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Non-competition clauses in labour contracts

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Preliminary remarks

Non-competition clauses are mainly a problem to the national statuary law and the dispensation of justice. The parties of a labour contract have only limited possibilities for individual contractual solutions.

The German statuary labour law differs between non-competition clauses during the labour contract and after the end of the employment (question 2).

Question 1

What clauses, if any, are in your country´s constitution relating to covenants not to compete in labour contracts? Are there clauses relating to the freedom of occupation, protection of property (if so, does this include intellectual property and trade secrets), freedom of contract etc. If there are such clauses, how are they applied relating to covenants not to compete? Which of the EU-Directives, if any, relating to this subject are applied in your country?

a. EU – Directives

I believe there is no EU-Directive that deals with non-competition clauses in labour contracts. As far as I know there are also no plans to standardize the law in Europe on this subject.

For self-employed commercial agents the EU Directive of December 18, 1986 (Abl. L 382/17) limits the prohibition of competition. The parties of such a contract could only reconcile not to compete for a period of 2 years.

b. Constitution

On the one hand, the prohibition of competition and the non-competition clauses touch upon the employee's constitutional right of freedom of occupation (Art. 12 'Grundgesetz' (GG)). Because of those regulations, employees are prevented from a number of occupations.

On the other hand, the parties of a contract have bound themselves – freely – to the term of the contract and the constitution protects the freedom of contract (Art. 2 GG).

In 1990 our Constitutional Court ('Bundesverfassungsgericht') decided on this problem in a very famous case (so called 'Handelsvertreterentscheidung'; judgment of February 7th, 1990, BVerfG 81,242). The court thought that private autonomy has to keep within the limits of the enforced law, in particular the constitution. The civil and the labour law have to be interpreted 'in the light of the constitution.' Therefore the freedom of occupation could not be completely ignored by the parties of a contract, when they sign the contract. If the parties of that contract are unevenly matched and one party can dictate a – timeless or without compensation (see question 2) – non-competition clause, this clause is invalid.

Question 2:

Is there a statue in your country that governs the enforceability of covenants not to compete? Or, is the law governed solely by case law?

In Germany the prohibition of competition and the non-competition clauses are fully regulated by statuary law.

As long as the labour contract lasts the employee must not enter into competition with his employer, he is not allowed to act as a competitor to his employer. This is laid down in a law in respect of commercial staff (Section 60 of the commercial code ('Handelsgesetzbuch' – HGB)). The Federal Labour Court ('Bundesarbeitsgericht' – BAG) has extended the logic of Section 60 HGB to all kinds of employees (judgment of October 17, 1969 – DB 1970, 497).

Pursuant to this provision a 'commercial assistant' must not, without consent of his 'principal' (the HGB dates from 1897 – the term refers to the employer), do business in the employer's branch on his own account or in the interest of a third party. Certain business activities outside the employer's branch are thus allowed even without the employer's consent provided that secondary employment is not inadmissible for further reasons. The other prohibition contained in Section 60 HGB, i.e. to operate a commercial enterprise, can – pursuant to a judgment by the BAG (January 16th 1975 – BB 1975, 1018) – only remain unchallenged by the Basic Law if the provision is interpreted restrictively. The operation of a commercial enterprise in the employer's branch therefore presents a danger to the employer's competitiveness. In the event of a violation of the prohibition of competition the employer may – depending on the individual case – dismiss the employee and claim damages. Instead of claiming damages he may also take over the contracts which the employee has concluded (Section 61 HGB).

Upon termination of the labour contract the employee's obligation towards his previous employer, i.e. not to enter into competition with him, as a rule, also ends. Special agreement must be reached if another provision is to apply. However, statuary and case law alike restrict such agreed prohibitions of competition which are to apply after termination of the labour contract. The statuary restrictions which in the past only applied to commercial employees and – in a slightly different form – to technical employees (Section 110 Industrial Code – 'Gewerbeordnung' (GewO)) have been declared as generally binding for all employees by the BAG (judgment of September 13th, 1969 – DB 1970, 396). After this decision, legal provisions for non-competition clauses have not been changed by business law in the past few years.

Non-competition clauses are regulated for all employees by Section 74 ff. HGB (in conjunction with Section 110 GewO). Section 74 ff. HGB is based on a legal amendment from 1914 and has not been significantly changed since then.

The contractual agreement of a non-competition clause is generally allowed. Section 74 ff. HGB standardizes limits for those clauses. The content of the non-competition clauses result from the contractual agreement of the parties. It is permitted to agree that employees cannot carry out a certain type of work or work for certain enterprises. The non-competition clause must be agreed to in writing and a document that contains the agreed rules of the prohibition of competition is submitted to the employee. If this formality is not observed the clause is null and void.

According to Section 74 (2) HGB a contractual non-competition clause is only binding when it includes compensation. In every year of the ban, the employer has to pay the employee at least half of what he was most recently paid for his contracted services, i.e. all of his salary and bonuses. The compensation, also called compensation for restraint of competition, is to be paid monthly (Section 74 b (1) HGB). The employee must deduct other wages or salaries from this sum. This is only the case if the compensation and the wages earned from the other work exceed 110% of the previous income. If the employee was required to move due to the non-competition clause, the limit is 125% (Section 74 c (1) HGB). If there is no compensation, the non-competition clause is null and void. If the compensation is too low, the clause is not binding. The employee can then decide if he wants to accept the lower level of compensation and remain bound to the clause, or be released from it.

