SUMMARY

2016/27 Employers must compensate employees separately for restricting their right to work for others, not only after, but also during their employment (LI)

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Following the latest case law of the Supreme Court of Lithuania, it is not enough to state that an employee cannot work for a competitor during their employment. It is necessary to pay compensation in order for the non-compete obligation to be legally enforceable, because of the onerous nature of the obligation.

Facts

The employee in this case was dismissed because he had used his company car on behalf of his wife's employer. This was in breach of his contract, which (a) required him to devote all his working time to his employer, (b) prohibited him from performing work for any one other than his employer during working hours and (c) prohibited him from performing work, directly or indirectly, for third parties without his employer's permission. The court of first and second instance held that, although the employee had breached provisions (a) and (b), the breach was insufficiently serious to justify dismissal. They declared the dismissal to be invalid.

The employer appealed to the Supreme Court.

Judgment

The Supreme Court upheld the lower courts' decision.

With regard to provision (c), the Supreme Court started by reiterating its existing doctrine that the parties to an employment contract may enter into a non-compete agreement that is effective both during employment and afterwards. The Supreme Court stressed that a non-compete agreement restricts the constitutional right of an employee to choose a job, and therefore the restriction must be limited in time and adequate compensation must be paid.

The Supreme Court disagreed with the employer's interpretation of its doctrine, being that compensation in consideration of a non-compete obligation is required only inasmuch as the employee's freedom is restricted after termination of the contract, and that compensation is therefore not necessary for restricting competition during employment. By contrast, the court emphasized that the amount and purpose of non-compete compensation must be clearly specified and distinguished from other payments and it must be paid to employees even during their employment.

On these grounds the Supreme Court affirmed the lower courts' decision that the dismissal was unlawful. It ruled that in the absence of compensation, a non-compete clause in an employment contract is contrary to law and therefore void.

Commentary

Non-compete agreements are not regulated by statute in Lithuania. The rules governing such agreements are entirely judge-made. Previously, the Supreme Court had clarified that a former employee must be paid compensation if the former employer is to be able to enforce a contractual non-compete obligation. The judgment reported above has made it clear that such compensation must be paid during the employment as well as following termination. In a way, this is a little strange, because the Labour Code of Lithuania requires both employers and employees to comply with the law, respect the rules of communal life, act in good faith and adhere to the principles of reasonableness, equity and fairness. One would think that not competing against one's employer would be covered by these general obligations. Further, employees are under an obligation not to act in a way that could damage the employer's interests.

In practice, most companies have employment contracts or policies which prohibit employees from working for competitors or being engaged in the same activity as their employer during

employment. However, separate compensation for this is not paid, the idea being that the salary paid to the employee covers this, in other words it is deemed adequate consideration for the non-compete agreement. Following this judgment, the message to business seems to be that employers must clearly provide for non-compete compensation either in the employment contract or in a separate non-compete agreement in order to protect the business from unfair competition. Failing this, the employer may have a non-compete clause that is unenforceable.

On the other hand, a well-drafted non-compete agreement with clearly distinguished consideration could prove harm has been caused following a breach. If it is hard to assess damage meaningfully, a claim for unfair competition may be refused by the court – or the employer may simply not think it is worth making a claim. But an employer's investment in its employees, commercial relations, trade secrets and confidential information is too valuable to leave exposed to unfair competition.

There is also a practical difficulty. Lithuanian law does not allow employers to amend terms of employment unilaterally. Many employers will likely want to do just that in order to be able to enforce 'during employment' non-compete clauses in their employment contracts. This means that they will have to ask each individual employee to sign a new contract or an amendment to their contract. Will all employees agreed to do so? And how much should the compensation be? Some employees may be tempted to draw a parallel with compensation for non-compete agreements that apply after termination of the contract. Such compensation varies widely, but is rarely below 20% of last-earned salary for as long as the employer wishes to enforce the non-compete clause. It is hard to imagine employers either offering their staff a 20% pay raise or accepting that their non-compete clauses are unenforceable. There may well be employers who propose something like the follow: your current salary is 100, so let's amend it to state that your salary from now on is 80 and that you will be paid a monthly bonus of 20 in consideration of your non-compete obligation. Of course, it is far from certain that such an attempt would survive a legal challenge.

On 24 March 2016, the Supreme Court delivered a similar judgment to the one described here – indicating just how seriously it takes the need to compensate employees for restricting their constitutional freedom to choose a job.

Comments from other jurisdictions

Croatia (Dina Vlahov Buhin, Schoenherr): In contrast to Lithuanian law, the Croatian Labour Act provides that a non-compete obligation exists ex lege during the employment relationship. According to this Act, an employee must not, during employment, on his own account or for the account of third parties, enter into business transactions in the field of employer's

business activity without the employer's consent (statutory non-compete obligation). Violation of this prohibition represents a severe breach of employment obligations and is a valid reason for extraordinary dismissal (Supreme court Revr-1024/12-2 of 19 March 2013).

