

## Restrictive covenants in Europe

Sarah Stanzel's and Andreas Tinhofer's article is based on a presentation, 'Restrictive covenants – cross-border aspects', to the 2010 Annual Conference of the European Employment Lawyers Association in Luxembourg in April. The presentation compared the law on restrictive covenants across Europe and revealed some interesting differences. Here, they give an insight into the relevant rules in Germany, France and Italy

### Legal restrictions

In Germany, paragraphs 74 and 75 of the commercial code regulate the question of post-termination restrictive covenants. In France, the labour code is silent on the issue and the rules are entirely derived from judicial decisions. In Italy, article 2125 of the civil code deals with the issue. In all countries, the law is further defined by numerous judicial decisions.

There are legal rules preventing competition during the employment relationship in all countries. Restrictive covenants are required only after the employment relationship has ended. All three have similar types of covenant; for example, not to compete with the former employer, not to solicit customers or staff of the former employer and not to disclose confidential information.

All countries require the employer to have a legitimate interest to protect. This is to be balanced against the employee's constitutional right to work. For instance, the covenant will usually be too wide if it would make it impossible for the employee to find a job for which he is appropriately qualified, whatever the employer's interest. There are signs in this area of employment law, as in other areas, that continental law favours employees more than English law.

All countries require the covenant to be limited in duration, geographical area and sector/activities. In all countries, the nature of the interest to be protected determines the extent of the covenant. The three countries provide a maximum duration for the covenant, though this is not the case in every EU country. In Germany and France, the maximum term is two years; in Italy it is three years for employees and five years for managers. In all countries, the law requires written form and signature for the covenant.

### Compensation

The greatest difference from the English rules is that in Germany, France and Italy – and some other but not all EU countries – the employer must pay compensation to an employee who is subject to a restrictive covenant. This is different to the English concept of 'garden leave' as compensation refers to the period following termination



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during which the employee can work for another employer, provided this does not breach the terms of the covenant.

The countries do not have compensation for every type of covenant. In Germany, all clauses with the exception of confidentiality clauses require payment of compensation. In France, only non-compete and non-solicitation of clientele clauses require payment of compensation; in Italy, only non-compete clauses.

Where there is an obligation to pay compensation, the employer must think more carefully before asking an employee to sign a contract containing a restrictive covenant. Covenants are likely to be used only for senior employees. Employers are forced to weigh up the cost of the covenant against the benefit gained from it. What will be more expensive: the covenant or the damage that the employee may potentially do to the business in the absence of a covenant? These are not usual considerations in England.

The countries have different provisions on the amount of compensation required. In Germany, compensation must be at least 50 per cent of the employee's most recent salary. Non-cash benefits are taken into account in the calculation; for instance, the use of a company car or mobile telephone. If during the currency of the covenant the employee receives income from a different source, this is set off against the compensation.

Other income may be the salary from a job that does not breach the covenant or any benefit payments, such as unemployment benefit, but not the employee's pension. In certain circumstances, the employer can argue that the employee should have had an income if he had acted reasonably; for example, in accepting an appropriate job offer. The other income is set off according to a particular formula. The compensation and other income are added. If the aggregate is

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at least 110 per cent of the employee's salary before termination, the amount that exceeds 110 per cent is deducted from the compensation. The duty to pay compensation applies where the employee is incapable of working due to illness or where he has retired (although it can be agreed by contract that the covenant shall lapse on retirement).

In France, compensation is usually between 33 and 50 per cent of salary. Italian law requires the amount of compensation to be 'appropriate', which is assessed according to the circumstances of the case. Appropriate compensation is usually in the region of 15 to 25 per cent. Neither country has provisions on set-off.

### Termination

The different countries make it more or less difficult to 'get out of' the covenant. In Germany, the circumstances in which employment is terminated may give one of the parties a choice over whether to be bound by the covenant. For instance, the employee has this choice over where he terminates the contract of employment by reason of a breach of contract by the employer. If he chooses to be bound he will be in receipt of compensation for a certain period; if he does not, he can take up a job offer from a competitor straight away.

His choice will depend on his particular circumstances at the relevant time. He has the same choice where the employer terminates the contract, unless termination is for a reason connected with the employee's conduct or capability. Where termination is for an economic reason, the employee may not exercise his choice if the employer is prepared to pay the employee's full salary during the currency of the covenant. It follows that in a redundancy case, the amount of compensation for the covenant is the employee's full salary. In another scenario, the employer has a choice of whether to be bound by the covenant, namely where he terminates the contract of employment by reason of a breach of contract by the employee. Now he can choose between paying compensation or allowing the employee to compete with him.

