

# INVALIDITY OF NON-COMPETITION CLAUSE IN EMPLOYMENT LAW

PhD student **Alina ROTARU**<sup>1</sup>

## **Abstract**

*The need to introduce some special clauses in a separate main contract appeared from the need of employers to ensure the favourable conditions and prospects of carrying out economic activities with some rivals on a competitive market, where staff fluctuations are frequent and the economic agents appear and disappear with a relatively high frequency. In the following article we want to answer some questions related to the validity of non-competition clause, the causes leading to the invalidity of the non-competition clause, in what situation it is necessary or not to insert such a clause, stretching in time and in space of the non-competition clause.*

**Key words:** *non-competition clause, competitive market, validity of clause, abusive practices, relative invalidity, absolute invalidity.*

**JEL Classification:** *K31*

In terms of a functional market economy, as it is the case with Romania, the special non-competition clause appears to be on the foreground between the clauses of the individual employment contract, through its significance and frequency. In the initial regulation of the Labour Code, art. 2-24 of the Law no. 53/2003, the non-competition clause forces the employee that, during the execution of the employment contract and only in exceptional cases, after its termination, not to perform in his/her own interest or of a third party an activity that is in competition with the activity carried out by his/her employer, not to perform an activity for a third party that is a competitor of his/her employer.

The admissibility of non-competition clause in the individual employment contract represented along time a discussed and analyzed subject. Although the whole legal literature agrees about the usefulness of such clauses, the Romanian law on the matter, a mixture of provisions adopted in profoundly different periods, allows the doctrinaire a little freedom of movement<sup>2</sup>.

In the opinion of a Romanian author “through the competition clause ... there is not diminished a fundamental right, but there is established its exercise framework<sup>3</sup>”. Such constitutional provisions concerning the obligation of each citizen to exercise his/her rights in good faith, in compliance with the principle of proportionality between restriction and the situation that determined this limitation.

According to article 21 paragraph 1 of the Labour code „the clause must be expressly stipulated in individual employment contract” either upon the conclusion or during its execution.

Inserting this clause in the individual employment contract is not mandatory, the employer and the employee will decide if they will conclude or not this agreement.

Given that the employer is interested in ensuring conditions and prospects favourable to the carrying out of its economic activity, it may resort to traditional methods of amiable, transactional settlement with a specific competitor or to the achievement of some independent conventions, in the form of special clauses inserted in a main distinct contract.

By the insertion of the non-competition clause it is intended to remove abusive practices, to avoid competitive situations between the former employee and the employer.

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<sup>1</sup> Alina Rotaru, Bucharest University of Economic Studies, [alina.rotaru@gmail.com](mailto:alina.rotaru@gmail.com).

<sup>2</sup> Raluca Dimitriu, *Duty of loyalty in employment relationships*, Tribuna Economică Publishing House, page 91

<sup>3</sup> Alexandru Țiclea, *Non-competition clause in the individual employment contract*, Journal of Commercial Law, no 7-8/1999

The explicit commitment of non-competition<sup>4</sup> was defined by Octavian Capatana as a contractual obligation that one of the parts, called debtor, assumes not to carry out a specific professional activity, in detriment to the other party, called the creditor. Inserting a non-competition clause implies the existence of a justified interest of the creditor of the clause. In this case, the debtor of such conventional obligation of non-competition can restrict his/her freedom to act on the market only if the beneficiary's protection would be necessary both economically and legally.

The premise from which we start considering the validity of the non-competition clause is that the protection offered by this clause does not exceed the necessary.<sup>5</sup>

As a principle, a clause which brings restrictions to the freedom of trade, industry and labour freedom can be inserted only if this is indispensable for the protection of the legitimate interests of the employer or of the creditor economic agent.

The legitimate interest of the employer leads to the insertion of such a clause in the individual employment contract. In the absence of a legitimate interest, the non-competition clause is deemed void, regardless of the fulfilment of the other validity elements listed in clause, for example limitation in time and space. Such a legitimate interest of the employer is the protection against the diversion of customers by the former employee. Gaining, maintaining and expanding the customers represent the main reasons for the confrontation between merchants. The economic agents have full right to confront on the market, but only in good faith, observing the rules of conduct imposed by professional ethics.<sup>6</sup>

The type of invalidity of a non-competition clause depends on the cause of invalidity, the triggering factor. It is a cause of absolute invalidity completely absent of one of the conditions of validity at the end of the legal act, for example, of consent. This happens, for instance, when the employee is not acknowledged of the existence of a non-competition clause within the employment contract. Similarly, in a legal system where the written form is required *ad validitatem* (as a condition of validity), the non-observance of this condition will lead to the absolute invalidity of the non-competition clause. In Romanian law, where the amendment of the Labour Code by the Law no. 40/2011 drew to the imposition of the written form as an *ad validitatem* condition, the validity of the non-competition clause depending on its written form. There shall be reported the fact that before the year 2011 also, when the employment contract was considered a consensual contract, the non-competition clause was a formal act.

Given that invalidity occurs due to a vice of consent, the sanction will consist in relative invalidity. Article 1206 of the new Civil Code provides that consent is not valid "when it is given through error, surprised by misrepresentation or taken away by violence".

Beside the general causes of invalidity, the non-competition clause may be also affected by specific causes. Thus, in the event that a non-competition clause does not contain the provisions required by law on the stretching in time and space and of the cause, it will be deemed null and void and of no effect.

