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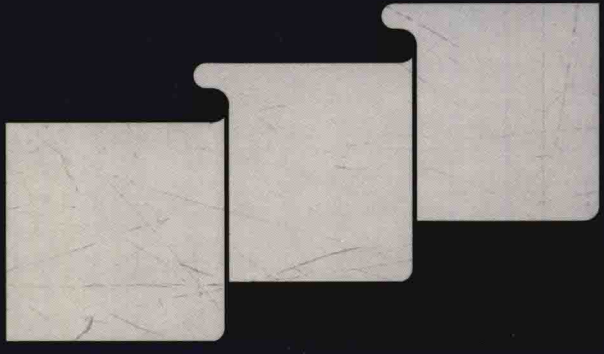
POST-EMPLOYMENT COVENANTS IN EMPLOYMENT RELATIONSHIPS



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Post-Employment Covenants in Employment Relationships

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Editor's Note

This edition of the Comparative Law Yearbook of International Business surveys issues involved in post-employment employer-employee relations and the ability of employers to control the conduct of a former employee.

The survey's introductory chapter provides a general review of issues in the context of multiple jurisdictions, followed by country-by-country analyses of 17 jurisdictions, encompassing reports on Argentina, Belgium, Canada, China, Germany, Gibraltar, Hungary, Iran, Italy, Japan, Luxembourg, Mexico, The Netherlands, New Zealand, the Slovak Republic, Switzerland, and the United Kingdom.

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Introduction

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Setting

Imagine, somewhere in the world, that a key employee of a United States-based multinational — an executive or a technical expert or sales star — defects, joins a competitor, and starts openly competing, divulging trade secrets, and luring away former colleagues and customers. Laws on the books in many countries ostensibly protect trade secrets and require employee loyalty, but often those laws reach only currently working employees.[1]

Savvy employers prefer not to have to rely on these employee loyalty or trade secrets statutes to arm them with powerful enough ammunition to stop former employees from sabotaging their business. Rather, to protect themselves, multinationals resort to self-help, binding key employees around the world to restrictive covenants — non-compete covenants, confidentiality and trade secrets restrictions, and non-solicitation, non-poaching, and "non-dealing" agreements that prohibit poaching customers and co-workers. However, a restrictive covenant that an employee knows to be unenforceable is worthless. And some jurisdictions impose fines merely for executing an illegal restrictive covenant.

Restrictive covenant enforceability standards vary widely from country to country, as every jurisdiction struggles to balance the competing interests inherent in enforcing these agreements. Different jurisdictions balance the competing interests in very different ways.

What are the competing interests here? For an employer, restrictive covenants make good business sense because they help insulate a

1 Argentine Labor Contract Law Number 20, 744, Section 88; Austrian Employment Act, Sections 7 and 36; Bulgarian Labor Code, Article 111.

business from competition, data leaks, corporate espionage, and customer/employee poaching. For an employee, restrictive covenants can look like handcuffs restraining the freedom to find and succeed in a new job.

Another interest in the mix is that restraint on trade and employment-context restrictive covenants can raise antitrust and competition law issues. Society, acting through law and courts in each jurisdiction, balances these interests, recognizing on one hand that, yes, employers need to protect their businesses and individuals should follow commitments they contracted to uphold. However, on the other hand, society has an interest in freeing up the newly unemployed to use their skills to earn a living and contribute to the economy while staying off the rolls of the unemployed. Society also has an interest in fostering free trade.

With each jurisdiction balancing these interests in its own particular way, a multinational operating internationally confronts a panoply of restrictive covenant enforceability standards across its worldwide operations. From a global operations perspective, accounting for so many rules is daunting.

Fortunately, determining which jurisdiction's law governs the most common type of restrictive covenant — the "plain vanilla", single-jurisdiction covenant — is easy. One-country covenants need only meet the enforceability rules of a single jurisdiction — the place where the employee works, where the covenant restricts competing, disclosing secrets, and poaching, where any covenanted choice-of-law clause selects as operative law, and where some alleged violation ultimately occurs.

When all those places are the same place, the employer faces no conflict-of-law analysis and enforceability is a simple question of whether the covenant conforms to the host jurisdiction's domestic law and public policy, its so-called "mandatory rules". The more complex scenario, obviously, is a crossborder restrictive covenant that implicates two or more jurisdictions' laws and thus triggers a conflict-of-laws problem — how to resolve competing public policies and competing "mandatory rules". Here, to analyze restrictive covenants in a foreign jurisdiction, the first section of this chapter addresses "plain vanilla" single-jurisdiction covenants in many countries. The second section will consider the conflict-of-law issue inherent in crossborder restrictive covenants.

