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CALIFORNIA BUSINESS LAW Practitioner

A GUIDE TO CURRENT PRACTICE

Hiring Employees From Competitors

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BACKGROUND

The average employer probably thinks it has the right to hire a competitor's employee, unless that employee is restrained by a covenant not to compete. The average employer couldn't be more wrong. Covenants not to compete usually are invalid in California, but under various theories, including breach of fiduciary duty, corporate raiding, trade secret theft, and unfair competition, employers have successfully stated causes of action against competitors who have hired away their employees.

Also, an employee who has been properly hired from a competitor can expose himself or herself and the new employer to liability by engaging in unfair competitive practices, such as using the former employer's trade secrets.

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Knowing the pitfalls commonly encountered in hiring a competitor's employees can reduce the risk of litigation and increase the probability that the employee or the hiring company will be able to successfully defend a suit by a former employer.

This article highlights some of the most common situations that give rise to litigation against employers for hiring a competitor's employees, and provides tips on avoiding conflict and building a convincing defense in advance.

NONCOMPETITION CLAUSES

Except for certain enumerated situations, Bus & P C §16600 voids clauses in employment contracts that prohibit a former employee from competing with a former employer. This statute expresses a "strong public policy of the state which should not be diluted by judicial fiat." *Scott v Snelling & Snelling, Inc.* (ND Cal 1990) 732 F Supp 1034, 1043 (discussing trade secrets exception). *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573; *South Bay Radiology Medical Assocs. v Asher* (1990) 220 CA3d 1074, 1080, 269 CR 15 (discussing sale of business and partnership exceptions).

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Nonsolicitation Clauses Are Valid

At least one reported opinion held that an agreement in which a departing employee agreed not to solicit co-employees after his departure was enforceable and did not violate Bus & P C §16600. In *Loral Corp. v Moyes* (1985) 174 CA3d 268, 276, 219 CR 836, the court reasoned that the provision restrained neither the departing employee nor his former colleagues from working for the competitor. Rather, it simply prohibited active solicitation. "Equity will not enjoin a former employee from receiving and considering applications from employees of his former employer, even though the circumstances be such that he should be enjoined from soliciting their applications." 174 CA3d at 279.

Thus, although a noncompetition clause usually will be invalidated, a "nonraiding" clause may be permissible. A competitor who wants to gain a foothold by hiring a key employee with the ultimate goal of having that employee lure away additional useful employees from the former employer may be unfairly competing. But if additional employees follow a departing employee of their own volition, there may be no unfair competition, as the court found in *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1181.

COMPETITOR'S LIABILITY FOR SOLICITING OTHER FIRM'S EMPLOYEES

A competitor can solicit and hire employees of another firm when the employee is not induced to breach a term contract, and when the underlying motive or likely result is not unfair competition with the former employer. *Hollingsworth Solderless Terminal Co. v Turley* (9th Cir 1980) 622 F2d 1324, 1337. As the court stated in *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 860 n2, 27 CR2d 573, in addressing Bus & P C §16600, "[t]he corollary to this proposition is that competitors may solicit another's employees if they do not use unlawful means or engage in acts of unfair competition." 22 CA4th at 859.

When a firm hires a competitor's employees, the former employer generally has three avenues of attack. The former employee may claim that the competitor:

- Induced the employee to breach a term of his or her employment contract;
- Engaged in corporate raiding in a manner giving rise to an unfair competition claim; or
- Hired the employee for the purpose of, or in a manner that inevitably will result in, theft of the former employer's trade secrets.

Inducing Breach of a Term Employment Contract

An employee who has an agreement for a certain term may be contractually bound to his employer. If a competitor induces the employee to breach this contract, the causes of action that the former employer may assert against the competitor include (1) inducing a breach of the employee's contract, (2) interference with contract, and (3) conspiring with the former employee to breach the contract.

Whether the competitor that interferes with an existing employment contract is subject to tort liability is questionable. In *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 45 CR2d 436, the

court held that a plaintiff seeking to recover for an alleged wrongful interference with economic advantage must plead and prove not only the existence of the relationship, the interloper's knowledge of the relationship, intentional interference and damages, but also that the defendant engaged in wrongful conduct separate and apart from the interference itself. *The court expressly declined to rule whether this additional element was required in a claim for interference with an existing contract.*

However, in *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 28 CR2d 475, the court specifically mentioned that California law recognizes tort causes of action against *noncontracting parties* who interfere with the performance of a contract. 7 C4th at 513.