The non-competition clause is also not binding unless it serves a justified business interest of the employer or if it exceeds the time-limit of two years (Section 74 a (1) HGB). The employer's interest alone to restrict competition is thus not sufficient. It is rather necessary that the employer has reason to fear the employee's competition because of the employee's previous job with him (e.g. a sales person knowing all the employer's traditional customers). The prohibition is also not binding if it contains – while considering the compensation granted in respect of the place, the time or the subject – an inequitable obstacle to the employee's future career (Section 74 a (1) HGB).

The parties of the labour contract can be released from a non-competition clause under certain circumstances. But, a non-competition clause would not be void automatically if the labour contract comes to an end by a dismissal of a contracting party. In general, in a case of a dismissal without prior notice the prohibition of competition becomes void if the contracting party, who declared the dismissal, declares within one month after the termination of the employment that it does not feel bound by the agreement (Section 75 (1 + 2) HGB). In cases of dismissals with notice the consequences are different: If an employee terminates his labour contract, the non-competition clause will be applied and cannot be disposed. If the employer dismisses the employee, in general, the employee – but not the employer – can release himself from the prohibition of competition. This right is exposed for the employee, if he was dismissed on the basis of a breach of duty (and contract) or for other personal reasons; in this case the employee can not release himself from a non-competition clause (Section 75 (2) HGB).

Finally, the employer can cancel the non-competition clause before the termination of the labour relationship under the condition that he pays the compensation for one year (Section 75

a HGB). In this case the employee may then enter into competition immediately following the dissolution of the working relationship.

Question 3

In general, are covenants not to compete in labour contracts enforceable in your country?

As you see above, in Germany covenants not to compete are enforceable under certain conditions and to a certain extent.

Question 4

What are the employer's protected interests and how are they defined?

The limits for non-competition clauses are defined by the interest of both parties of the labour contract.

Therefore, the only interest that can justify a prohibition of competition is the protection of a business secret or the protection of names, habits and the financial situation of the employer´s customers and suppliers (customer lists, sometimes price lists or systems of work) (judgment BAG August 1st, 1995 – AP HGB § 74 a Nr.5). The employer's interest alone – as I already mentioned – to restrict competition is not sufficient to be protected.

Furthermore you must take in consideration that the 'justified business interest' of the employer (Section § 74 a (1) HGB) is not absolute. The justified business interest depends on each individual case. For examples, the court has to prove whether or not the employer has such an interest in a special individual case: The employer – a chemical company – reconciled a non-competition clause with a sales-manager and with an engineer. Both leave the company. The sales-manager goes to a company, which produces cars, the engineer signs a contract with another chemical firm. Only in the case of the engineer, should a 'justified business interest' be acceptable.

What are the public's interest in enforcing covenants not to compete? Is this a reason for statutes and case law?

None.

The public's interest in unlimited competition does not influence the legal situation.

Question 5

If covenants not to compete are enforceable in your country: what must the plaintiff show to prove the existence of an enforceable covenant not to compete?

(a) Is a written contract required?

Yes – as I mentioned above – a non-competition clause must be agreed to in writing (signed by both contracting parties) and a document that contains the agreed rules of the prohibition of competition must be submitted to the employee (Section 74 HGB).

(b) Is a trade secret required to prove the employer's case? If so, how is a trade secret defined. Does it include customer lists, price lists, systems of work?

2 see Question 4 -

c) Does the employer need to give the employee consideration (in addition to a regular salary) as a condition for the covenant not to compete to be enforceable?

Yes, one of most important aspect for a binding contractual non-competition clause is the fixing of a compensation for the prohibition of competition. Without any compensation a non-competition clause is not binding (see Question 2).

(d) Will geographical factors, time factors and the special characteristics of an industry be considered when deciding whether to enforce a covenant not to compete?

No.

There is no statistical information available on such factors. Probably in some areas of the industry – especially in the retail trade – non-competition clauses are more widespread than in other industries, for example in the construction industry.

(e) Must the covenant not to compete meet a 'reasonable test'? If so, who has the burden of proof? How, if at all, does your case law balance between such rights as freedom of contract, property rights and freedom of occupation?

Yes – as I mentioned above – non-competition clauses are only valid by statute under certain conditions. It depends on the type of dispute, who (the employer or the employee) has the burden of proof. The employer has the burden of proof, when he sues for observing the labour contract and the non-competition clause. The employee has the burden of proof, when he sues for the compensation for restraint of competition.

(f) May the new employer be sued for employing an employee who is violating the covenant not to compete in his labour contract with the former employer? If so, in which court? Is this hearing held jointly with the suit against the employee?

Normally not. But it is conceivable that in certain cases the 'old' employer can sue – in a civil court – the 'new' employer not to take advantage of a business secret (case Lopez – Volkswagen and Opel).

(g) If the employer terminates the labour contract, is the covenant not to compete enforceable? Does it matter what the reason for the dismissal is?

3 see above – Question 2

7. If a covenant not to compete is held by a court in your country to be overly broad, will the court modify the covenant? What other flexibility do courts have relating to relief they can grant?

No, if a non-competition clause is 'overly broad' the contractual prohibition of competition is ineffective and the clause is null and void. In this case the employee can release himself from

the non-competition clause and may then enter into competition. If he will not do so, he can claim for compensation due to restraint of competition.

8. Do the courts issue preliminary (temporary) injunctions for violation of covenants not to compete in labour contracts?

Yes. The labour courts will give a temporary injunction, if the employee violates the contract and the non-competition clause. But the employer has to prove that the employee's competition is considerably disadvantageous to him.

9. What are the remedies which courts can do and grant when an employee has violated his/her covenant not to compete?

The labour court can convict the employee to pay compensation and to omit to compete. Furthermore the labour court can declare that the employee has lost his compensation of restraint of competition.

10. Which court (s) in your country have jurisdiction over legal matters relating to covenants not to compete in labour contracts?

The labour courts in general.