New legislation on restrictive covenants

2 March 2016
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Introduction

• The Danish Parliament has passed new legislation on restrictive covenants to limit the use of restrictive covenants and gather the rules regarding restrictive covenants into one joint law.
• The new legislation prohibits the use of non-solicitation of employees clauses (save for clauses entered into in connection with the transfer of undertakings). Existing clauses remain valid until 1 January 2021.
• The new legislation gather the rules regarding restrictive covenants into one joint law applicable to all employment relationships and categories of employees.
• The law regulates the application of non-competition, non-solicitation of customers and combined non-competition and non-solicitation of customers clauses, and the prohibition against the non-solicitation of employees clauses.
• The law does only apply to non-competition and non-solicitation of customers clauses entered after 1 January 2016. Restrictive covenants entered into before 1 January 2016 remain valid.
• The law may be dispensated by collective bargaining agreement.
Employee categories

Salaried Employees

- Salaried Employees, cf. section 1 of the Danish Salaried Employees Act,
  - persons whose work tasks are of a certain kind – as for example office work, equivalent warehouse operations, technical or clinical services, managerial work and work mainly as salaried employees work - employed for more than eight hours a week on average and occupied in a position in which the employee works under the instructions of the employer.

- Non-competition clauses and non-solicitation of customers clauses have been regulated by section 18 and 18 (a) of the Salaried Employees Act and section 36 and 38 (2) of the Act on formation of agreement.
  - The Act on non-solicitation of employee clauses.
Employee categories

Other employees

• Previously, no legislative regulation of non-competition and non-solicitation of customers clauses. Thus there was previously freedom of contracting within the legal framework of the Danish Contracts Act in relation to entering non-competition and non-solicitation of customers clauses.

• Only limitations in section 36 and 38 (2) of the Danish Contracts Act.

• Danish Act on Non-Solicitation of Employees Clauses
Employee categories

Managing directors / shareholders

• No legislative regulation of non-competition and non-solicitation of customers clauses. Thus there is freedom of contracting within the legal framework of the Danish Contracts Act in relation to entering non-competition and non-solicitation of customers clauses.

• Only limitations have been section 36 and 38 (2) of the Danish Contracts Act.

• Employee shareholders
Previous regulation
Previous regulation

During employment
• Duty of loyalty

After employment
• Non-competition, non-solicitation of customers and non-solicitation of employees clauses
• Section 19 of the Danish Marketing Practices Act
Previous regulation

Non-competition clauses

• **Purpose**
  • Protective after expiry of the employment
  • Protective against the employee carrying out competitive activities

• **Relevant rules**
  • Section 18 of the Danish Salaried Employees Act
  • Section 36 (general provision) and 38 (2) of the Danish Contracts Act
Previous regulation

Non-competition clauses (continued)

• Only valid if:
  o The employee undertakes a trusted position at the company or the employee enters agreement concerning the right of use for an invention made by the employee,
  o The clause is agreed in writing,
  o The employee receives compensation during the period of validity, and
  o The right to compensation follows from the clause.

• Compensation
  o Must represent at least 50 % of the salary at the date of dismissal
  o Payment of compensation
    o Lump sum corresponding to 3 month’s compensation should be paid at the date of dismissal
    o The remaining compensation should be paid continuously
  o Right to compensation lapses, if the employer has summarily dismissed the employee legitimately
  o Salary earned from other suitable work may be set off against the compensation (except for the lump sum of 3 month’s salary)
Previous regulation

Non-competition clauses (continued)

• **Limitations in the period of validity of non-competition clauses**
  - Grading on basis of fairness
  - Limitations for shorter-serving employees

• **Limitations in the scope of non-competition clauses**
  - Grading on basis of fairness

• **Termination of non-competition clauses**
  • 1 month’s notice to expire on the last day of a month
  • Except right to lump sum payment of 3 month’s salary, if the clause is terminated later than 6 month’s before the employee’s termination, and if the non-competition clause is applicable