"In most cases, the courts have found that the 'privilege of competition' permits the solicitation of a competitor's employees."

If the competitor simply negotiates with the employee to change employment at the end of the employee's term with his or her employer, no wrong has been committed. Moreover, the employee who breaches a contract of employment by terminating it prematurely can be liable only for contractual damages. See *Applied Equip. Corp. v Litton Saudi Arabia Ltd., supra.* It is not clear whether, and under what circumstances, a contract with a liquidated damages clause will be upheld and deter a departing employee.

COMMENT: In any situation, a competitor should inquire whether the target employee is under a term contract of employment. See *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1177 (no liability when competitor inquired of employee "early in their negotiations" whether employee was under an employment contract with present employer.)

A number of decisions discuss in dicta the issue of a competitor's liability for hiring employees who are under term contracts (rather than at-will employees). See, *e.g., Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 255, 67 CR 19 (no term employment contracts); *Loral Corp. v Moyes* (1985) 174 CA3d 268, 276, 219 CR 836 (issue was nonraiding agreement between former employee and his employer); *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 860 n2, 27 CR2d 573 (employees were at-will); *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1177 (options contracts not interpreted as term employment contracts); *Litton Sys., Inc. v Honeywell Inc.* (Fed Cir 1996) 87 F3d 1559, 1575 (issue was technology licensing agreement between employee and former employer, not employment contract). The dicta in each of the above opinions suggests that soliciting a competitor's employee who is under a term contract of employment might constitute unfair competition.

Raiding a Corporation of Its Employees

The former employer may also allege that the competitor lured away one or more choice employees in an attempt to unfairly raid the former employer. In most cases, the courts have found that the "privilege of competition" permits the solicitation of a competitor's employees. Significantly, in these cases there was no evidence that the hiring was intended to disable the former employer. And, in each instance, the court noted that the former employer could have avoided the "raid" by hiring the departing employees under long-term contracts, rather than allowing the employees to remain employed at-will, in which case either the employer or the employee can terminate the relationship without notice. See Lab C §§2920, 2522.

For example, in *Metro Traffic Control*, the court noted that the privilege of competition allowed the hiring of multiple at-will employees (22 CA4th at 862):

> If [plaintiff] wanted to assure the continued availability of these employees for future assignments or simply to shrink the pool of available talent, it could enter into exclusive long-term contracts to that end.

Similarly, in *Motorola*, the district court rejected plaintiff employer's assertion that a stock-option agreement constituted a term employment agreement with its employees who departed to a competitor. The option agreement was not a traditional employment contract in the sense that the employee agreed to stay for a particular period and the employer agreed to keep the employee for a particular period. The evidence showed that Motorola deliberately drafted the option agreement in such a way as to retain maximum flexibility in dealing even with its top executives. "They cannot expect more from their employees than they were willing to give." *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1179.

If the raiding involves prohibited conduct, then the competitor may be liable for tortious interference. In *Buxbom v Smith* (1944) 23 C2d 535, 145 P2d 305, an employer hired the owner of a business engaged in the distribution of periodicals for a set term, encouraging the employee to build up a distribution network and a number of employees. The employer then pre-

maturely terminated the contract and hired the group of employees directly. The court had no problem condemning this practice as a tortious interference in the relationship between plaintiff and his employees. 23 C2d at 548.

COMMENT: The rule for practitioners is unambiguous. Unless an employee is bound to serve for a term, with a mutual promise by the employer to employ for a term, a competitor may be able to lure away the employee with impunity, and with the shield of the "privilege of competition," unless the employer's actions are clearly outside the bounds of legitimate conduct.

Disclosure of Trade Secrets

To prevent competitors from luring away employees, employers also contend that these sought-after employees will inevitably disclose company trade secrets.

"[T]he Seventh Circuit [has] ruled that a company cannot hire its competitor's employee if the employee in his new position will necessarily misuse his former employer's trade secrets."

Departing employees who take nothing with them to their new employer and who do not use any recollected trade secrets of their former employer, generally have been deemed not to be misappropriating their former employer's trade secrets. See *Scott v Snelling & Snelling, Inc.* (ND Cal 1990) 732 F Supp 1034, 1043; *Aetna Building Maintenance Co. v West* (1952) 39 C2d 198, 246 P2d 11.

COMMENT: A trade secret may be broadly defined as information or a process that provides economic value for a company by not being generally known in the industry or to the public, and is the subject of efforts that are reasonable, under the circumstances, to maintain the secrecy of the information. CC §3426.

