The Value of Employment Contracts

by Galit Kierkut

As soon as a potential new employee accepts a verbal job offer, and testing and background check results are positive, the employer's first order of business should not be to determine whether an employment contract should be offered to that potential employee, but rather to determine what *kind* of employment contract should be offered to the employee. Many factors should be considered in making this determination, including the level of the employee, in terms of both responsibility and compensation; the importance of the employee to the organization; the type of company information that will be entrusted to the employee and that the employee is expected to develop; and the amount of training the employee will receive.

If the employee is an executive-level employee, the company will be assessing issues such as the term of the employment, the compensation and bonus structure, relocation compensation, duties, benefits, stock options, deferred compensation, termination, change of control, and severance. All of these issues will likely be negotiated, and the contract for high-level executives will likely contain a term of employment and termination/severance provisions. The employee will potentially have counsel if the level and value of the contract is significant, and the form agreement the company prefers to use may not always be acceptable.

In some industries, for both executives and certain types of employees, including sales employees, employers incorporate some kind of restrictive covenant into employment agreements. All employees should be asked to sign an employment agreement (although it need not be so titled) that addresses confidentiality, intellectual property assignments, right to privacy in electronic communications, dispute resolution forum and choice of law. Finally, all employees should sign acknowledgments of receipt of the employee handbook, and disclaimers should be included that specifically disclaim contract formation.[1]

When drafting employment contracts, employers must keep in mind that New Jersey is an at-will employment state, and that unless there is a contractual obligation to hire an employee for a fixed term, both employees and employers can sever the relationship at any time, without notice and without cause.[2] For this reason it is important to specifically note, in employment contracts that address only restrictive covenants and the like, and are not intended to guarantee employment for a fixed term, that the contract does not in any way affect the at-will nature of the employment.[3]

Restrictive Covenants

Many employers choose to include restrictive covenants in their employment contracts for sales employees, or employees in industries with significant confidential information. "Restrictive covenant" is a broad term that includes many types of post-employment restrictions. These covenants can include restrictions on competition, non-solicitation agreements, and/or non-interference agreements with customers or prospective customers. Non-competition agreements can also take many forms; they can restrict employees from working in a particular industry in a limited location, or simply restrict employees from working with clients with whom they worked at the specific company. They are enforceable in some states (like New Jersey and New York), and not in others (like California).

In New Jersey, contractual agreements restricting post-employment activities of employees are enforceable provided the agreement is not merely an attempt to extinguish competition, but rather is intended to prevent a real threat to the employer's business.[4] In order to establish enforceability, an employer must show the employee received consideration in

exchange for signing the covenant not to compete, otherwise the agreement will be deemed unenforceable. Adequate consideration exists where an employee commences employment under a contract containing the restrictive covenant.[5] Continued employment following the signing of a covenant during the employment relationship also constitutes sufficient consideration.[6]

Further, to be enforceable a restrictive covenant must be "reasonable under all the circumstances of the case."[7] To determine the reasonableness of restrictive covenants, the New Jersey Supreme Court has articulated a three-prong test, the *Solari/Whitmyer* test, under which a covenant will be found to be reasonable if it is established that:

- the covenant protects a legitimate interest of the employer;
- the covenant imposes no undue hardship upon the employee; and
- the covenant is not injurious to the public interest.[8]

The courts in New Jersey have found that an employer has a legitimate interest in protecting customer relationships, trade secrets, and confidential business information, and that these are valid bases for the imposition of a restrictive covenant.[9] New Jersey courts have also upheld restrictive covenants against medical professionals.[10] In 2005, the New Jersey Supreme Court, in *Cmty. Hosp. Group, Inc. v. More*, upheld a two-year restrictive covenant between a hospital, JFK Medical Center and a neurosurgeon, but reduced the geographic scope of the restriction from 30 miles to 13 miles to protect the public interest.[11] The Court set forth the employer's legitimate protectable interests, including: 1) confidential business information, including patient lists; 2) patient and patient referral bases; and 3) protecting investment in the training of a physician.[12] The *Solari/Whitmyer* test of reasonableness is used by New Jersey courts to determine the enforceability of restrictive covenants in all cases except those involving attorneys[13] and psychologists.[14]

The second factor, undue hardship, is often analyzed by the courts in conjunction with the temporal and geographical restrictions.[15] The hardship on an employee is undue if, upon balancing the interests of the parties, the restriction would protect more than that in which the former employer has a legitimate protectable interest.[16] A court is less likely to find undue hardship if the employee terminates the employment relationship, because the employee's actions caused the restriction to become effective.[17]

When a covenant not to compete is found to be unreasonable, a court may refuse to enforce its terms entirely, or a court may rewrite the restrictive covenant, either excising the unenforceable portion or modifying the covenant to make it reasonable or appropriate to the circumstances presented. Partial enforcement of restrictive covenants, through rewriting or modifying terms, is allowed in New Jersey. Specifically, if a restrictive covenant is unduly burdensome, courts are allowed to "blue pencil" the covenant so that it is reasonable under the circumstances.[18] Therefore, New Jersey courts may modify geographic areas and time restrictions that are more excessive than is necessary to protect an employer's legitimate business interests.[19]

All of these factors should be taken into account when drafting restrictive covenants, in order to maximize potential for enforceability. Employers should also take into account the type of job the employee will be performing, and the nature of the restriction that is most necessary for that type of job. Further, the geographical and temporal restrictions should be carefully examined to ensure they are no broader than necessary to protect the employer's interest.

