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German Tax and Legal News

German Federal Court of Justice: Post Contractual Customer Protection Clauses for Shareholders of Limited Liability Companies exceeding a period of two years are void

The BGH recently made an important ruling on the term for customer protection clauses.

Questions are always posed when selling companies, particularly to competitors, about how the vendor and purchaser will remain in competition in the future. It is important for the purchaser that the vendor of the company does not commence a "new" business directly after the sale in order to be in competition with its "old" business which now belongs to the purchaser. Prohibitions of competition clauses which are subject to boundaries defined by law are therefore generally concluded. On the other hand, however, the situation can also be such that the vendor "is allowed to keep" certain customers pursuant to agreement. In such cases the vendor is protected from its customers being enticed away contrary to agreement following the sale. The time period of such customer protection clauses was recently defined by the German Federal Court of Justice (Bundesgerichtshof – BGH ruling dated January 20, 2015 – Case No.: BGH II ZR 369/13), referring to corporate relationships.

I. Facts of the Case
The managing director of the plaintiff was originally a shareholder of the defendant limited liability company (Gesellschaft mit beschränkter Haftung – GmbH) which was active in hiring out employees. The branch of the defendant GmbH was managed by the managing director of the plaintiff.

In a settlement agreement from September 2006 the managing director of the plaintiff sold his share in the defendant GmbH to its managing director and co-shareholder and withdrew from the company. At the same time the defendant GmbH assigned, among other things, some claims from certain customer agreements to the plaintiff. These were agreements with customers who were allocated to the branch managed by the managing director of the plaintiff and who were to transfer to the plaintiff. Furthermore the defendant GmbH and the remaining sole shareholder committed not to approach or entice the transferred customers away by offering services for hiring out employees and recruiting personnel for five years. This customer protection clause was safeguarded with a contractual penalty. The objective of the agreements was that the plaintiff managing director who was leaving the company as a shareholder should retain the customers of the branch he had enlisted himself.

In September 2011, shortly before the end of the five-year period, an employee of the defendant GmbH wrote to potential customers who were covered by the customer protection clause and offered them services for hiring out employees. The plaintiff then requested the payment of the agreed contractual penalty from the defendant GmbH citing a breach of the agreed non-competition clause.

II. Decision by Previous Instances
The legal action was allowed to a very limited extent in the first instance (Regional Court (Landgericht – LG) in Hamburg, ruling dated March 7, 2013 – Case No.: 418 HKO 68/12). The appeal court (Higher Regional Court (Oberlandesgericht – OLG) in Hamburg, ruling dated October 29, 2013 – Case No.: 9 U 38/13) imposed a contractual penalty on the defendant GmbH almost as applied for.

III. Decision by the Federal Court of Justice
The BGH annulled the ruling by the appeal court, rejected the legal action as a whole and stated that the plaintiff had no claim to the payment of a contractual penalty. The agreed obligation to cease and desist no longer existed in September 2011 since the prohibition to approach and entice employees away which was agreed in the settlement agreement with its time period of five years exceeded the permitted time limit of two years for non-competition clauses and was immoral (sittenwidrig) pursuant to § 138 German Civil Code (Bürgerliches Gesetzbuch – BGB) and therefore null and void.

As an explanation the BGH stated that considering the freedom to practice an occupation which is protected in the German Constitution (Grundgesetz – GG) post-contractual non-competition clauses are only justifiable if and as far as such prohibitions are necessary in order to protect a contractual partner from disloyal exploitation of the fruits of his work by the other contractual partner. Non-competition clauses are therefore only permitted and valid if they do not exceed the required scope with respect to region, subject and time. That also applies to the post-contractual non-competition clause in this case which was only agreed when the relationship under corporate law came to an end.

The BGH believed that the objective of agreeing a customer protection clause was to divide the assets of the defendant GmbH between the shareholders and to give the managing director of the plaintiff the possibility to be able to take the customers he had enlisted with him in an unhindered manner and to secure the fruits of his work. In the instant case it was therefore only possible for the plaintiff to have an interest which was worth protecting as long as the defendant GmbH continued to have a relationship with former customers who had transferred to the plaintiff. Neither side could have a justified interest in continuing the restriction on competition any longer after the end of the time period.

In comparable cases, such as a freelancer partnership, for example, the BGH had already considered a period of two years to be sufficient for protecting the interests of the parties involved since the client relationships are typically looser after that time. The fact that the parties are entrepreneurs and not freelancers does not justify a longer time limit. The BGH is of the opinion that the grounds for restricting non-competition clauses are not in the fact that non-competition clauses are not compatible with freelance professions but rather in the freedom to practice an occupation which is protected in the German Constitution and to which entrepreneurs and shareholders of a GmbH with a personalized structure are entitled. If they are not manufacturers but rather offer services, there are no differences regarding customer retention from the beginning in comparison with freelancer client relationships.

The BGH has left it open so far whether in exceptional cases an entrepreneur can have an interest which is worth protecting in a longer prohibition of enticing customers away. The BGH left this question again unanswered in the instant case, however, since no arguments were submitted for the plaintiff having such an interest.

IV. Assessment and Practical Advice

With its decision the BGH creates legal certainty and also affirms the applicability of the standard maximum period of two years for non-competition clauses for GmbHs with a personalized structure. Said standard time period was already subject of high-court decisions in other cases with different arrangements. The BGH therefore continues along its same line of subjecting all non-competition clauses to a consistent maximum time limit of two years and only allowing exceptions in particular arrangements which are hardly conceivable in practice and will probably be difficult to justify. The current decision by the BGH refers to companies with a personalized structure; the interests will probably be different for companies with a capitalized structure since the focus is not on the personal contribution and the work of the company but rather on its financial investment. Furthermore the particularity of the instant case was that the customer protection clause was not to protect the remaining shareholder but rather the departing one and enabling him to take his customers with him. It does not therefore matter on which contractual party the non-competition clause is imposed.

It continues to remain unclear, however, whether a non-competition clause which lasts longer than two years can be permitted as an exception, and if so, in which particular exceptional arrangements. Although the legal literature sometimes considers exceeding the two-year limit permissible as an exception, at least if it can be demonstrated why the customer relationships have not yet ceased to exist in the two years or are generally looser, there are no specific conditions and hints given for the question under which particular circumstances and with which arguments a longer time period than two years can be sufficiently justified. It is therefore particularly advisable in practice to limit non-competition clauses, including those in the form of customer protection clauses, to a maximum of two years.

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