Recently, however, the Seventh Circuit ruled that a company cannot hire its competitor's employee if the employee in his new position will necessarily misuse his former employer's trade secrets. *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262. In that case, PepsiCo's General Manager of its Northern California Business Unit left to work for a competitor. As a high-level manager at PepsiCo, the employee had access to confidential business plans, marketing strategies, and distribution channels of PepsiCo. His position at the competitor would have involved similar responsibilities. Plaintiff argued at a preliminary injunction hearing that the employee would inevitably disclose that information in his new position. Analyzing Illinois common law and the Illinois Uniform Trade Secrets Act, the district court issued a preliminary injunction prohibiting the employee from assuming his position at the competitor for approximately six months. 54 F3d at 1267. The doctrine of "inevitable disclosure" also is discussed in a number of California treatises. See, *e.g.*, Trade Secrets Practice in California §4.15 (2d ed Cal CEB 1996); 1 Milgrim on Trade Secrets §5.02[3][d]-[e] (Rev ed 1993).

If this doctrine is accepted in California, it could be very significant. Rather than placing the burden on employers to protect valuable confidential information known to key employees by entering into long-term contracts, the hiring competitor is at risk for trade secret misappropriation claims simply because the former employee had knowledge of trade secrets. It also leaves the employee virtually unemployable in his or her field of expertise, and the former employer has theoretically made the employee an indentured servant.

DEPARTING EMPLOYEE'S LIABILITY FOR SOLICITING CO-EMPLOYEES

Special rules apply when the "competitor" that is hiring a company's employees is a second company comprised of the first company's former employees.

Employee's Duties of Loyalty and Care to the Employer

All full-time employees have duties of loyalty and care toward their employers. Officers and key employees have heightened duties of loyalty and care. These duties restrict an employee's conduct when he or she is departing.

Nonmanagerial Employees

The rule is that an employee's duty of loyalty prohibits the employee from soliciting other employees to join an existing competitor while he or she is employed by the first employer, but not after the employee has departed. On the other hand, it is permissible for co-employees to agree to form a competing enterprise effective at the end of their terms of employment, provided that they do not depart in a manner intended or obviously likely to cause their present employer to be disabled from carrying on its business.

This rule is derived from Comment e to §393 of the Restatement Second of Agency (adopted as California's rule in *Bancroft-Whitney v Glen* (1966) 64 C2d 327, 346 n10, 49 CR 825, and *Loral Corp. v Moyes* (1985) 174 CA3d 268, 276, 219 CR 836):

> [B]efore the end of his employment, he can properly purchase a rival business and upon termination of employment immediately compete. He is not, however, entitled to solicit customers for such rival business before the end of his employment nor can he properly do other similar acts in direct competition with the employer's business. The limits of proper conduct with reference to securing the services of fellow employees are not well marked. An employee is subject to liability if, before or after leaving the employment, he causes fellow employees to break their contracts with the employer. On the other hand, it is normally permissible for employees of a firm, or for some of its partners, to agree among themselves while still employed, that they will engage in competition with the firm at the end of the period specified in their employment contracts. However, a court may find that it is a breach of duty for a number of the key officers or employees to agree to leave their employment simultaneously and without giving the employer an opportunity to hire and train replacements.

Departing Officers and Directors

Former directors or officers may also solicit employees from their former employer after they have started working for a competitor. *Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 255, 67 CR 19.

In *Diodes*, defendants were two former officers, directors, shareholders, and employees in charge of the company's research and development program. They left and formed defendant Semtech, and then solicited Diodes employees to work for Semtech. Diodes sued both the individuals and their new company for breach of fiduciary duties by competing with Diodes, by hiring its employees, and for trade secret theft. The court of appeal affirmed the trial court's dismissal of the suit after sustaining defendants' demurrer to the third amended complaint. It agreed with the trial court that Diodes had not sufficiently alleged the existence of any protectible trade secrets. Further, in discussing the claim that defendants lured remaining employees from their former company, the court of appeal said (260 CA2d at 255):

> Even though the relationship between an employer and his employee is an advantageous one, no actionable wrong is committed by a competitor who solicits his competitor's employees or who hires away one or more of his competitor's employees who are not under contract, so long as the inducement to leave is not accompanied by unlawful action. [Citations omitted.] In the employee situation the courts are concerned not solely with the interests of the competing employers, but also with the employee's interests. The interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of the employers, where neither the employee nor his new employer has committed any illegal act accompanying the employment change.
>
> However, if either the defecting employee or the competitor uses unfair or deceptive means to effectuate new employment, the injured former employer has a cause of action to recover for the detriment he has suffered. Neither the wrongdoing employee nor his new employer will be heard to say that his conduct was justifiable as a part of competitive strife. Their interests under the circumstances are neither equal nor superior to those of the former employer.

