LEGAL Q&A | NON-COMPETE CLAUSES

March 2020

This Legal Q&A two pager gives an overview of non-compete clauses with a focus on post-contractual non-competes. Non-compete clauses can effectively protect the know-how of companies, especially in the tech sector. But their use has its pitfalls, so every employer should at least know the essentials which are covered here.

1. What forms of non-compete clauses exist?

There are two types of non-competes: contractual non-competes are non-compete clauses that apply during the term of employment, whereas post-contractual non-competes take effect after termination of employment.

2. Does the employment contract have to contain an express non-compete clause?

Not necessarily. During the term of employment, employees must refrain from competing with their employer due to their general obligations arising from the employment relationship – this is true even if no non-compete has explicitly been agreed upon in the employment contract.

Nevertheless, it is strongly recommended including a non-compete explicitly in the employment contract in order to avoid any doubts about the exact demarcation lines. For example, there can be confusion about holding shares in competing companies or self-employment during leisure time. Furthermore, an express agreement can provide for a contractual penalty (liquidated damages) in the event of a breach, which often has its own deterrent effect. This is recommendable to avoid the difficulty of having to prove exactly what damage was caused by the violation. In any case, however, if the employee breaches the contractual non-compete, the company may terminate employment and claim damages or, if agreed, a contractual penalty.

3. What are the requirements for an effective post-contractual non-compete?

The mandatory requirements in relation to post-contractual non-competes are regulated by the Commercial Code (*Handelsgesetzbuch – HGB*). Post-contractual non-competes must be agreed explicitly and in written form, *i.e.*, wet ink signature is required. They can be included directly in the employment contract or later in a supplementary agreement. The maximum period of a post-contractual non-compete restriction is two years after termination of employment.

Most notably, other than in most jurisdictions, under German law an effective post-contractual non-compete clause requires a compensation to be paid for the non-compete period. During the restrictive period, the company must pay their former employee at least half of the last contractual benefits, *i.e.*, 50 % of the fixed salary, variable remuneration and other benefits.

The scope of the post-contractual non-compete must be in line with the employer's legitimate interests. An excessively strict prohibition on any activity for competing companies worldwide is therefore ineffective. Instead, a post-contractual non-compete clause must only relate to those activities where the company's interests in preventing the activity outweighs the employee's interests in having a free choice of occupation. This includes, *inter alia*, a restriction to the employer's sector and geographical area of business.

4. For which employees is a post-contractual non-compete clause worthwhile?

Since post-contractual non-competes come with substantial financial obligations, it should always be decided on a case-by-case basis whether this protection is desirable and worth the money. This is usually only the case for employees with special know-how or customer contacts. In other cases, longer notice periods combined with short post-contractual non-competes can be a more favorable, equally effective option to protect the company's know-how. It may also be agreed that the duration of the post-contractual non-compete will be shortened by a prior garden leave.

5. What are the legal consequences of an ineffectively agreed post-contractual non-compete clause?

A post-contractual non-compete clause that either exceeds the maximum period of two years, does not provide for a compensation, or does not protect the employer's legitimate interests is not binding. The non-binding nature of a non-compete clause gives the employee the right to choose whether to comply. If the non-compete clause is non-binding as a whole, the employee has two options: He can decide to comply with the erroneous post-contractual non-compete clause in return for payment of the agreed (or statutorily required) compensation. Alternatively, the employee can invoke the non-binding nature of the non-compete clause and compete with his former employer – thereby waiving the claim to payment of compensation though. If the post-contractual non-compete clause is partially non-binding, the employee does not lose the claim to compensation if he only observes the binding part. On the other hand, the employer does not have such a right of choice but is bound by the post-contractual non-compete clause without restriction.

6. Are employers even obliged to pay the compensation in case of an immediate termination for good cause?

No, it is possible for the employer to be released from paying compensation under a post-contractual non-compete clause after terminating the employment relationship for good cause due to the employee's breach of contract. In this case, the employer is in principle entitled to withdraw from the post-contractual non-compete clause within one month after giving notice of termination by written declaration to the employee. This not only eliminates the employee's obligation to refrain from competition, but also the employer's obligation to pay compensation for the post-contractual non-compete with immediate effect.

7. Can employers also cancel a post-contractual non-compete clause in which they have no further interest?

Yes, the employer can generally waive the post-contractual non-compete clause without any reason. However, this is only possible during the employment relationship, *i.e.*, prior to the termination date, and requires a written declaration to the employee. Notably, a waiver does not lead to immediate cancellation of the non-compete without compensation. Although the employee is released from his obligation to refrain from competition directly upon receipt of the waiver, the employer remains obliged to pay compensation for the period of non-compete for one year (or until the end of the non-compete period if the duration of the non-compete is shorter). As the one-year period already begins with the declaration of waiver and not only when the employment relationship ends, employers are well-advised to regularly check whether the post-contractual non-competes in place are still considered necessary, and if not, to express their waiver in time. If the waiver is made at least one year prior to the termination of employment, the one-year period already has expired when the employee leaves the company, so no further compensation is to be paid.

8. What are the consequences of an employee violating the post-contractual non-compete?

If the former employee breaches the post-contractual non-compete, the employer may cease compensation payments and demand reimbursement of the compensation already paid although the employee has been competing. In addition, they may apply for a (preliminary) injunction to stop the competing activity with immediate effect. In principle, the employer may also claim damages from the former employee, however, often the concrete damage is difficult to quantify and to prove. Therefore, it is advisable to include a contractual penalty in the post-contractual non-compete clause that may be invoked in case of a violation.

9. Is it feasible to just conclude broad client protection clauses instead of post-contractual non-competes?

While a mere circumvention of the strict requirements of post-contractual non-competes is not feasible, in some cases a client protection clause may be the better option. However, a broad client protection clause restricts employees in a similar way in their professional activities

and will therefore often be considered as a post-contractual non-compete clause by the courts. Consequently, compensation must be paid in these cases as well. Furthermore, client protection clauses may also only be agreed for a maximum period of two years and only for those clients with whom the employee has had direct contact in the two years before the end of the employment relationship.

10. Are there any particularities for post-contractual non-compete clauses agreed with managing directors?

Yes. The strict statutory requirements for post-contractual non-compete clauses are not directly applicable to managing directors. Therefore, in principle, companies are more flexible in agreeing on post-contractual non-competes with managing directors than with employees. It is recommendable to make use of this leeway on an individual, customized basis. Notably, the courts have also set certain requirements for post-contractual non-competes with managing directors, *e.g.*, regarding duration, compensation, and waiver that must be considered.

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