

10 pitfalls when entering into a post-contractual non-compete covenant under German law

During the term of employment, the duty of loyalty prohibits the employee from, among other things, exercising or engaging in any activity, which competes with that of the employer.

However, upon termination of employment, the employee is generally free to work in any activity, even a competing one, unless the employee is subject to an employment-based non-competition agreement. While in some states of the US, especially in California, non-compete agreements are prohibited, in Germany an employment-based post-contractual non-competition agreement is allowed if certain requirements are met as outlined below. Adhering to such requirements is crucial, as the consequence of non-adherence are severe for the company.

1 Form Requirement

Post-contractual non-compete covenants must be in writing and signed with a wet-signature by both parties. If not, they are null and void. As such, no electronic signature, such as through DocuSign, is permitted. If the employment contract has been validly electronically signed, the post-contractual non-compete covenant should be signed as an addendum with wet-signature.

2 Prohibited Activity

A post-contractual non-compete covenant must be reasonable and can only be agreed to protect the legitimate interests of the company. In order to be valid and enforceable it is key to specify the restricted area. Usually, this is the company's area of operation (scope of business and/or employees' area of work).

3 Geographical Scope

The geographical scope needs also to be limited to the company's area of operation in order to justify legitimate interests. The justification of a worldwide post-contractual non-compete covenant would require that the company has substantial business worldwide. This is usually impossible to argue.

4 Duration

A post-contractual non-compete covenant can only be agreed for a maximum period of up to two years after the termination of the employment relationship. If this period is exceeded, the post-contractual non-compete covenant is non-binding and the employee will have the choice between continuing to comply with the covenant and receiving the compensation or starting to compete. Usually, one agrees to 6 – 12 months.

5 Compensation

The post-contractual non-compete covenant is only valid and enforceable if a compensation payment of at least 50% of the formerly received contractual remuneration is agreed. Besides the base salary, all variable payments and also any benefits in kind (e.g. a company car) have to be taken into account. Payments are usually made in monthly instalments during the period of the post-contractual non-compete covenant.

6 Group of employees has to be specified

A post-contractual non-compete covenant can generally be entered into with every employee regardless of their level within the hierarchy of the company. However, in most cases, such a covenant only makes commercial sense (due to the compensation) for more senior employees, who have gained certain knowledge that might be harmful if used by competitors. Regular employees most likely are in no position to compete.

7 Reservation/Conditions for effectiveness

The reservation of the employer to decide later, whether parties enter into a post-contractual non-compete covenant or not, is invalid. However, parties can agree that the post-contractual non-compete covenant does commence if employment relationship ends during a probationary period. It is important to agree on the relevant terms, however.

8 Possibility to withdraw

A unilateral waiver of the post-contractual non-compete covenant is only possible prior to the end of the employment relationship. This has to be declared in written form. If done so, the company is free from the payment-obligation after one year (so called grace-period). Thus, this option only makes sense if the post-contractual non-compete time period (which starts with end of employment relationship) exceeds the grace period. Of course, the parties are always free to waive the post-contractual non-compete covenant by mutual consent. However, most employees seek financial compensation for doing so.

9 Right of the Employer in case of breach

If the employee breaches his post-contractual non-compete duties the employer

- can claim for damages from the employee,
- file an injunction to hinder the employee for further competition activities and
- stop paying the compensation payments and claim back already paid instalments.

However, it is almost impossible and subject to time-consuming and costly litigation to prove such breaches. Thus, it is always the better option to include a contractual penalty clause for such breaches in the post-contractual non-compete covenant.

10 Non-compete covenants with legal representatives

The strict rules do not apply for managing directors or board members to the same extent, as they are not considered employees under German law. However, German courts have developed case law which states that a post-contractual non-compete covenant is only justified if it also protects a legitimate interest of the company and does not hinder the legal representatives in their further career development. Whilst it is not clear whether a compensation payment is required, it is always recommended to include such a compensation clause in order to be on the safe side.

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