

Legal Updates & News

Bulletins

Are Employee 'No-Hire' and Non-Solicitation Provisions Enforceable Under California Law?

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In most states, noncompetition agreements are enforceable if reasonably necessary to protect trade secrets and other confidential information. California, however, has a long standing public policy generally prohibiting noncompetition agreements. This policy is embodied in California Business & Professions Code section 16600 ("Section 16600"). Limited exceptions are set forth in subsequent sections of the California Business & Professions Code, such as the "sale of business" exception in Section 16601.

In *VL Systems v. Unisen, Inc.*,^[fn1] the California Court of Appeal found that an employee no-hire provision in a business-to-business computer consulting agreement was overbroad and unenforceable. The holding was based in part on the public policy established by Section 16600. As drafted, the no-hire clause in the consulting agreement purported to prohibited the client from hiring: (1) employees of the consulting company that did not provide any consulting services to the client; and (2) individuals that were hired by the consulting company *after* its engagement by the client ended.

The Court of Appeal, however, was careful to point out that its decision was limited to the facts of the case, and that a "more narrowly drawn clause limited to **soliciting** employees who had actually performed work for the client might pass muster." ^[fn2]

Below is a summary of the facts and analysis set forth in the *VL Systems* case, and other relevant California cases addressing employee no-hire and non-solicitation clauses.

Case Background

In *VL Systems*, Star Trac Strength ("Star Trac") engaged VL Systems ("VLS") to provide approximately 16 hours of computer consulting services. The contract between the parties included the following no-hire provision:

BUYER WILL NOT ATTEMPT TO HIRE SELLER'S PERSONNEL. Any hiring, or offer of employment entitles, but does not require VL Systems, Inc. to immediately cancel the performance period of this agreement. If, during the term of, or within (12) months after the termination of the performance period of this agreement, buyer hires directly, or indirectly contracts with any of seller's personnel for the performance of systems engineering and/or related services hereunder, BUYER AGREES TO PAY TO THE SELLER SIXTY PERCENT (60%) OF EITHER THE NEW ANNUAL COMPENSATION PAYABLE TO SUCH PERSONNEL or the fees paid to, or in favor of such personnel for one (1) year after such personnel separates from service with seller, which ever is applicable, as liquidated damages. ^[fn3]

After the contract was completed, Star Trac hired a VLS employee (David Rohnow), who had been working for VLS for a total of 22 weeks as a senior engineer. Rohnow was hired following his response to Star Trac's internet job ad. Rohnow did not provide any services to Star Trac during the term of the consulting agreement. In fact, VLS had only hired Rohnow after its contract with Star Trac had been completed. Nevertheless, VLS

sent Star Trac a bill for \$60,000 pursuant to the no-hire provision, which Star Trac declined to pay.

Court Action

VLS subsequently filed a lawsuit against Star Trac for breach of the consulting agreement, and the trial court found that the no-hire provision was enforceable. However, the trial court only awarded a portion of the liquidated damages based on the number of months Rohnow had been with VLS.

The Court of Appeal reversed. It held that the no-hire provision was unenforceable in light of the public policy established by Section 16600. The Court of Appeal found that the liquidated damages provision would have effectively precluded Star Trac from hiring Rohnow, and thus, his opportunity to pursue employment where he chose would be unlawfully curtailed by the no-hire agreement. The Court of Appeal stated that “[t]he interest of the employee in his own mobility and betterment are deemed paramount to the competitive interests of the employers, where neither the employee nor his new employer has committed any illegal act accompanying the employment change.” [fn4]

The court pointed out that this was “not a case where the happy client of a consulting firm attempts to poach an employee.” [fn5] In fact, the court speculated that “it appears to be a coincidence that VLS had performed recent work for Star Trac.” [fn6]

Distinguishing the impact of a non-solicitation provision from a no-hire provision, the court noted that under a non-solicit clause an employee only loses the option of being contacted first by the company, but he/she is not restrained from being employed by the company as occurs with a no-hire clause.

VL Systems Distinguishes Webb

In reaching its decision, the *VL Systems* Court distinguished its holding from *Webb v. Westside District Hospital*, [fn7] in which the California Court of Appeal upheld a liquidated damages provision between a hospital and physician placement agency. The contract between the parties in *Webb* required payment of a fee if the hospital hired a physician placed with it by the agency within a limited amount of time. The agreement in *Webb* provided:

Hospital acknowledges that [Webb] will recruit, train, and contract with other physicians for the [emergency room] Department Service and this is a costly and time-consuming endeavor. Should Hospital wish within two (2) years following the termination of this Agreement – measured from the last extension thereof – to directly or indirectly employ any physician who shall have contracted with [Webb] for Department service, Hospital shall first pay [Webb] the sum of \$30,000 per physician, which accurately reflects the reasonable value of [Webb's] time and costs. [fn8]

Unlike the no-hire provision at issue in *VL Systems*, the provision in *Webb* applied solely to employees that had actually been provided to the hospital by the plaintiff. Further, the hospital's negotiators conceded that the sum in the agreement was “fair and reasonable” [fn9] given that Webb would be unable to recoup the costs incurred in recruiting the physicians if the contract was prematurely terminated. For this reason, and because the hospital would have had to expend approximately the same amount to obtain physicians through a placement agency, the Court of Appeal in *Webb* upheld the agreement as necessary to protect the placement agency from “unfair exploitation” [fn10] of labor.

