. Id. at *18.


19. Id. at *20 – 21.

20. Id. at *23.

21. Id. at *24.

22. Id. at *22 to *23.

23. Id. at 25.

24. Id. at 26.

25. Id. at 27.


27. Id. at *18 to *19 (quoting Ingersoll-Rand Co. v. Ciavatta, 110 N.J. 609 (N.J. 1988)).

28. Id. at *5.

29. Id. at *6 - *7.

30. Id. at *18.

31. Id. at *27 - *28.

32. Id. at *29.

33. Id. at *30- *31.

34. See Cnty. Hosp. Group, Inc. v. More, 183 N.J. 36 (2005) (remanding case for a determination of whether a 30-mile geographic restriction could be detrimental to the public interest because it limited access to medical services in a rural area).

James J. Ferrelli, a partner in the trial department of Duane Morris LLP, is resident in its Cherry Hill office, and concentrates his practice primarily in the areas of business and commercial litigation, products liability, and class actions. He is the chair of the editorial board of the New Jersey Lawyer Magazine and a past trustee of the New Jersey State Bar Association. John P. Kahn, an associate in the trial department of Duane Morris LLP, is resident in its Cherry Hill office, and concentrates his practice in employment and healthcare law, business and commercial litigation, and class actions.