• **Lapse**
  • If the employee is dismissed due to circumstances of the company
  • If the employee is dismissed without having given reasonable cause to be dismissed
  • If the employee leaves the employment and the company’s failure to meet the company’s obligations provides a valid reason for leaving
Previous regulation

Non-competition clauses (continued)

• Enforcement of non-competition clauses
  o Injunction
  o Compensation
  o Agreed penalty

• Clauses entered before 15 June 1999
  o No requirement to pay compensation as a requirement of validity (except for non-competition clauses applicable more than 1 year)
  o ”Old” clauses are continuously valid

• Clauses entered after 15 June 1999 – 31 December 2015
  o Compensation of 50 % of annual salary
Previous regulation

Non-solicitation of customers clauses

• **Purpose**
  - Non-solicitation of customers clauses protect against the employee’s employment with or professional contact with the employer’s customers, suppliers and/or other business partners, and thus protect against the employee soliciting the employer’s customers in the new employment.

• **Relevant rules**
  - Section 18 (a) of the Danish Salaried Employees Act
  - Section 36 of the Danish Contracts Act (general clause)

• **The clause does only apply in relation to customers etc.**
  - which the employer has had professional contact with within 18 months preceding the date of termination, and
  - which the employee has had dealings while working for the company, or
  - which appear from a list of customers handed out to the employee before the date of termination.
Previous regulation

Non-solicitation of customers clauses (continued)

- Non-solicitation of customers clauses are only valid, if
  - The clause is agreed in writing
  - The employee receives a monthly compensation of minimum 50 % of the salary at the time of termination during the relevant period
  - The right to compensation is stated in the clause

- Payment of compensation and set off
- Limitations in non-solicitation of customers clauses
- Termination of non-solicitation of customers clauses
- Enforcement of non-solicitation of customers clauses

- Clauses entered before 15 June 1999
  - No requirement to pay compensation as a requirement of validity
  - ”Old” clauses are still valid

- Clauses entered into on 15 June 1999 – 31 December 2015
  - Compensation of 50 % of the salary
Previous regulation

Non-solicitation of employee clauses

- Regulated by the Danish Act on Non-Solicitation of Employees Clauses
- Requirements for non-solicitation of employee clauses (writing, consent, compensation)
- Application of non-solicitation of employee clauses are administratively burdensome in practice
- However, clauses at transfers of undertakings are important
The new rules
Overall structure

• Scope of application and definitions, section 1 and 2
• Non-solicitation of customers clauses, section 3 and 4
• Non-competition, non-solicitation of customers and combined non-competition and non-solicitation of customers clauses, section 5 - 7
• Compensation, section 8 and 9
• Termination and breach, section 10 and 11
• Enforcement and amendments in other legislation, section 12 - 16
Employee categories covered by the rules

• The legislation on restrictive covenants apply to all employee categories.

• The definition of an employee in section 1 (2)(2) of the act corresponds to the definition of an employee in the Danish Holiday Act: the act applies to all employees receiving salary for work performed under the instructions of the employer.

• Managing directors / shareholders are not covered
  • Section 11 of the legislation on restrictive covenants (which re-enacts the legal position following from section 38 (1) and (2) of the Danish Contracts Act) applies to others than employees.
What is a non-competition clause?

• A non-competition clause is an agreement between an employee and the employer stating that the employee for reasons of competition cannot do business activities or other activities of a certain kind or undertake employment after termination, cf. section 1 (2)(5).
What is a non-solicitation of customers clause?

• A non-solicitation of customers clause is an agreement between an employee and the employer according to which the employee cannot undertake employment or directly or indirectly do business activities with the former employer’s customers and other business connections after termination, cf. section 1 (2) (6).