The situation in France and Italy is quite different. The covenant remains in force whichever party terminated the contract of employment and for whatever reason the contract was terminated. All countries permit termination of the covenant by agreement; for example, by entering into a compromise agreement on termination of employment. In the countries under consideration, this presents difficulties that are not usually encountered in England, as the employee who agrees to revoke the covenant will lose his right to

compensation and so has to balance the advantages and disadvantages of agreeing. In all countries, the employee loses the entitlement to compensation if he breaches the terms of the covenant.

### Waiver

In certain circumstances, the employer can avoid paying compensation by waiving the covenant. In Germany, the employer can waive the covenant in writing provided he does so before the termination of employment. The effect of waiver is that the employee is free to compete with the former employer immediately. However, the employer will be bound by the duty to pay compensation for one year from the date of the waiver. Where the waiver occurs shortly before termination, the employer may have to pay compensation without obtaining the counterpart of protection from competition. During the course of employment, the employer must constantly weigh up whether the covenant is still necessary as it risks becoming more onerous for himself than for the employee. While the employer must pay compensation, the employee may have no chance or intention of competing with him.

French law requires a contractual clause allowing the employer to waive the covenant unilaterally. In the absence of such a clause, the employee's agreement to the waiver is required. Usually, a waiver must occur within either the period provided by the contract (or collective agreement) or within a reasonable period from termination. Unlike in Germany, the duty to pay compensation will cease immediately. In Italy, on the other hand, it is not possible for the contract to allow a unilateral waiver of the covenant. The agreement of the employee is required in all circumstances.

Clearly, due to the existence of compensation in the countries under consideration, there are likely to be disputes about issues that English lawyers do not usually encounter.

### Penalty clause

All three countries permit clauses providing for a penalty in case of breach of the covenant by the employee. It is easier than in England to include such clauses, so on this issue the continental rules are favourable to employers. In the event that the amount of the penalty is deemed too high, the court has power to adjust it.

In Germany, the amount of the penalty must be 'appropriate' in all circumstances. The usual amount is in the region of one month's salary. In France, the amount of the penalty must not be 'derisory'. However, in the event of a dispute, if the court considers the amount to be 'derisory', it may increase it. In

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Italy, it is quite usual for the contract to provide for a penalty that is double or triple the amount of compensation that the employer must pay.

### **Effect of non-compliance with legal restrictions**

In this area, the rules are also quite different to the English ones. A number of ways of dealing with non-compliance are available. The exact effect of non-compliance depends on the form that non-compliance takes in a particular case. The different approaches might lead English lawyers to consider whether there are useful alternatives to the current rules in English law.

In Germany, the covenant is void in the following circumstances: (i) it is not in written form; (ii) there is no provision for compensation; or (iii) the employee is below the age of 18. In other cases, the covenant will be 'non-binding' on the employee, giving the employee a choice of whether to be bound by it.

This is the case where (i) the employer does not have a legitimate interest to protect; (ii) there is provision for compensation but compensation is too low, ie not at least 50 per cent of former salary; or (iii) the covenant is subject to conditions. In yet other circumstances, only part of the covenant will be non-binding on the employee, ie only the part that does not comply with the legal restrictions. For instance, the covenant may contain a provision seeking to prevent the employee from working in a certain sector or for a certain company. Where that provision is deemed excessive with regard to the interest to be protected, only the particular provision will be non-binding while the rest of the covenant remains in force. It should be noted that where the covenant provides for a duration in excess of the legal maximum of two years, the duration is automatically reduced to two years, by operation of law.

In France, the covenant is void where (i) there is no provision for compensation; (ii) there is provision for compensation but

compensation is 'derisory'; or (iii) the employer does not have a legitimate interest to protect. In certain circumstances, the court has power to modify the terms of the covenant in order to render it proportionate to the employer's interest. This is the case where the covenant is deemed to be excessive in terms of geographical area or duration or amount of compensation.

It follows that in France, where a covenant seeks to restrain competitive activities within a radius of 50km but the employer has customers only within a radius of 25km, the court can reduce the geographical area of the covenant and uphold it in the modified form. The court will take the view that the employer has a legitimate interest to protect within a 25km radius but not within a 50km radius. In England, in the same scenario, the covenant would be unenforceable even though the employer may well have a legitimate interest to protect within the smaller area.

In Italy, the covenant is void where (i) it is not in written form; (ii) it is deemed excessive in terms of geographical area or sector/activities; or (iii) its duration exceeds the legal maximum of three years for employees and five years for managers. Where the covenant contains a provision allowing the employer to waive the covenant unilaterally, only that provision is void while the rest of the covenant remains in force.

### **Conclusion**

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