Non-Competes and Other Restrictive Covenants

In General

Courts in every country tend to be reluctant to force former employees to heed non-compete, confidentiality and trade secret, and non-solicitation restrictions buried in a prior employer's low-touch human resources policy, company rules, code of conduct, or employee handbook. A restrictive covenant, to be restrictive, needs to be a covenant.

For a restriction to be enforceable after an employee leaves the workplace, the ex-employee should have, at some point, contractually bound himself to it. However, even where a former employee has signed a restrictive covenant, local courts will not necessarily enforce it. Enforceability in each jurisdiction turns on a number of local legal and public policy standards. A multinational that imposes restrictive covenants on its staff needs a strategy to enhance enforceability in each relevant jurisdiction.

In a number of jurisdictions, including Chile, India, Russia, Mexico, Vietnam, and the United States states of California and North Dakota, post-employment non-compete covenants — but not necessarily other restrictive covenants or sale-of-a-business-context non-compete covenants — are, for the most part, void.

In a handful of jurisdictions, other types of restrictive covenants may not be enforceable; for example, post-employment non-solicitation agreements that prohibit poaching customers and co-workers are void in Russia and disfavored in Hong Kong. A restrictive covenant analysis should begin by determine whether a proposed covenant is viable in the relevant jurisdiction.[2]

Determining Viability

In General

The most fundamental strategy for drafting a "plain vanilla" single-jurisdiction restrictive covenant is to start with a locally tailored form. The best single-jurisdiction restrictive covenants are always organic

2 Good starting points for researching restrictive covenants abroad include Lazar and Siniscalco, "Restrictive Covenants and Trade Secrets in Employment Law" (2 Volumes) *ABA/BNA*, 2010 and Supplement; Lagesse and Norrbom, *Restrictive Covenants in Employment Contracts and Other Mechanisms for Protection of Corporate Confidential Information*, 2006; Ius Laboris, *Non-Compete Clauses: An International Guide*, 2010.

local ones, and the worst are always those thoughtlessly transplanted from abroad.

In the single-jurisdiction context where the employee gets hired, works and, after separating, remains in a single jurisdiction (and where any covenanted choice-of-law clause invokes that same jurisdiction's law), restrictive covenant enforceability analysis is a straightforward matter of "coloring within the lines", adhering to the strictures of what the host jurisdiction requires.

Because enforceability rules differ markedly across jurisdictions, restrictive covenant boilerplate perfectly appropriate for one place will not necessarily be enforceable even in a neighboring jurisdiction. A non-compete form that works in Arizona may contain provisions void in California and Mexico; a viable English form may omit clauses necessary in France and Belgium.

After selecting the proper restrictive covenant form, a covenant should be tailored for the specific situation. Even within a given country, one form, unchanged, will not work in all situations. What was appropriate for the last employee may need tweaking for another. What works for an executive will not likely work for a secretary. When tailoring a new restrictive covenant — or, for that matter, when seeking to enforce an existing covenant against an ex-employee who might now be flouting it — one must analyze the relevant legal system's position on seven core issues, namely:

(1) Public policy;
(2) Consideration;
(3) Garden leave;
(4) Remedies;
(5) Competition and antitrust;
(6) Red/blue pencil clauses; and
(7) Unusual local constraints.

Public Policy

In General To be enforceable, a restrictive covenant must conform to the relevant jurisdiction's public policy — the society's unique balance of competing interests inherent in enforcing a restrictive covenant. Even if both parties freely agree to restrictions that violate so-called local "mandatory rules", local courts will void the parties' arrangement as unenforceable because it offends local public policy.

For example, Austria, the Czech Republic, and (in most cases) England treat non-compete covenants running more than one year after employment as *per se* unreasonable. Local courts in those jurisdictions,

therefore, will refuse to enforce any three-year non-compete covenant, no matter how artfully articulated or how freely and unambiguously agreed. The rationale of the courts here parallels the reason why courts reject contracts executed by children, contracts for the sale of heroin, and contracts for prostitution: Contractual arrangements that violate statutes or offend public policy are void no matter how clearly and willingly parties themselves agree to comply.