• Distinction between direct / indirect contact with former employer’s customers
  • Direct contact is e.g. where the employee in connection with new employment contacts the former employer’s customers
  • Indirect contact is e.g. where the employee has also committed himself/herself not to undertake employment with a company which does business activities with the customers, regardless of the fact that it is stated in the employment contract with the new employer that the employee cannot do business with the customer directly.
What is a non-solicitation of employees clause?

- A non-solicitation of employees clause is an agreement that the employer enters with other businesses for the purpose to prevent or reduce the employee’s possibilities to obtain employment in another business, or an agreement entered with an employee for the purpose to prevent or reduce other employees’ possibilities to obtain employment in other businesses, cf. section 1 (2)(4).
What is a combined restrictive covenant?

- A combined restricted covenant is an agreement according to which the employee is bound by a non-competition and non-solicitation of customers clause in the same period of time, cf. section 1 (2)(7)
Requirements of validity for non-solicitation of employees clauses

As a starting point an employer cannot enter non-solicitation of employees clauses, cf. section 3

- Exceptions:

- Transfer of undertaking, cf. section 4: the employer may in connection with negotiation for transfer of undertaking enter agreements with other businesses for the purpose to prevent or reduce the employee’s possibilities to obtain employment in other businesses.

- The agreement may be kept in force until 6 months after the closure of the negotiations regardless of whether the negotiations result in a transfer of undertaking.

- If the negotiations result in a transfer of undertaking, the agreements may be kept in force until 6 months after the time of the transfer of undertaking.
  - If an employee has been employed in the transferring company for 3 months or less, the employee cannot be covered by such agreement entered in accordance with section 3 (2) or (3).
  - Non-solicitation of employees clauses entered before 1 January 2016 (and in accordance with the Danish Act on Non-Solicitation of Employees Clauses) apply until 1 January 2021 cf. section 21 (3).
Requirements of validity for non-competition clauses

Non-competition clauses are only valid if:

• The employee undertakes a highly trusted position or the employee enters an agreement with the employer concerning the right of use for an invention made by the employee,
  
  o ”highly entrusted employee” = increase in relation to current practice following from section 18 of the Danish Salaried Employees Act.
  
  o Special factors are necessary to enter a valid non-competition clause.

  o Same requirement apply to salaried employees and non-salaried employees.

  o The employee is regarded as having a highly entrusted position at the company if the employee has access to the company’s confidential information, including financial accounts, supplier agreements, client registers, price agreements, discount schemes, that can be used to potentially harm the company if the employee initiates competing activities himself/herself.
Requirements of validity for non-competition clauses

• The employer must in writing provide the employee with a description of which circumstances of the employee’s position makes the employee highly entrusted
  o It is the employer’s responsibility to ensure that the description is adequate.
  o The employer is, however, not obliged to update the description, if the employee during employment obtains more or other areas of responsibility, access to more confidential information etc. than before entering the non-competition clause.
  o It is the employer’s risk if the description is not adequate to keep a non-competition clause in force and the employer cannot repair the description subsequently by providing evidence of the position having developed into more responsibility / greater insight in the situation of the business.

• The employee has been employed by the employer for a continuous period of at least 6 months.
Requirements of validity for non-competition clauses

• The employee receives compensation for the period the non-competition clause applies in accordance with section 8,
• The employee is not covered by a non-competition clause for more than 12 months from the time of termination, and
• The employee receives written confirmation about these conditions.
Requirements of validity for non-solicitation of customers clauses

A non-solicitation of customers clause is only valid if:

• The clause covers customers with whom the employee has had dealings while working for the company within 12 months preceding the date of termination,
• The employee has been employed by the company for a continuous period of at least 6 months,
• The employee receives compensation for the period the non-solicitation clause applies according to section 8,
• The employee is not covered by a non-solicitation of customers clause for more than 12 months from the time of termination, and
• The employee receives written confirmation about these conditions.
Requirements of validity for non-solicitation of customers clauses

• Non-solicitation of customers clauses are subject to the requirement that the employee in connection with termination is provided with a list of customers with whom the employee has had dealings while working for the company within 12 months preceding the date of termination.