Confidentiality Agreements and Works Made for Hire

All employers have confidential information they wish to protect from disclosure by both current and former employees of all levels, and all employers want to ensure that intellectual property developed by their employees remains the property of the employer. Therefore, it stands to reason that all employees should be asked to sign confidentiality and works made for hire agreements as a condition of employment.

Certain confidential information does not require contractual protection because it rises to the level of trade secrets, and is therefore protected by common law principles, and now by statute, since New Jersey has adopted the New Jersey Trade Secrets Act (NJTSA).[20] However, there are gaps in the law and statutes that can easily be set forth in contractual obligations with post-termination provisions.

At common law, the definition of a trade secret was "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."[21] The NJTSA's broad definition of trade secret does not vary greatly from the common law. It defines a trade secret as information, without regard to form, that derives actual or potential economic value from: (a) not being generally known; (b) not being readily ascertainable; and (c) being the subject of reasonable efforts to maintain its secrecy.[22] The key distinction between the NJTSA and the common law definitions is that the requirement that the information be currently used in one's business is not set forth in the statute.[23]

Employers should be guided by the

principles in the NJTSA in creating policies and practices to safeguard their trade secrets. Accordingly, employers should make a concerted effort to identify the specific trade secrets held by their businesses, implement policies to ensure secrecy and regularly review policies, both with employees and with counsel, to have the best chance to capitalize on the protections afforded by the NJTSA. For purposes of drafting contractual obligations for all employees with respect to safeguarding confidential information, employers should review the distinction between trade secrets and other confidential information they may wish to protect. Then, employers can include in employment agreements definitions of confidential information that extends to information that does not rise to the level of a trade secret and protections for such confidential information that extend beyond the term of employment.

Another issue employers must consider when assessing the safeguarding of confidential information is the threat that social media poses to the inadvertent or deliberate disclosure of confidential information by both current and former employees. Social media policies should be implemented for current employees, but employers should also consider incorporating social media constraints into employment contracts in post-employment restrictions. Confidentiality, especially in this age of easy remote access to documents, and dissemination of information faster and to a broader audience than ever before, is a significant issue for any employer, and it is prudent to take steps to ensure that invaluable information is properly safeguarded.

Arbitration Provisions

Another issue that should be addressed in any employment agreement is choice of forum, venue and law for disputes. The choices should be made explicit in the agreement to avoid confusion and races to the courthouse later, especially between jurisdictions that have vastly different approaches to post-employment restrictions.

Many employers favor arbitration over traditional litigation as a forum to resolve employment claims because it is generally more cost-effective, is typically a private proceeding, is not decided by an unpredictable jury and provides for limited rights to appeal. There are also disadvantages to arbitration, such as the employer bearing the cost of the arbitration, and the fact that arbitrators are perceived to be more likely to attempt to reach a compromise award regardless of the merits of the case, and are less likely to dispose of a case through summary judgment or a motion to dismiss. Many employers who decide against arbitration insert jury trial waivers, preferring to take their chances with a judge than with a jury.

By now, most practitioners are familiar with the Supreme Court's 2011 decision in *AT&T Mobility LLC v. Concepcion,*[24] which addresses the enforceability of class and collective action waiver provisions within arbitration agreements in a consumer context. *Concepcion* held that when a private party to a consumer agreement contracts to arbitrate disputes individually, the Federal Arbitration Act (FAA) requires that contract to be enforced.[25] The Court found that state laws and procedures cannot interfere with the FAA's primary purpose of enforcement of clearly drafted arbitration provisions.[26]

Given the rise in wage and hour class and collective actions, employers are hopeful the *Concepcion* decision will be applicable in the employment context as well. The Third Circuit has already addressed this issue, and applied *Concepcion* to the employment context in two recent decisions, *Litman v. Cellco P'ship* and *Quilloin v. Tenet HealthSystem Phila., Inc*.[27] In these cases, the Third Circuit found the FAA preempted New Jersey case law, rendering all class action waivers unconscionable, and preempted Pennsylvania law, finding class action waivers substantively unconscionable when class action litigation would be the only effective remedy.[28]

The other consideration in this area is the National Labor Relations Board (NLRB) ruling in *D.R. Horton, Inc*.[29] The NLRB ruled it is a violation of federal labor law to require employees to sign arbitration agreements that prevent them from joining together to pursue employment-related legal claims in any forum, whether in arbitration or in court. The NLRB found the agreement unlawfully barred employees from engaging in "concerted activity" protected by the National Labor Relations Act. Notably, this decision applies to private sector employers whether or not they are unionized.