However, the issue arises as to how to assess whether the employee has entered into the field of the employer's business activity. According to Croatian jurisprudence, the statutory non-compete obligation relates to the performance of the same or substantially the same business the employer is engaged in, and must be assessed on a case by case basis.

Besides the statutory non-competition obligation, the employer and the employee may also agree (in the form of a separate contract or as a part of the employment contract) that the employee shall not, after termination of the employment relationship, work as an employee for a competitor of the employer or enter into business transactions on his own account or for the account of third parties regarded as the employer's competitors (contractual non-compete obligation). Such an obligation may not last longer than two years after termination of the employment agreement, during which time the employer undertakes to compensate for adhering to the obligation to the tune of at least half of the average salary paid to the employee in the three months prior to termination of the employment contract.

Therefore, under Croatian law, payment of compensation for restricting competition is not regulated during employment, but only after termination of the employment contract. This approach, from our point of view, seems reasonable, as it allows the employer to protect its justified interests (e.g. in terms of business secrets, information on business partners and market conditions).

Czech Republic (Nataša Randlová, Randl Partners): The freedom to choose a job is, in my opinion, an important basic human right which must be taken seriously. However, this right should guarantee to each individual the freedom to decide whether he or she will be employed or will run their own business and freedom to choose the employer or business in which to operate. When the individual decides to be employed, he or she should be free to decide to terminate the employment and find other employer or start a business. However, the employment relationship itself limits the employee – because of the notice period, a change of employer usually cannot be immediate and working hours limits the to what extent an individual can work for more than one employer. An essential element of the employment relationship is also the obligation not to act contrary to the employer's interests. In my view, this should include an obligation not to compete with the employer. Reimbursement for all these limitations should be included in the salary – and salary is usually one of the most important factors that the employee considers when choosing a job.

In the Czech Republic, a non-compete obligation is imposed on employees directly by the Labour Code during employment and they are not entitled to any compensation for complying with this obligation. On the contrary, breach of this obligation is considered to be a breach of the employee's duties and can lead even to termination of employment.

Finland (Kaj Swanljung and Janne Nurminen, Roschier): There is a clear distinction between competing employment and (other) secondary employment in Finland. The Finnish Employment Contracts Act explicitly prohibits employees from engaging in, or even preparing for, competing activity that would harm their employer. Even without such an explicit prohibition, the non-compete obligation derives from the employee's duty of loyalty. Since an employee has by law an obligation not to compete during the employment, compensation for a non-compete obligation can be considered to be part of salary. In comparison, if a post-employment non-compete obligation is agreed upon, the employer is only obliged to pay compensation to the employee if the restriction exceeds six months after the employment has ended. However, a clause that would prohibit secondary employment in general could be considered invalid or at least unenforceable if the employee was able to perform his or her duties irrespective of the secondary employment without violating the duty of loyalty.

Romania (Andreea Suciu, Noerr): In my view, the obligation not to compete with an employer is not only one of the most essential obligations on an employee, but of the utmost importance, as it ensures the proper development of employment relations. It is the personal character (intuitu personae) of an employment relationship as well as the mutual trust between the parties that makes the duty on every employee not to compete with the employer an absolute obligation.If an employee sets up a competing business based on know-how acquired during employment, in a way which competes with the current employer, is regarded as lawful unless the employee has been paid to refrain from doing this. I have encountered countless cases practice in which employees have set up competing businesses without the employer even being able to prove the employee's involvement in the business, often because of ruses such as appointing third persons as shareholders or managing directors. Moreover, the harm caused to employers by employees breaching their non-compete obligations is often difficult to quantify in practice.

Further, a code of conduct highlighting the employee's obligation to declare and avoid conflicts of interests – which is an increasingly popular device – is useless, unless each and every employee is paid compensation.

Nevertheless, a proposal to amend Romanian Labour Law is currently being assessed by Parliament. Although the proposal was issued last year, the chances of it being passed this year quite rather low. The draft law expressly proposes an amendment to the non-compete

obligation on employees during the period of the employment contract provided the parties agree on compensation to be paid to the employee. Efforts have been made by employers' associations and chambers of commerce to avoid this law being passed.

United Kingdom (Colin Leckey and Katie Honeyfield, Lewis Silkin): In the UK, it has never been normal, nor a legal necessity, to pay for post-employment restrictive covenants, such as non-compete, non-solicit or non-dealing clauses, during the term for which they are in force. Instead, the test has always been whether an employer can demonstrate that it had a legitimate business interest justifying the restriction. However, there has been debate about whether the UK might one day converge towards the continental norm, as seen in Lithuania, of paying for post-employment restrictions. In the recent UK case of Bartholomews Agri Food Limited v Thornton [2016] EWHC 648 (QB), the High Court confirmed that the answer remains a resounding "no". The Court ruled that payment during the restriction period did not make any difference to enforceability, stating "it is contrary to public policy in effect to permit an employer to purchase a restraint".