• The list of customers is a requirement of validity. The list must be correct for all listed clients for the company to make the customer list enforceable against the employee.

• The customer list should be handed out to the employee in connection with the employee serving notice of termination or terminating the employment of the employee.
Requirements of validity for combined restrictive covenants

A combined restrictive covenant is only valid if:

- The employee is not covered by the combined restrictive covenant for more than 6 months from the time of termination, and
- The specific requirements applicable to non-solicitation of customers and non-competition clauses in section 5 and 6 are meet.
The rules concerning compensation / set off

• The size of the compensation depends on the duration of the clause after the termination of employment and whether the employee seeks other suitable work.

• The compensation for the first 2 months after the effective date of termination is paid out as a lump sum at the effective date of termination regardless of whether the employee obtains other suitable work.
The rules concerning compensation / set off

Duty to mitigate loss

- The employee must seek other suitable work after the effective date of termination (duty to mitigate loss).
- If the employee accepts other suitable work, the compensation to the employee is reduced.
  - As previously according to the Salaried Employees Act other suitable work = work within the employee’s area of expertise, as the employee is trained within or has been employed within previously.
  - Might also be undertaking of independent business depending on the circumstances.
- Breach of the duty to mitigate loss results in lapse of the continuously paid compensation, except for the lump sum payment.
The rules concerning compensation / set off

Non-competition or non-solicitation of customers clauses applicable up to 6 months:

- The compensation must constitute at least 40 % of the monthly salary at the time of termination. If the employee obtains other suitable work the compensation constitutes at least 16 % of the monthly salary at the time of termination with effect from the 3rd month until the 6 month after termination.

- The lump sum payment for the first 2 months constitutes at least 40 % of the salary regardless of whether the employee obtains other suitable work.
The rules concerning compensation / set off

Non-competition or non-solicitation of customers clauses applicable up to 12 months:

• The compensation must constitute at least 60 % of the monthly salary at the time of termination. If the employee obtains other suitable work, the compensation constitutes at least 24 % of the monthly salary at the time of termination from the 3rd month until the 12th month.

• The lump sum payment for the first 2 months constitutes at least 60 % of the salary, regardless of the employee obtaining other suitable work.
The rules concerning compensation / set off

Combined restrictive covenants applicable up to 6 months:

• The compensation must constitute at least 60% of the monthly salary at the time of termination. If the employee takes other suitable work, the compensation will constitute at least 24% of the monthly salary at the time of termination from the 3rd month until the 6th month.

• The lump sum payment for the first 2 months constitutes at least 60% of the salary, regardless of the employee taking other suitable work.
The rules concerning compensation / set off

Illustration of the level of compensation for non-competition and non-solicitation of customers clauses:

<table>
<thead>
<tr>
<th></th>
<th>Level of compensation</th>
<th>Duration of the restrictive covenant</th>
<th>The employee has accepted other suitable work</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>60 %</td>
<td>Up to 12 months</td>
<td>No</td>
</tr>
<tr>
<td>2</td>
<td>40 %</td>
<td>Up to 6 months</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>24 %</td>
<td>Up to 12 months</td>
<td>Yes</td>
</tr>
<tr>
<td>4</td>
<td>16 %</td>
<td>Up to 6 months</td>
<td>Yes</td>
</tr>
</tbody>
</table>

For combined clauses:

<table>
<thead>
<tr>
<th></th>
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<td>2</td>
<td>24 %</td>
<td>Up to 6 months</td>
<td>Yes</td>
</tr>
</tbody>
</table>
The rules concerning compensation / set off

Calculation of compensation

• The compensation must be paid – with respect to the time of payment – as the salary pay during the employment relationship.

• The salary must be calculated on the basis of all fixed and variable salary components which the employee’s salary consist of at the time of termination.