In every jurisdiction that enforces these restrictions, it is easy to craft a compliant and enforceable covenant. However, employers want more than more enforceability. An obviously enforceable covenant is usually too anemic. A twenty-day non-compete covenant limited to a four-block radius may be unquestionably enforceable as to time and territory, but its restriction is worthless to the employer. Employers prefer restrictive covenants that push the margins of what local jurisdictions accept.

In assessing whether a given covenant meets a jurisdiction's public policy, look to what that jurisdiction deems "reasonable". Courts usually require that post-term restrictions be "commercially reasonable". In the words of the French Labor Code (Article L. 1121-1), a restriction must be "justified by the nature of the job . . . and proportionate to the goal sought".

"Reasonableness" is a local analysis; a scenario that one jurisdiction accepts as reasonable can, in another, be unacceptable. Within a single jurisdiction, "reasonableness" analysis differs from case to case. A long, global non-compete clause reasonable for a senior executive will be held unreasonable for his secretary. In assessing what is commercially reasonable, courts the world over tend to scrutinize the same pool of four core "reasonableness" criteria, namely:

(1) Duration;
(2) Geographic footprint;
(3) Industry; and
(4) Reason for leaving.

Duration Where restrictive covenants are allowed at all, public policy voids as unreasonable employment-context covenants that run too long after employment. How long is too long?

In the post-employment context, twenty years is always too long and twenty days is never too long. Where to draw the line between those extremes depends on two issues:

(1) Local law; and
(2) Specific employee situation.

As to local law, most states in the United States accept at least some employment-context non-compete covenants of two or more years, but English courts have been reluctant to enforce employment-context non-compete covenants beyond six months, with only a handful of cases accepting beyond one year. Venezuela imposes a statutory cap of six months after employment; Austria, the Czech Republic, and Slovakia impose statutory caps of one year; and China, Germany, Portugal, Saudi Arabia, Spain, and Sweden impose caps of two years. As caps, these are outside parameters; thus, the focus becomes the specific employee situation.

Geographic Footprint Where restrictive covenants are allowed, law almost everywhere voids, as unreasonable, covenants, particularly non-compete covenants, that stretch across too large a territory. How big is too big? This analysis depends on the two issues of local law and specific employee situation. As to local law, smaller jurisdictions like Singapore and (to a lesser extent) Hong Kong frown on non-compete covenants confined even to a city, whereas larger jurisdictions like many states of the United States sometimes accommodate even global restrictions.

However, jurisdiction size is not always determinative. Argentina, for example, questions the enforceability of non-compete covenants with a footprint bigger than the country (but case law there continues to evolve). As to specific employee situations, within any one jurisdiction, the reasonableness of a given covenant's footprint turns on the facts. A senior executive with global responsibilities always supports a larger restricted territory than a hairdresser drawing customers from a single neighborhood.

Industry Where restrictive covenants are allowed, law in perhaps every jurisdiction will void covenants — particularly customer poaching prohibitions and non-compete covenants — unless they delimit a reasonably restricted industry, sometimes referred to as the covenant's "scope", "subject matter", or "field of activity".

Attempting to stop an ex-employee from taking any job for any employer or from launching a business in any industry whatsoever is impossible to justify as commercially reasonable, even in the sale-of-a-business context. What legitimate business interest does a technology company or auto-parts maker have in stopping former engineers from working as fitness trainers or from joining the priesthood? What legitimate business interest does a bank or accounting

firm have in stopping former financial managers from soliciting customers to buy Amway products or to donate to animal shelters?

To enhance reasonableness and enforceability, always limit non-compete clauses and customer poaching restrictions to the narrowest possible industry scope. For example, a scope defined as "consultants" or even "compensation consultants" may be too broad; better would be "board of director compensation consultants". A scope defined as "fund managers" or even "hedge fund managers" may be too broad; better would be "distressed-asset hedge fund managers" to tailor the restriction to a list of named competitors.

Reason for Leaving Courts rarely include "reason for leaving" among the elements they say they account for when assessing the commercial reasonableness of a post-term restrictive covenant but, in practice, this can be the most vital factor in determining outcomes of non-compete and customer poaching litigation.

Courts are far more comfortable enforcing post-term restrictive covenants against quitters than against victims of no-cause firings. In jurisdictions such as Austria, Turkey, and The Netherlands, non-compete covenants are flatly unenforceable against employees fired without cause or at least against those fired wrongfully. In the United States, having been fired "will, at least to some degree, compromise enforceability" of a restrictive covenant in "New York", "Pennsylvania", and beyond.[3] The same can be said for China and many other countries.

