THE Blue Eraser

New Jersey's Proposed Move Against Restrictive Covenants

By Michael Coco and Gigio K. Ninan

According to a New Jersey Business and Industry Association October 2022 update, the state ranks dead-last in business climate.[1] One group of lawmakers are trying to fix that by loosening trade restraints. Last May, new legislation was introduced that would restrict the rights of businesses to negotiate non-compete and non-poaching agreements with prospective employees. The bill, A3715,[2] seeks to make such agreements unenforceable unless the employer adheres to a set of strict provisions that, among other things, require all newly-signed non-competes to include in them a "garden-leave" provision of up to one year. These agreements are governed by a mix of common law, statutory provisions, and statutes, making their enforceability different in each state.

The bill proposal is part of a growing national trend to restrict the use of non-compete agreements under the auspices of employee protection. In January, the Federal Trade Commission proposed a new rule that would ban the use of non-competes on a federal level.[3] The FTC estimates that 30 million people are subject to non-compete agreements and restricting their use would increase earnings by $250 billion to $298 billion per year.[4] The proposed rule would ban most future non-competes and require employers to rescind any current non-compete agreements, but non-compete clauses would still be enforceable if related to the purchase of a business.[5] The time for comment on this rule closed on April 19 after receiving nearly 30,000 submissions.[6] Currently, New Jersey's restrictive covenant proposal is one of the most viewed bills on at least one major legislation-monitoring website.[7]

Restrictive covenants and non-competes are used frequently in industries that offer apprenticeships, such as residency and training opportunities for new physicians. They are also common in professions where a former employee could take a significant number of clients or patients with them and leave to start their own practice or join a nearby competitor. Currently, New Jersey courts will enforce a restrictive covenant if it is reasonable, protects a legitimate business interest, does not impose an undue burden on the employee and is not harmful to the public.[8] When assessing reasonableness, the courts examine the time, scope, and geographic confines of the restrictions.[9] If the court finds the covenant overly broad, it can use a "blue pencil" to limit the scope without invalidating the entire agreement.[10] This current practice protects the rights of the employer while ensuring fairness to the employee.[11] However, if passed in its current form, the bill will replace the court's blue pencil with an eraser—removing all boundaries in favor of near prohibition.

Bill A3715 purports to stop anti-competitive behavior that

impedes business development and innovation. It places severe restrictions on restrictive covenants. In its present form, the law would limit the duration of any post-employee agreement to 12 months but is not enforceable against an employee who is laid off or terminated without a determination of misconduct. Like the current court test, the law proposes to limit these agreements to a "reasonable" geographic area in which the employee provided services or "had a material presence or influence during the two years preceding the date of termination." The agreements would not be enforceable in other states.

Employers would not be permitted to "penalize" an employee for "defending against or challenging" the covenant. Presumably, this means no fee-shifting provisions in favor of the employer. There is, however, a fee-shifting provision in favor of the employee contained in the bill. Liquidated damages are available to a plaintiff up to $10,000. The law would prohibit "choice of law" clauses that might void the agreement so long as the employee is "a resident of or employed in the State" at the time of termination and 30 days prior to such termination. The agreements cannot limit an employee's "substantive, procedural and remedial rights." In other words—no arbitration clauses. The law allows for permissive restrictive covenants, meaning that any covenant not covered by the law is null and void. The law specifically exempts certain interns, "low wage" employees, employees participating in a Department of Labor apprenticeship program, and other special cases.

A3715 requires an employer to notify the employee within 10 days of termination if it intends to enforce the restrictive covenant. If the employer does seek to enforce the agreement, it must pay the employee for the length of the agreement. For example, if the employee is prohibited from working within a certain geographic area for eight months after resignation, the employee must pay the employee the equivalent to eight months of wages at the time of separation. This "garden leave" provision is not applicable if the employee is terminated for misconduct. The proposed bill also includes a blanket prohibition on "poaching" of "low-wage" employees. No-poach agreements are contracts between employers that prohibit the other from hiring or "poaching" the other's employees.