• The salary at the time of termination is calculated as an average of the salary for the last 3 months before the termination. If the salary in this period of time is substantially different from the employee’s normal salary pay, the salary may be estimated on the basis of the average salary for the last 12 months before the termination.
Termination and breach

• Section 10: The employer may terminate the restrictive covenants by 1 month’s notice to the end of a month.
• If a clause is terminated by the employer during an employment relationship e.g. because it is no longer needed, the employer must pay a lump sum payment corresponding to 2 months compensation to the employee, if the following cumulative requirements are met:
  • If the employee has been employed for at least 3 months, and thus the employee is entitled to a lump sum payment regardless of the fact that the clause is not effective until 6 months after employment.
  • If the termination is effective prior to 6 months after the employer has terminated the clause.
  • If the reasons for the termination would have made the employer entitled to apply the clauses.
• If the agreement is terminated earlier than 6 months before the termination of the employee, the employee is not entitled to compensation.
• Purpose: to limit the use of restrictive covenants in general - supported by the fact that it is easy for the employer to terminate the clauses.
Termination and breach

Section 11 (1):

- If the employer terminates the employment relationship without the employee has given reasonable cause to do so or the employee terminates the employment and the employer’s failure to fulfill its obligations has given just cause to do so, a non-competition clause cf. section 5 and the part concerning competition in a combined clause cf. section 7 are not applicable and the employee will be entitled to a lump sum payment in accordance with section 8 (3).

The section results in:

- The employer in the latter situation cannot enforce the non-competition clause or the part concerning competition in a combined clause.
- The employee is not entitled to on-going compensation. The employee will be entitled to a lump sum payment of 2 months salary because the clause is considered as terminated by the employer, which constitutes a change in relation to section 38 (2) of the Danish Contracts Act.
- Purpose: continuation of the legal position following from section 38 (2) of the Danish Contracts Act.
Termination and breach

Section 11 (2):

- An agreement concerning a non-competition clause in accordance with section 5 and the part concerning competition in a combined clause under section 7 are not binding for the employee to the extent that it with respect to the duration, geographical scope and other circumstances exceeds what is necessary to protect the interests of the employer or unduly restrict the employee’s access to business. In the assessment of whether the clause unduly restrict the employee’s access to business the employer’s interest to enforce the agreement must also be taken into consideration.

Purpose: continuation of the legal position following from section 38 (1) of the Danish Contracts Act.
Termination and breach

- Section 11 (1) and (2) also apply to other groups than employees who have committed themselves for competitive reasons not to do business activities or other activities of a certain kind or accept employment in such business.

- The provisions cover all anti-competitive agreements, including agreements entered between two self-employed persons or agreements entered with managing directors.

- Section 11 has thus a wider scope of application than the rest of the legislation which only applies to employees.
Termination and breach

- The employee’s breach of the employment contract

- If the employer makes a justified summary dismissal of the employee, a clause may be kept in force and the employee’s right to compensation lapses.
  - In this respect the employee is obliged to comply with the limitations in relation to business in the clause.
  - The employee is not entitled to receive compensation as a lump sum payment or current compensation.
  - This covers both non-competition, non-solicitation of customers and combined clauses.
Commencement

The new legislation applies to restrictive covenants entered into 1 January 2016 or later, with the following exceptions:

Agreements concerning non-solicitation of employees clauses entered on the basis of the rules then in force may be kept in force until 1 January 2021.

Collective bargaining agreements entered before 1 January 2016 are valid until the time where the collective bargaining agreement may be terminated.

The new legislation does not apply to non-competition and non-solicitation of customers clauses entered into before 1 January 2016. These agreements remain valid.
Final remarks

The new legislation will not affect

- The duty of loyalty
- The application of the clauses during the employment
- Enforcement
THANK YOU FOR YOUR TIME
Anne Marie Abrahamson
Attorney-at-law, Partner

Areas of expertise
- Employment and Labour Law
- Data Protection

Contact information:
- E-mail: ama@rl.dk
- Direct: 3525 2858
- Mobile: 2154 9010