VL Systems Distinguishes Loral

The *VL Systems* Court also distinguished its decision from *Loral Corp. v. Moyes*. [fn11] In *Loral*, the California Court of Appeal upheld Loral's agreement with a terminated employee providing that, in exchange for various severance benefits, Moyes (the terminated employee) would:

[N]ot now or in the future disrupt, damage, impair or interfere with the business of Conic Corporation, or its TerraCom Division [subsidiaries of Loral Corp.] whether by way of interfering with or raiding its employees, disrupting its relationships with customers, agents, representatives or vendors, or otherwise. [fn12]

After leaving Loral, Moyes was hired as President of Aydin Corporation. He then solicited and hired two important TerraCom employees. In addition, numerous other TerraCom employees were interviewed and offered employment by Moyes, causing TerraCom to expend over \$400,000 recruiting their successors.

In support of its finding that the no-raiding provision was enforceable, the Court of Appeal noted that while

section 16600 invalidates agreements that attempt to prevent an ex-employee from working for competitors, it “does not necessarily affect an agreement delimiting *how* he can compete.” [fn13] (emphasis added) It reasoned that since the no-raiding provision does not restrain an individual’s right to engage in his profession any more than do agreements prohibiting trade secret disclosure or customer solicitation, the provision does not contravene the public policy underlying section 16600.

As in *VL Systems*, the *Loral* court stressed the difference between broad no-hire agreements and those that merely prohibit solicitation. It indicated that the latter are more palatable because they only marginally impinge on the opportunities available to employees.

Relevance Of *Strategix*

Although not mentioned by the court in *VL Systems*, *Strategix v. Infocrossing West*, [fn14] is also relevant to the discussion concerning the scope of an employee non-solicitation clause that is enforceable under California law. [fn15] There, the court addressed the enforceability of a non-solicitation of customers and employees provision in the context of a sale of a business. The case provides an example of an employee non-solicitation provision that (even though less onerous than a no-hire provision and in the sale of business context) was found to be unenforceable because it was not narrowly tailored.

The case arose from *Strategix*’s sale of its goodwill and most of its assets to *Infocrossing*. The parties entered into an agreement that barred *Strategix* from soliciting *all* of *Infocrossing*’s employees or customers for one year. Issues subsequently arose concerning the purchase, and *Strategix* sued *Infocrossing* asserting claims that included breach of contract. In response, *Infocrossing* sued *Strategix* for breaching the non-solicitation agreement signed in connection with the sale transaction. *Infocrossing* also moved for and obtained a preliminary injunction enjoining *Strategix* from soliciting any of *Infocrossing*’s customers and employees.

Strategix appealed the issuance of the preliminary injunction arguing that the non-solicitation agreement was unenforceable under Section 16600. *Infocrossing* argued that the non-solicitation agreement was enforceable because it fell within the sale of business exception provided in Section 16601. The Court of Appeal agreed with *Strategix*.

The Court of Appeal found *Infocrossing*’s non-solicitation agreement unenforceable because the non-solicitation covenant was not tied directly to the assets of *Strategix*’s business. The court focused on the fact that the covenant barred *Strategix* from soliciting *all* of *Infocrossing*’s employees and customers, rather than only the former employees and customers of *Strategix* – the “sold business.” It reasoned a restriction of this nature went beyond the restraints permitted by Section 16601:

[C]ourts may enforce nonsolicitation covenants barring the seller from soliciting *the sold business*’s employees and customers. These covenants prevent the seller from unfairly depriving the buyer of the full value of its acquisition, including goodwill. The sold business’s goodwill is the “expectation of . . . that patronage which has become an asset of the business On the other hand, nonsolicitation covenants barring a seller from soliciting *all* employees and customers of the buyer, even those who were not former employees or customers of the sold business, extend their anticompetitive reach beyond “the business so sold.” They do more than ensure that the buyer receives the full value of the business it bought, whose goodwill does not include “the patronage of the general public.” [fn16]

Further, the Court of Appeal expressed concern that the non-solicitation covenant failed to give *Strategix* adequate notice of what was prohibited because *Strategix* would likely not know which customers and employees pertained to *Infocrossing*’s business. The Court of Appeal, however, made it clear that the non-solicitation covenant would have been enforceable if it were limited to prohibiting *Strategix* from soliciting only its own former employees and customers.

Conclusion

Based on the foregoing authorities, companies should carefully review the scope of any no-hire and employee non-solicitation provisions that they use in the employment or business-to-business context. Potential agreements to be reviewed include, Employment Agreements, Proprietary Information Agreements, Separation and Severance Agreements, Outsourcing Agreements, Consulting Agreements, Pre-Merger Confidentiality Agreements, Merger and Acquisition Agreements, and Non-Competition Agreements. The enforceability of such terms under California law will vary depending on the context of the agreement and the scope of the provision at issue.

Footnotes

¹ 152 Cal.App. 4th 708 (2007).

² *Id.* at 713 n.4

³ *Id.* at 710.

⁴ *Id.* at 714 (quoting *Diodes, Inc. v. Frantzen*, 260 Cal. App. 2d 244, 255 (1968)).

⁵ *Id.* at 715.

⁶ *Id.*

⁷ 144 Cal.App. 3rd 946 (1983).

⁸ *Id.* at 949.

⁹ *Id.* at 950.

¹⁰ *Id.* at 954.

¹¹ 174 Cal.App.3rd 268 (1985).

¹² *Id.* at 274.

¹³ *Id.* at 276.

¹⁴ 142 Cal.App.4th 1068 (2006).

¹⁵ For a complete discussion of *Strategix*, see Recent Developments In California Law Regarding Noncompetition Agreements, Employment Law Commentary (Oct. 2006)

¹⁶ *Id.* at 1073.