Although former directors or officers may solicit employees from their former employer, a broader range of their actions, as compared to the actions of non-officers, may be deemed unlawful. A director or other management employee necessarily possesses confidential information regarding former colleagues, such as salary information, which might be "useful" to the new enterprise.

A departing officer was found liable for breach of fiduciary duties in *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 49 CR 825, partially because he used knowledge of his former subordinates' salaries when negotiating on behalf of his new employer. The trial court found that Glen had breached his fiduciary duties in the way in which he had prepared to leave Bancroft-Whitney for Matthew Bender. For months before his resignation from Bancroft-Whitney, with Bender's knowledge and assistance, Glen prepared to compete with his employer. He disclosed the salaries of his subordinates and made plans for and cooperated in the hiring of Bancroft-Whitney managing and assistant editors for Bender at salaries Glen knew were higher than they were making at the time. Further, the managing editors Glen successfully lured had been at-will employees of Bancroft-Whitney, as had Glen. When he negotiated their future employment positions on Bender's behalf, however, he persuaded Bender to offer them five-year contracts with a profit-sharing plan. During these efforts, the president of Bancroft-Whitney's parent company, Gosnell, heard rumors that Bender was considering a raid on Bancroft-Whitney employees. When asked, Glen misled Gosnell and denied he knew anything about such a plan. Glen also convinced Gosnell to delay full implementation of salary raises for Glen's subordinates that Gosnell suggested as a way to avoid a raid on Bancroft-Whitney employees. The supreme court had no difficulty finding that Glen had clearly breached his fiduciary duties to his former employer. Although emphasizing that an officer or director had no duty to disclose his plans to compete, the *nature* of the preparations had been improper (64 C2d at 348):

If Glen while still president of plaintiff had performed these acts on behalf of Bender without also obligating himself to join the company, there could be no doubt that he would have violated his duties to plaintiff.

The court found that deliberately misleading Glen's superiors about Bender's attempt to "raid" Bancroft-Whitney was an "inexcusable" failure to inform his superior of a matter of vital interest to his employer. Further, the court held that providing the names of useful employees and their salaries with the intention of facilitating their recruitment by a competitor was a breach of his fiduciary duties (64 C2d at 352).

The supreme court expressly noted that plaintiff did not contend that Bender should not have hired Glen, who had been both president and editor-in-chief of Bancroft-Whitney. Rather, Bender and its agents were liable for their role in cooperating in Glen's breach of fiduciary duties.

Contractual Duties of Departing Employees

Unless an employer and an employee have an employment agreement covering termination of their relationship, the relationship is presumed to be "at-will," which means that an employee can quit any time without notice. At-will employment gives the employer flexibility regarding its work force, but it also gives employees freedom to shop their talents to others. Lab C §2922; *Stokes v Dole Nut Co.* (1995) 41 CA4th 285, 293, 48 CR2d 673.

However, as discussed above, a departing employee may be enjoined from soliciting co-employees if he has agreed contractually not to do so. See p 67, "Nonsolicitation Clauses Are Valid."

PRACTICE TIPS FOR COMPETITORS

Although a former employer intent on retribution against a competitor who hires its employees may assert viable claims, the competitor can deter these claims by careful preparation and adhering to high standards of conduct in competition. The competitor should:

- Consider hiring employees from the pool of talent outside the industry, or at least from other companies not in competition with it.
- When soliciting a person presently employed, inquire if he or she is prohibited by contract or otherwise from negotiating with competitors.
- Discourage recent hires or prospective employees from soliciting their former co-workers.
- Adopt a strongly worded trade secrets policy that prohibits use of any competitor's secret information or processes.
- Ask prospective and new employees not to bring anything they may have acquired from their former employer to work, and advise prospective employees and new employees of this policy. Have new workers sign the written policy.
- Avoid limiting searches for prospective employees to any particular competitor's employees, or otherwise "focusing" on a competitor's employees.
- Consider hiring certain employees or classes of employees under term employment agreements with anti-raiding and other provisions.
- Adopt and maintain a trade secrets policy for the company that clearly identifies the secrets and adopts procedures to maintain their confidentiality.