Proportionality in compensation for post-termination unfair competition

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An adjudger's determination regarding the non-proportionality of the amount of compensation set for post-termination unfair competition is the subject of dispute. In all cases, from upholding full payment under a non-compete clause when its wording is clear to taking the view that the sum claimed, though set out in the contract, is not proportional to the harm inflicted on the company, quantification has proved controversial. Currently, the need to adjust compensation to the loss seems to prevail in the employment sphere, allowing courts to modulate the amount set by the parties.

1. The inclusion of penalty clauses in non-compete agreements has resulted in situations where what the company claims in the event of a former employee's act of unfair competition has been deemed disproportionate; a view that runs counter to the parties' private autonomy by virtue of which said parties, freely accepting the terms of the agreement, require full compliance therewith.

   The judgment of the Supreme Court of 26 October 2016, Ar. 254428, settles the contradiction between the judgment handed down in the review of an employment court decision (*recurso de suplicación*) that raises the amount determined at first instance – 18,000 euros, amount annually paid by the company as non-compete extra pay – to reach the sum claimed by the company – 59,000 euros, equivalent to the former employee's gross annual salary, and to which the latter bound himself in the event of breaching the non-compete agreement – and the conflicting judgment (judgment of the Supreme Court of 30 November 2009, Ar. 252/2010) where only repayment to the company of what has been earned by the former employee as non-compete extra pay is upheld. In the first case, it is understood that the penalty clause is absolutely clear and it cannot be held that the amount must be proportional to the sacrifice assumed thereunder by the former employee. To the contrary, the conflicting judgment holds that the former employee must repay what was earned as non-compete extra pay, but not twice that amount – as set forth in the penalty clause – because there is, according to the court, no

real proportion between the forfeiture the former employee assumed and the income paid on a monthly basis by the company.

2. The Supreme Court recalls in this new pronouncement what was already stated in the judgment of the same Court of 6 February 2009, Ar. 621, according to which "*the post-termination non-compete agreement generates expectations both for the employee (compensation for any loss incurred by dint of having to engage, after termination of the contract and during the agreed time, in a different activity for which he or she may not be prepared) and for the employer (avoid the loss that may be caused by the employee's use of the knowledge acquired in the company in a competing activity)*" (Third Point of Law). If, in addition, there is a penalty clause, such does not play the role of additional penalty but rather, as provided in article 1152(1) of the Civil Code ("*unless otherwise provided, in obligations with a penalty clause, the penalty shall replace compensatory damages and the payment of interest in the event of non-compliance*"), replaces damages in compensation (liquidated damages). This would mean – according to the Court – release from proving the amount but not from the requirement of proportionality between one and the other, which is a principle consubstantial with the entire penalty or sanctioning sphere.

   From there, the adjudger can freely determine the proportionality of the penalty clause, inasmuch as it must be interpreted within the meaning of the clauses of the contract as a whole (judgment of the Supreme Court – Civil Division – of 20 December 2012, Ar. 1253/2013). This means that where, as in the present case, the breach of the former employee is such, damages for loss should be based on proof of the latter, "*which would undoubtedly contribute to justify compliance with the penalty clause (but) only non-compliance is contended and, based exclusively on it and according to what has been agreed, such compensation is required, notwithstanding the disproportion between what is earned and what is demanded*" (contention contained in the judgment of first instance and reproduced and upheld by the judgment of the Supreme Court of 26 October 2016, Ar. 254428, Third of Point of Law).

   The Supreme Court acknowledges in this ruling that it is not in every case that the former employee's liability will be settled with repayment of what he or she earned as non-compete extra pay since this view, depending on the terms and circumstances of both the contract and the process itself, could involve an unjustifiably favourable treatment for such former employee. However, in this specific case, "*the provision of pecuniary compensation payable by the former employee in excess of thrice the amount agreed for the latter as extra pay for the post-termination non-compete undertaking, without any explanation other than the contractual provision itself, rejecting in the review judgment, as has already been pointed out, that the amount must be proportional according to, ultimately, civil case law cited*", prevents this Division from determining on appeal, in an exercise of spontaneous unilateral balancing, a different sum that has not been raised in the alternative (Third Point of Law).

3. It is true that civil case law has always been based on the judge's inability to modulate the penalty clause solely on the grounds of it being excessive, since art. 1154 of the Civil Code provides for modulation in the case of partial or irregular compliance, not in the event of complete non-compliance (judgment of the Supreme Court - Civil Division - of 17 January 2012, Ar. 287).

But it is also true that the Division upholds that, since it is a clause that prejudges damages in advance - which is an exception to the normal rules on obligations by substituting compensation for a penalty - its interpretation must necessarily be restrictive (judgment of the Supreme Court - Civil Division - of 5 December 2007, Ar. 8901).

That is the justification of the employment branch of the judiciary for its distancing from the previous settlement of these conflicts by the civil branch. And, thus, the Employment Division recalls that, as pointed out by the judgment of the Supreme Court of 9 February 2009, Ar. 1443, raising in the employment branch the proportionality of the compensation provided is not rare (in view of the reference made by art. 21 of the Workers' Statute Act to the validity of post-termination non-compete agreements provided that the worker is paid "adequate pecuniary compensation") on the basis that the clause may be unconscionable and contrary to the principle of good faith under art. 7(2) of the Civil Code. Not surprisingly, from such a reference to "adequate pecuniary compensation" it follows that the compensation payable to the company in the event of a breach by the former employee must be equally adequate or proportional.

Moreover, the Employment Division is of the opinion that there are two factors that allow it to distance itself from what is laid down in the civil branch. Firstly, if civil case law is taken into account as an interpreter of the general theory of obligations and contracts, this must be bearing equally in mind that pronouncements are made in a context, according to its own denomination, of generality, so that in a more specific field such as that of employment and in a case with the features of the present one, reaching an identical conclusion is not possible when, furthermore, the calculated compensation is set out precisely on the basis of the employee's gross salary, an eminently employment-related item and with an impact of the same kind in all it extends to. Secondly, the not entirely matching scope of enforceability or operability of the principle of private autonomy in the civil and employment spheres must be taken into consideration.

In conclusion, it is in the employment context and in the determination of loss within the same that the employment jurisdiction finds the justification to move away from principles of the civil legal system. And thus, upholding an interpretation that alters the content of the parties' private autonomy, on account of deeming unconscionable and disproportionate the amount of compensation set, does not infringe freedom of contract. It is true that the employment sphere, characterized by the inequality of the contracting parties, requires greater oversight of the agreements reached, some of them forbidden. But it is also true that agreements such as the one examined are not the general rule, but are found rather in certain sectors, for strategic jobs and, usually, in respect of skilled workers. Balancing may have to be the guiding principle, but matching compensation to the extra pay given by the company to the worker for his or her non-compete undertaking does not necessarily have to be the rule.