The NLRB's ruling in *D.R. Horton* has already been rejected and distinguished by some federal courts, but it remains to be seen how the Third Circuit, and ultimately the Supreme Court, will address this concern. For the time being, employers should simply be aware of these issues when drafting employment contracts and deciding choice of forum.

Conclusion

Employment contracts clearly have value for all employees, not just high-level executives. It is important for in-house counsel to identify the goals of the employer in light of the types of employment contracts that can be utilized, and to then work with outside counsel to develop forms for use in certain repetitive situations.

There are also considerations not addressed in this article, such as works made for hire provisions to clarify ownership rights and assignment obligations with respect to intellectual property developed during employment, as well as considerations related to the employment of H1B visa employees,

and the inclusion of specialized contractual terms for such employees that track the requirements of federal law.

So, it is important to recognize that there is not a one-size-fits-all employment contract that can simply be downloaded from the Internet; there are many considerations that must be assessed in drafting an enforceable, effective employment agreement. ⚖

Endnotes

1. *See Woolley v. Hoffman-LaRoche, Inc.*, 99 N.J. 284, 297-98, *modified on other grounds*, 101 N.J. 10 (1985) (holding written employment manual distributed company wide may create an enforceable unilateral contract unless a properly written disclaimer is included in the manual).
2. *See Witkowski v. Thomas J. Lipton, Inc.*, 136 N.J. 385, 397 (1994).
3. *See generally Shebar v. Sanyo Bus. Sys. Corp.*, 111 N.J. 276 (1988)(examining the terms of the contract and the surrounding circumstances, including an oral promise to plaintiff that he would only be discharged for cause, and finding a bargained-for exchange creating an enforceable contract abrogating plaintiff's at-will employment status).
4. *Ingersoll-Rand Co. v. Ciavatta*, 110 N.J. 609, 635 (1988). *See also Whitmyer Bros., Inc. v. Doyle*, 58 N.J. 25, 33-34 (1971) (*citing* New Jersey's Antitrust Act, New Jersey Statute sections 56:9-1 to -19, for proposition that employers have no legitimate interest in using such agreements solely to prevent competition).
5. *A.T. Hudson & Co. v. Donovan*, 216 N.J. Super. 426, 432 (App. Div. 1987).
6. *See, e.g., Quigley v. KPMG Peat Marwick, L.L.P.*, 330 N.J. Super. 252, 265-66 (App. Div. 2000).
7. *Karlin v. Weinberg*, 77 N.J. 408, 417 (1978).
8. *Solari Industries, Inc. v. Malady*, 55 N.J. 571, 581 (1970); *see also Whitmyer Bros., Inc. v. Doyle*, 58 N.J. 25, 32-33 (1971)(the covenant must "simply protect [ ] the legitimate interest of the employer, impose[ ] no undue hardship on the employee, and [not be] injurious to the public") (citation omitted).
9. *See Coskey's Television & Radio Sales & Service v. Foti*, 253 N.J. Super. 626, 636 (App. Div. 1992).
10. *See Karlin v. Weinberg*, 77 N.J. 408.
11. *Cmty. Hosp. Group, Inc. v. More*, 183 N.J. 36 (2005).
12. *Id.* at 57.
13. *See Jacob v. Norris, McLaughlin & Marcus*, 128 N.J. 10 (1992).
14. *See Comprehensive Psychology Sys., P.C. v. Prince*, 375 N.J. Super. 273 (App. Div. 2005).
15. *See Karlin*, 77 N.J. at 408; *Solari*, 55 N.J. at 585.
16. *See Coskey's Television*, 253 N.J. Super. at 636.
17. *See Pathfinder, L.L.C. v. Luck*, No. 04-1475, 2005 U.S. Dist. LEXIS 44782, *2 (D.N.J. May 20, 2005).
18. *Solari Indus., Inc.*, 55 N.J. at 579-86.
19. *See Karlin*, 77 N.J. 408; *Solari Indus., Inc.*, 55 N.J. at 585.
20. N.J.S.A. 56:15-1 to 9.
21. *Rycoline Products, Inc. v. Walsh*, 334 N.J. Super. 62 (App. Div. 2000).
22. N.J.S.A. 56:15-2.
23. N.J.S.A. 56:15-2.
24. 131 S. Ct. 1740 (2011).
25. *Id.* at 753.
26. *Id.*
27. *Litman v. Cellco P'ship*, No. 08-4103, 2011 U.S. App. LEXIS 17649 (3d Cir. 2011); *Quilloin v. Tenet HealthSystem Phila., Inc.*, 673 F.3d 221 (3d Cir. 2012).
28. *Id.*
29. 2012 NLRB LEXIS 11, 357 NLRB No. 184 (N.L.R.B. Jan. 6, 2012).

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