Nonetheless, UK employers may still want to pay for post-employment restrictive covenants in some cases because, practically, payment may make an employee more likely to comply, even if the payment is unlikely to make any legal difference if the covenants are not enforceable because they go further than is reasonably necessary to protect the employer's business interests. Additionally, employers are increasingly faced with the practical problem of cross-border competitive threats: if (say) an employer wants a court in Paris to enforce an English injunction (as opposed to simply relying on the employee's unwillingness to place himself or herself in contempt of the English court), might the employer place itself in a better position by demonstrating a willingness to pay at least the minimum levels of compensation required under French law? It's a question without a clear answer in the UK, but of increasing pertinence.

What about restrictions affecting employees during employment? Such covenants are arguably seen as unnecessary in the UK given employees' implied duty of faithful service, or fidelity, which encompasses several further important duties, such as the duty not to compete with the employer, not to entice away other employees and not to solicit clients. In this regard, UK law is similar to that contained in the Labour Code of Lithuania. Despite this, many employers will often include express provisions in the employment contract to afford them better protection. For example, employers will often stipulate that employees must devote all of their time, attention and abilities to their business and must promote, protect and further the interests of that business (which in effect, act as non-compete, non-solicit and non-dealing clauses during employment). If UK employers choose to impose these explicit restrictions they are not legally required to compensate employees above and beyond their

salary, but in all reality they may be a factor in determining the appropriate financial package.

It is worth noting that in the UK employers can achieve the same result as a restrictive covenant by invoking a garden leave clause during an employee's notice period. In this case, the individual on garden leave remains an employee and subject to all of the rights and obligations contained in their employment contract but is not required to work. The individual is therefore still bound by the duty of fidelity and by any other explicit contractual non-compete provisions that apply during employment. During garden leave, the employer continues to pay the employee's normal salary. And while the public policy arguments against restraints of trade will still be engaged if a garden leave clause is excessively long, the employer is not held to the same standard as with a post-termination covenant.

The Netherlands (Ruben Houweling, Erasmus School of Law): Dutch law makes a sharp distinction between clauses that restrict competition during employment and post-employment non-compete clauses. The latter are explicitly regulated by statutory law, whilst non-competition during the employment contract is governed by the general duty of faithful service. The duty of faithful service implies that an employee is not allowed to compete with his employer during the employment relationship (he may not start his own competing business nor enter into an employment relationship with the employer's competitor). Since statutory law does not prohibit a non-compete-clause during the employment relationship, such clauses are valid. Basically all of these clauses during the employment contract are simply governed by contract law.

Dutch jurisprudence shows that if the employee is preparing to establish a competing business while still employed, but has not yet started to actually run that business, in the absence of a clause prohibiting such preparation, a breach of non-competition or duty of faithful service has not yet been made. Much depends on how the non-compete clause is worded (for example, if the contract expressly prohibits preparation of a competing business, the court will uphold the prohibition).

Under Dutch law a (post employment) non-compete clause is only valid, if agreed (1) with an adult (18 year +) employee and (2) set out in writing. Additionally, since 1 July 2015, a non-compete clause is prohibited in temporary employment contracts, unless the employer can demonstrate that it has a legitimate business interest justifying the imposition of the restriction. A compensation during the period of non-competition is not required. However, the court has the power to order payment of compensation if it finds the non-compete clause too harsh. In practice, such compensation is seldom ordered. The main reason for this is that the court has wide discretion to (partially) mitigate the non-compete clause. This discretion is often used to mitigate the duration or scope of the non-compete clause (e.g. mitigating the

non-competition clause to a prohibition not to do business with the former employer's clients). The constitutional right of 'free choice of employment' is often heard as an argument for mitigation. If Dutch employers choose to impose explicit restrictions during the employment contract they are not at all legally required to compensate employees.In 2005 Parliament rejected a legislative proposal that would have stipulated that post-employment non-compete clauses are null if a fair compensation was not agreed upon. In 2015 the government ordered a review of the non-competition clause in Dutch legislation, without any results yet. Up till today compensation for non-compete clauses is not required nor (in practice) agreed upon (as part of salary) in The Netherlands. The Lithuanian case mentioned above might inspire our Supreme Court to rule likewise in a similar case, since non-compete clause during and after the employment contract are poorly regulated, taking into account the major restriction of one of employees' most fundamental rights: free choice of employment. Given the current state of legislation, jurisprudence and legal practice (no compensation required and the wide discretion of the court to mitigate the non-compete clauses) such a ruling is not likely to follow soon.

Subject: non-compete, compensation

Parties: A. V. – v – UAB Robert Bosch

Court: Lietuvos Aukščiausiasis Teismas (Supreme Court of Lithuania)

Date: 12 February 2016

Case number: 3K-3-32-687/2016

Publication: www.lat.lt | TEISMO NUTARTYS | Bylos nr.: | 3K-3-32-687/2016

Creator: Lietuvos Aukščiausiasis Teismas (Supreme Court of Lithuania)
Verdict at: 2016-02-12
Case number: 3K-3-32-687/2016