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Federal Government Signals Intention to Limit Enforcement of Restrictive Covenants

By Eric Inglis and Thomas Cotton

In one guise or another, antitrust sentiment has been growing in academia, in our political discourse, and in our courts, as demonstrated by the Department of Justice's recent lawsuit against Google and former President Trump's lawsuit against social media giants. A less splashy manifestation of this sentiment, and one that could have a greater impact on the average worker and businessperson, is buried in Executive Order 14036 ("EO") signed by President Joseph Biden on July 9, 2021. One target of that EO is non-compete agreements (a/k/a restrictive covenants) that could directly impact business litigation in New Jersey.

Restrictive covenants take many forms, but one typical version is a pre-employment contract between an employer and employee that restricts certain actions the latter might take post-employment. For example, a young computer programmer starting at a tech company might be required, as a condition of employment, to sign a restrictive covenant that prevents her from leaving for certain competitors, to certain fields, or within certain geographic limitations for a period of time after leaving her employer. These agreements promote the employer investing in the new employee by contractually preventing the employee from soaking up all of the employer's intellectual capital and later sharing it with a competitor. There is little question that these agreements can serve an economic good.

On the other hand, some companies have required prospective employees filling low-level, less skilled positions to sign similar restrictive covenants. These agreements are prevalent and perhaps more justifiable for employees taking sales positions that require the employer to share sales strategies or relationships that feed the employer's sales business. The agreements have often been used and are less justifiable for "boiler room" sales positions, where salespersons are cold-calling potential customers and are reading off of bland sales scripts.

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The further down the salary-rung these restrictive covenants are made a condition of employment, the more the agreements appear to be anti-competitive, anti-capitalist, and oppressive devices that inhibit dynamism in the economy and prevent low-paid workers from attempting to improve their station in life. Such restrictive covenants could justifiably be characterized as "tin handcuffs" (contrasted with the "golden handcuffs" awarded to senior executives as an incentive to stay with an employer). "Tin handcuffs" are cheap, off-the-shelf, pre-printed agreements that are easily slipped in by the employer at the outset of the relationship but will appear substantial and intimidating to the

employee living on the margins of the economy and contemplating a slightly more high-paying job offer.

Within New Jersey's public policy toolbox there already exists a litigation mechanism for clipping these "tin handcuffs." An employee can bring an action, typically by Order to Show Cause in the Chancery Division, seeking to have a restrictive covenant invalidated.

New Jersey's seminal case on restrictive covenants is *Solari Industries v. Malady*, 55 N.J. 571 (1970), where the New Jersey Supreme Court established the following test for enforcement of these agreements. A restrictive covenant in an employment contract can be enforceable if it: (1) protects a legitimate interest of the employer; (2) imposes no undue hardship on the employee; and (3) is not injurious to the public. This is a flexible, perhaps vague, standard that vests a fair amount of discretion in a trial judge, and the reality is that one side typically lands a knock-out punch if they prevail at the initial hearing.

Restrictive-covenant litigation makes up a substantial percentage of New Jersey business litigation, and Chancery judges are well-versed in these standards. The cases are fact intensive, with courts focusing on factors like the nature of business, the specific training or intellectual capital provided to or invested in the employee, and the length of employment. New Jersey judges have broad authority to scrutinize the agreements and strike out any provisions that unduly restrict competition. *Community Hospital Group v. More*, 183 N.J. 36, 62 (2005) (discussing the "blue pencil doctrine," which calls for courts to revise an overbearing non-compete agreement and enforce it as revised).

Beyond the broad authority vested in and routinely exercised by Chancery judges, New Jersey's own Antitrust Act, N.J.S.A. 56:9-1 et seq., and the federal Sherman Antitrust Act, 15 U.S.C. §1 et seq., contain provisions that can form causes of action available to plaintiffs seeking to void a restrictive covenant.

As a practical matter, New Jersey judges are extremely hesitant to hold an employee to a restrictive covenant, unless the employee showed bad faith or engaged in devious conduct.

So, there should be no problem for workers, right? The law and judges generally favor workers and the free movement of labor. But there is a problem.

Like much of what occurs in the courts, the cost of access to justice and the expense of maintaining the fight means that economic might is often more important than the state of the law. An hourly employee typically does not have the funds to hire a lawyer to invalidate a non-compete so they can leave their $20/hour job in order to jump to a competitor willing to pay them $22.50/hour. The mere prospect of getting haled into court for attempting to work for a competitor is enough to keep some employees locked into a job. For certain employees, lucky ones, the prospective future employer might be willing to fight for the employee willing to take a chance on being sued, but that is a rare case.

We operate in an economy that extols capitalism and applauds the brave entrepreneur who bets his or her savings to pursue the capitalist dream of accumulating private wealth. What is equally striking is that those with the skill and (let's be serious) luck to be successful business owners, will quickly turn their back on capitalism, or at least the free labor market, when it suits their interest to tie up low-level employees with restrictive covenants. This "capitalist when convenient" mindset can be seen among small sales organizations and exists on a grand scale in non-poaching agreements among our economy's corporate titans. In 2015, Apple (of the "Think Different" slogan) and Google (founded with the unofficial motto "Don't Be Evil") defied their hippie marketing mantras and were among a number of tech

giants who paid $90 million to settle a federal lawsuit alleging a conspiracy to not hire each other's employees.

In ways big and small, the game is rigged.

Enter now, the federal government.

On April 15, 2016, President Barack Obama signed Executive Order 13725, which directed the Department of Justice and the Federal Trade Commission to take actions to "protect American consumers and workers and encourage competition in the U.S. economy." Ultimately, the pronouncement was drenched in platitudes, lacked specific directions, and ran only about 20 paragraphs.

On July 9, 2021, President Joseph Biden signed the much more robust and detailed Executive Order 14036, which promotes 72 initiatives across more than a dozen federal agencies to tackle perceived anti-competitive behavior in our economy. The comprehensive and detailed nature of the EO suggests more robust action could follow.

The EO provides at Section 5(g):

To address agreements that may unduly limit workers' ability to change jobs, the Chair of the FTC is encouraged to consider working with the rest of the Commission to exercise the FTC's statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility.

The EO bears the imprint of Timothy Wu, Columbia University law professor, member of Biden's National Economic Council, and author of a book extolling the economic merits of robust antitrust enforcement, The Curse of Bigness. Professor Wu is a proponent of bringing back the Progressive Era's aggressive confrontation of concentrated economic wealth, which he feels "yields gross inequality and material suffering, feeding an appetite for nationalist and extremist leadership."

Like many government initiatives, this one aims at a real problem. Restrictive covenants aim to limit certain kinds of economic competition—the free movement of labor in particular. Some legal commentators argue these agreements generally stifle innovation; in an influential 1999 law review article, Professor Ronald Gilson argued that Silicon Valley ascended and Massachusetts's Route 128 tech corridor declined because California bans restrictive covenants while Massachusetts enforces them. Ronald J. Gilson, "The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete," 74 N.Y.U. L. REV. 575 (1999). The theory is that greater competition for labor quickens the pace of innovation.

Regardless of the economic theory to which one subscribes, the federal government is siding with Professor Wu.

Business litigators will need to keep an eye on the federal government now to see if it will change the rules. Will the Biden administration take a bold step, like abolishing restrictive covenants as California has done? Will it attempt a more modest step of evening the scales between employers and employees, by allowing employees to collect attorney fees from employers when they successfully challenge a restrictive covenant? Or will this EO gather dust, like Obama's? Only time will tell.

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