Consideration

In General Many jurisdictions refuse to enforce an otherwise commercially reasonable restrictive covenant unless it is supported by adequate "consideration", something of value one party gives up in exchange for the other party's commitment to do or refrain from doing something.

In the international context of restrictive covenants, consideration requirements break down into two very different, but frequently confused, categories: contractual consideration and "staying-out-of-the-game" compensation.

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3 Woolf and Furlane, "The Fired Employee's Non-Compete Agreement", *Lexology*, 22 December 2011.

Contractual Consideration Common Law jurisdictions require that a binding contract or covenant, even if signed by both parties, be supported by three elements, namely:

(1) Offer;
(2) Acceptance; and
(3) Consideration.

Under Common Law contract analysis, one party's offer and another party's acceptance, without consideration, merely creates an unenforceable promise.

Sometimes, employment itself, be it a paid job for a new hire or continued work for a current employee, can count as enough consideration to support a covenant, but some jurisdictions require consideration other than the job, on the theory that the job already acts as consideration for wages received.

Earmarked restrictive covenant consideration is particularly likely to be necessary where current staff (as opposed to new hires) sign restrictive covenants after already having started work. Where parties designate a pay raise or bonus as restrictive covenant consideration, employers might accommodate the requirement for earmarked restrictive covenant consideration simply by relabeling compensation. For example, for every $1,000 the employer was prepared to pay in extra wages, the parties might label $800 as "salary" or "bonus" and designate the other $200 as "restrictive covenant consideration".

"Staying-out-of-Game" Compensation Common Law jurisdictions tend to require contractual consideration to make a promise binding as a contract. Civil Law countries, by contrast, tend not to require contractual consideration where both parties freely and unambiguously execute a covenant. Instead, a number of civil law jurisdictions require much more expensive "staying-out-of-the-game" compensation, mandated to help employees make ends meet during a post-term restrictive covenant period.

Civil law systems from Argentina and Brazil to China, the Czech Republic, France, Germany, Hungary, Italy, Poland, Sweden, Taiwan, and Venezuela explicitly or implicitly require payment of compensation to ex-employees for their post-term non-compete covenants to be binding in court.

The idea is to compensate the employee for "staying out of the game", refraining from competing, and perhaps remaining under-employed during the non-compete term. If the legal system is to enforce a business's contractual power to keep an ex-employee idle and out of the

workforce, the jurisdiction requires the business to support its former employee. The idea is perhaps similar to requiring child support in a divorce. Just as an absentee parent who no longer provides a home for a dependent child needs to pay support, so do employers that no longer provide a job but seek to enforce covenants that keep ex-employees underemployed and dependent.

Staying-out-of-the-game compensation sometimes makes sense to offer even in jurisdictions where it is not mandatory. In doing a "commercial reasonableness" analysis, jurisdictions such as Australia that do not flatly require this compensation but nevertheless view it as supporting the reasonableness of a post-term restriction.

Jurisdictions such as Italy let employers pay staying-out-of-the-game compensation during employment, paying in advance for the non-compete covenant to become binding later, upon separation. Presumably, the employee banks the earmarked extra compensation to spend during the post-term non-compete period. Employers might meet this requirement without spending extra money if they pay the mandated restrictive covenant compensation with regular payroll, earmarked and labeled as restrictive covenant compensation, but in an amount by which they reduce the employee's base pay or bonus. Examples of jurisdictions that require non-compete "staying-out-of-the-game" compensation include:

(1) Argentina and Brazil — Right-to-work provisions in the Argentine and Brazilian constitutions cast a long shadow over the enforceability of post-term restrictive covenants. Restrictive covenant law in both countries is underdeveloped, but neither seems to interpret its constitutional right-to-work provision as strictly as do Mexico and Chile, banning non-compete covenants entirely. Rather, the prevailing view in Argentina and Brazil is that post-term non-compete covenants are unconstitutional unless the employer pays enough to assuage the constitutional concern. Compensation amounts, although not fixed, may need to be approximately 50 to 60 per cent of final average pay. These payments might possibly be structured as earmarked money paid during employment, and thus perhaps the compensation may not have to be tendered over the post-term non-compete period.

(2) China — China's Labor Contract Law (Article 23) requires employers to pay post-term non-compete compensation monthly during the post-term period. However, that law offers no guidance as to how much to pay. Since 2009, municipalities from