

IN PRACTICE

EMPLOYMENT LAW

Breach of Restrictive Covenants: What Are the Damages?

By Michael L. Rich

In suits for breach of restrictive covenant agreements, such as noncompete and non-solicitation provisions, attorneys tend very often to focus their efforts on obtaining or defending against injunctive relief — both preliminary and final. Certainly, this early phase of a restrictive covenant lawsuit is critical because a primary purpose of such an agreement is to stop or limit a former employee or independent contractor from competing with an employer. But injunctive relief is only part of the story. Cases involving breach of a restrictive covenant agreement have the potential to result in extensive damages. Accordingly, it is imperative that attorneys on both sides of the dispute consider damages and plan a strategy from the beginning.

There generally are three types of damages available to plaintiffs in New Jersey for breach of a restrictive covenant. These include: (1) an accounting of the breaching party's profits, (2) recovery of the nonbreaching party's

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lost profits and (3) liquidated damages, where applicable.

Disgorgement of Breaching Party's Profits

A plaintiff may seek this type of relief in cases where the breaching party earned those profits through the wrongful use of the plaintiff's protected business information. *Platinum Mgmt, Inc. v. Dahms*, 285 N.J. Super. 274 (Law Div. 1995). These cases typically involve the wrongful solicitation of customers or the wrongful use of an employer's proprietary information or trade secrets. A plaintiff may recover the breaching party's profits only if the plaintiff would have secured them in the absence of the breach. Accordingly, it cannot be inferred that the plaintiff is entitled to all of the breaching party's profits. Rather, a plaintiff seeking to disgorge profits from the breaching party must be able to identify what portion of the profits is in fact attributable to the breach.

In an effort to maximize damages, a nonbreaching party seeking to recover the breaching party's profits is advised to gather evidence identifying the amount of profits the breaching party earned as a direct result of the breach. For example, in a case involving the wrongful solicitation of customers, the plaintiff must be prepared to prove which customers brought their business to the defendant

as a result of the breach and how much profit the defendant earned from those particular customers. Or, in a case involving the wrongful use of an employer's trade secrets, the plaintiff must be able to quantify the amount of money the defendant earned through the use of the plaintiff's trade secret. Conversely, from the defense vantage point, the alleged breaching party wishes to emphasize that the plaintiff is not entitled to all of his profits, but only at best those directly attributable to the proven breach. Therefore, in attempting to minimize the amount of damages it owes to the plaintiff, a breaching party must be prepared to explain why the profit he earned is unrelated to the breach of the noncompete agreement.

Nonbreaching Party's Lost Profits

Alternatively, a plaintiff may attempt to recover damages for its lost profits as a result of the defendant's breach. To receive damages for lost profits, a plaintiff must demonstrate by a preponderance of the evidence that the losses it seeks were a reasonably certain consequence of the breach. *Totaro Duffy, Cannova & Co. v. Lane, Middleton & Co., L.L.C.*, 191 N.J. 1, 28 (2007). This requires proof on two separate issues. First, the plaintiff must show that clients were lost as a "natural and probable consequence" of the breaching party's actions. Second, the plaintiff must demonstrate the appropriate method for quantifying that loss. Furthermore, damages for lost profits are recoverable only if they are capable of being estimated with reasonable certainty. Accordingly, merely prospective

customers cannot be considered in awarding damages because such damages are uncertain and speculative. *United Board & Carton Corp. v. Britting*, 63 N.J. Super. 517, 524, 530 (Ch. Div. 1959), aff'd 61 N.J. Super. 340 (App. Div.), certif. denied, 33 N.J. 326 (1960).

Damages for lost profits are not necessarily attributable to the entire temporal period of a breached restrictive covenant. Accordingly, in calculating damages, a plaintiff cannot simply multiply lost profits by the length of the noncompete agreement. Rather, courts will consider the totality of the circumstances. This analysis includes weighing factors such as the relationship between clients and the breaching party and the likelihood that clients would remain with the non-breaching party in light of the breaching party's absence.

For example, in *Totaro Duffy*, the New Jersey Supreme Court determined that the record supported awarding the plaintiff only one year's worth of losses attributable to the defendant's breach of a four-year client nonsolicitation covenant. The Court concluded that the evidence showed that "all of the clients would have left plaintiff and retained defendant to perform their compliance work once they learned of defendant's departure." Therefore, the Court held that the plaintiff's damages should be limited to one year because the evidence proved that clients would have left regardless of the solicitation package, but only left sooner because of the package.

Both breaching and nonbreaching parties need to consider the impact of the *Totaro Duffy* decision on calculating damages for lost profits. Post-*Totaro Duffy*, it is not simply the length of the restrictive covenant that necessarily dictates the calculation of damages, but rather a number of factors, including how long would the clients or customers have

remained with the nonbreaching party after the breaching party's departure. Consequently, in establishing lost profits, the non-breaching party not only needs to show what customers were lost due to the defendant's breach, but that such customers likely would have remained with the plaintiff but for the breach. Conversely, the defendant will want to try to show that the customers would not have remained with the plaintiff regardless of the defendant's alleged breach, or that the customer's decision to leave the plaintiff was due to factors other than any breach by defendant.

Liquidated Damages

One final way to calculate the measure of damages caused by the breach of a non-compete agreement is by referring to a liquidated damages provision contained in the agreement, where applicable. Many non-compete agreements contain a liquidated damages provision, whereby the parties set the amount of damages prior to the time it is breached. Parties will often agree to such a provision when they anticipate that the actual amount of monetary damages would be difficult to calculate. Such liquidated damage clauses are common, for instance, for insurance brokers. In New Jersey, courts will generally enforce a provision for liquidated damages contained in a non-compete agreement if it finds the provision to be reasonable under the circumstances. *Metlife Capital Fin. Corp. v. Washington Ave. Assocs. L.P.*, 159 N.J. 484, 504 (1999).

According to the Court in *Metlife Capital*, to determine whether a clause for liquidated damages is reasonable, courts will consider a number of factors, including the intention of the parties, actual damages sustained and the parties' relative bargaining power. This test of reasonableness may be applied at either

the time the agreement was made or at the time it was breached. A liquidated damages provision will be considered unreasonable, however, if a plaintiff does not suffer any monetary loss as a result of the defendant's breach of the restrictive covenant. In this situation, the liquidated damages provision would not be enforced because it would constitute a penalty, rather than compensation for damages suffered. *Pсарos v. Saropoulos*, 2009 WL 1393313, at *2-3 (App. Div., May 20, 2009).

A plaintiff attempting to collect on a liquidated damages provision must be prepared to justify why the amount is reasonable. This may require evidence of actual damages sustained as a result of the breach. In contrast, a breaching party attempting to reduce the amount of damages may accomplish this in two ways. First, the breaching party can try to establish that the amount of damages agreed upon is unreasonable because the plaintiff had substantially more bargaining power when the parties reached the agreement and that the contractual amount was not a reasonable approximation of foreseeable damages. Alternatively, the breaching party might avoid paying the liquidated damages amount by proving that the plaintiff did not suffer any meaningful harm as a result of the breach.

Conclusion

In cases involving breach of a restrictive covenant agreement, the parties cannot afford to focus only on obtaining or avoiding injunctive relief to the exclusion of developing the case for recovering, avoiding or limiting damages from the very outset of the dispute. Depending on the evidence developed, damages may be maximized or minimized. If considered only as an afterthought, a client's objectives or opportunities may be missed, or worse. ■