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# One Minute Memo®

# California Court of Appeals Says No on Broad "No-Hire" Contracts

The California Court of Appeals effectively banned the practice of allowing businesses to agree to refrain from hiring one another's employees, including consulting services agreements between two businesses. The June 25th *VL Systems, Inc. v. Unisen, Inc*. decision held that a broad "no-hire" provision between business parties that restricts employment opportunities for their respective employees is unenforceable. The Appellate Court determined that, as written, the "no-hire" provision in question was an impermissible restraint on trade and therefore unenforceable.

## The "No-Hire" Agreement.

In 2004, VL Systems, Inc. (VLS) and Star Trac Strength (Star Trac)[1] entered into a short-term computer consulting contract wherein Star Trac agreed to pay liquidated damages if it hired any VLS employee, or extended an offer of employment, during, or within 12 months after the completion of the contract. After the contract was signed, the project was completed without incident.

In April 2004, after completion of the contract, VLS hired David Rohnow as a senior engineer. Rohnow never worked with Star Trac, nor had any contact with Star Trac

as an employee at VLS. In July 2004, Star Trac posted a job listing for a director of information technology. Rohnow applied and eventually was hired in September 2004. At the time it hired Rohnow, Star Trac was aware of the "no-hire" provision but determined it to be inapplicable because (1) Rohnow had not performed work under the contract for VLS; and (2) it did not seek out Rohnow. After Rohnow was hired, VLS sent Star Trac a bill for $60,000 pursuant to the "no-hire" provision.

Star Trac declined to pay and VLS sued for breach of contract, breach of the implied covenant of good faith, and fair dealing and declaratory relief. Following a bench trial, the trial court determined that Star Trac violated the "no-hire" provision and was liable for damages.

## Court of Appeal Finds The Agreement Void.

The Court of Appeal reversed the lower court, finding that, in this particular case, the "no-hire" provision was unenforceable as a matter of law. The court framed the issue as whether two parties can contractually agree on a "no-hire" provision that may impact the rights of a broad range of third parties. The court reached its conclusion by emphasizing two main points: first, California Business

[1] Star Trac is a dba of Unisen, Inc.

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& Professions Code Section 16600 prohibits contracts that restrain an employee from engaging in a lawful profession, trade or business of any kind. In this case, the court rejected VLS's argument that the contract did not preclude Star Trac from hiring Rohnow or limit his mobility, but merely called for the payment of liquidated damages to VLS if an employee chose to work for Star Trac. The court rationalized that Star Trac would be unwilling to hire Rohnow if they had to (1) pay liquidated damages to VLS or face a lawsuit; and (2) also pay Rohnow's salary. As a result, the "no-hire" clause restricted Rohnow's ability to seek employment.

Second, notwithstanding the base rule, freedom of contract is an important principle; thus, reasonably limited restrictions that tend to promote rather than restrain trade are acceptable. However, the "no-hire" provision in question seriously impacted all VLS employees, including those who did not perform work for Star Trac under the contract. Rohnow was restrained, for example, even though he was not even employed by VLS at the time of the contract. On that point alone, the "no-hire" provision was overly broad, thus unenforceable.

The court distinguished prior California cases which upheld more narrow "no-hire" clauses. The Court implicitly suggested that more narrow "no-hire" clauses that are either (1) applicable only to employees that worked on the contract; or, (2) only restricted the contracting party from actively soliciting employees but not the other way around, might be enforceable.

## What Does *VLS* Mean To Businesses?

Although the court emphasized that its holding was limited to the facts of the case, business should exercise caution. First, the decision re-emphasizes the base rule in California that all but the narrowest of "no-hire" clauses may violate state law. Second, reasonably limited "no-hire" provisions which merely prevent solicitation of employees who actually performed work for the client may, but are not guaranteed to, meet the requirements of Section 16600.

### In responding to the *VLS* decision California employers would be wise to:

- Carefully assess any "no-hire" provisions in contracts with vendors, consultants, subcontractors and current or former employees.

- In making that assessment the first question should be whether the clause is more broadly worded than necessary to achieve the direct purpose of protecting the existing workforce from raiding.

- Particular attention should be focused on "no- hire" clauses in employment agreements because of the ban on including unlawful terms under Labor Code 432.5 and the potential for class action exposure to significant penalties under Labor Code 2699.

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