Analysis

Although all bills are a work-in-progress, this particular piece of legislation will have a long journey before achieving its sponsors' goal. Courts already limit the scope of these agreements based on the facts. This bill assigns a more arbitrary process of limiting the length and geography of an agreement. For example, a one-year restriction might work well to protect the business interests of a general practitioner physician, but a longer provision would be more equitable for a specialized surgeon. The state carve-out also presents a potential problem with employers who have businesses in towns that border Pennsylvania, New York, or Delaware. An employee could leave and set up shop only a few miles away, as long as it is across the state line. Instead of achieving its goal of stopping anti-competitive behavior, the law in its current form could give larger employers the advantage over small businesses. A large employer could, for example, place newer employees in offices in neighboring states that allow non-competes.

The "garden leave" provision and notice constraints will place difficult restrictions on large and small employers alike. However, larger employers with more resources might have the advantage of being able to pay off departing employees and could, in general, have a more efficient human resources process that ensures employees are provided with notice of enforcement. This creates a "structural bias" against smaller employers and practitioners, while raising the cost of hiring employees throughout the state. Finally, the bill might encourage termination of marginal employees for cause to avoid paying garden leave.

As for the non-poaching of low-wage employees provision, there is nothing presented in the bill statement that cites any evidence that such practice is occurring on any significant scale. If non-poaching agreements are being used to

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reduce employee pay and the ability to move from one employer to another, then this practice can harm employees of all wage levels in the same way as price-fixing agreements. However, employers who engage in price fixing and anti-competitive forms of employee poaching are already being pursued by the Department of Justice.[12] Thus, there is no compelling reason for state-based legislative action on this issue.

Overall, this bill needs work if it is to achieve its stated goal of increasing competition and business development in the state. Up until now, the courts have done a fine job of enforcing these covenants when reasonable and protecting employees from overly-burdensome provisions. Passing a law to address non-compete and non-solicitation agreements is a more democratic way to regulate anti-competitive behavior than leaving it up to the courts, but laws can be inflexible, resulting in harmful, unintended consequences rather than enhancing public policy. The bill has a long way to go in the legislative process. At the very least, the bill should be updated to better address enforceability of these agreements in neighboring states. Practitioners who draft and review restrictive covenants should keep their eye on this bill's progression and, hopefully, the final version will strike the proper balance between supporting businesses and preventing anti-competitive behavior. ■

Endnotes

1. *NJ Ranks Dead Last in Nationwide Comparison of Business Climates*, NJBIA, available at njbia.org/nj-ranks-dead-last-in-nationwide-comparison-of-state-tax-systems/
2. legiscan.com/NJ/text/A3715/2022
3. *Non-Complete Clause Rulemaking*, Federal Trade Commission, available at ftc.gov/legal-library/browse/federal-register-notices/non-compete-clause-rulemaking
4. *Id.*
5. *Id.*
6. *Non-Complete Clause Rulemaking*, Federal Trade Commission, available at regulations.gov/docket/FTC-2023-0007/comments
7. New Jersey Legislature, LegiScan, available at legiscan.com/NJ
8. *Community Hosp. Group v. More*, 183 N.J. 36, 869 A.2d 884, 890 (N.J. 2005).
9. *Karlin v. Weinberg*, 390 A.2d 1161, 77 N.J. 408, 419 (N.J. 1978).
10. *Community Hosp. Group v. More*, 838 A.2d 472, 485, 365 N.J. Super. 84 (N.J. Super. 2003).
11. *Coat v. Krzywulak*, 56 A.2d 584, 141 N.J.Eq. 212 (N.J. Ch. 1948).
12. Alex Malyshev and Jeffrey S. Boxer, *With DOJ's focus on wage fixing and no poach agreements, non-compete and antitrust laws collide*, Reuters, available at reuters.com/legal/legalindustry/with-dojs-focus-wage-fixing-no-poach-agreements-non-compete-antitrust-laws-2021-08-23/