The invalidity of non-competition clause may be established amiably, according to art. 57, para. 5. "The observation of invalidity and the establishment, under the law, of its effects can be made by the consent of both parties." This practice of observing the invalidity of a clause amiably can be found only in labour law, for the other systems of law this practice being impossible.

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<sup>4</sup> Octavian Capatana, *The Right of Commercial Competition – Honest competition*, Lumina Lex Publishing House, Bucharest, 1992, page 112

<sup>5</sup> Raluca Dimitriu, *Duty of loyalty in employment relationships*, Tribuna Economică Publishing House, Bucharest, 2001, page 108

<sup>6</sup> Octavian Capatana, *The Right of Commercial Competition – Honest competition*, Lumina Lex Publishing House, Bucharest, 1992, page 87

Another demarcation that can be imposed on the non-competition clause concerns the rules that govern its total or partial invalidity. In Romanian law, it is considered that partial invalidity represents the rule, and total invalidity only the exception.<sup>7</sup> In law practice, the courts will try first “to save the legal act”, declaring its partial invalidity, and only in the event that this solution would not be possible, they shall declare the total invalidity.

The non-competition clause is a legal act in itself, with a relative autonomy in relation to the contract within which it was inserted. So, if there is declared the invalidity of the non-competition clause, this issue does not involve the invalidity of the contract within which it was inserted.

The non-competition clause may include several elements, but the invalidity may be declared by the Court only for certain items, which come to restrict excessively the freedoms of the parties who have assumed the obligation. For example, if in a non-competition clause there are listed several categories of restricted competitive activities and the Court considers that only a part of the activities represents a risk for the creditor of the clause, respectively the employer, it may declare the invalidity of the clause related to these prohibited activities. In this situation, the declaration of partial invalidity of a legal act, the Court has the role to declare the invalidity or validity of the inserted non-competition clause, and not the adjustment of the clause depending on the decisions that have been taken after the declaration of invalidity.

Another requirement of the validity of the non-competition clause presupposes the existence of the condition of not leading to, by adopting it, the excessive restraint of freedom of the party that has undertaken the obligation not to execute a certain type of trade.

In practice, the appreciation criteria of tolerable limits of the clause are correctly delineated, both for its stretching in time and in space, as well as the decisive characteristic of the restriction.

The object of prohibiting the non-competition clause must be determined, measurable, it should not be general. In the case of a free and competitive market, no one can be stopped from exercising an activity or a profession under an agreement of private law. The restriction is usually imposed in practicing a trade similar to that carried out by the beneficiary of the clause and its operation area.

The validity conditions of such contractual clauses show differences of the items contained, for example, the nature of prohibitive, competition clause, the legal position of the parties, the territorial expansion or the duration of contractual prohibitions.

As it has been stated “a clause is licit only to the extent to which it aims to avoid the abnormal or dangerous competition, such as the case of alienation of the goodwill”.<sup>8</sup> In this case, normally, the non-competition clause includes clauses meant to protect the assignee against eventual acts of competition that the seller might exercise, by starting a similar economic activity in the vicinity of the purchaser. In most cases, the clientele will migrate to the former holder of the goodwill, at the new headquarters, which could lead to the bankruptcy of the new owner of the goodwill, due to the lack of consumers contracted through the acquisition of the goodwill.

As it results from the article 11 of the Civil code, the faculty of including or constricting the access on the market certain economic agent, through agreements or clauses inserted in a contract, “must not disobey neither the public order nor the good morals”<sup>9</sup>.

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<sup>7</sup> Raluca Dimitriu, *Duty of loyalty in employment relationships*, Tribuna Economică Publishing House, Bucharest, 2001, page 165

<sup>8</sup> Octavian Capatana, *The Right of Commercial Competition – Honest competition*, Lumina Lex Publishing House, Bucharest, 1992, page 117

<sup>9</sup> Accessible online on <http://www.cjo.ro/coduri-de-drept/codul-civil>

Most often, the insertion of such a clause was contested, in this sense being brought arguments according to which such agreements would restrict the freedom of customers in the choice of their supplier.

For certain branches of economy, namely the production field or that of circulation of goods, the restrictions may be introduced by the contracted parties only insofar as they comply with the principle of freedom of trade, provided in article 135 of the Constitution “the Romanian economy is a market economy, based on free enterprise and competition”.

The prohibition imposed by the non-competition clause must have a reasonable demarcation in time, the perpetual clauses being illicit in all cases. Stretching in time and space of non-competition clauses are generally influenced by the type of trade practiced. Thus, if we discuss the case of retail sales, the clientele is in most cases the local. In these conditions, carrying out a similar activity by the economic agent, debtor of the liability of non-competition will be excluded, normally, only in the perimeter, respectively the territory in case, remaining free in any other perimeter, even of the same town, and even more, in other localities.

In the case of a specialized productive activity, the prohibition area may be much wider. In similar case, the duration of the prohibition should be longer in case of branches of production, and shorter in the case of retail sales.

The period for which the non-competition clause produces its effects, after the termination of employment contract in Romania, was definitely changed, namely, the clause produces effects only after the termination of the individual employment contract. During the execution of the employment contract, the fidelity and respectively the loyalty question are running.

According to article 22, paragraph 1 of the Labour Code, the non-competition clause produces effects on a maximum period of two years from the date of termination of the individual employment contract. As newness to the previous regulation, the maximum limit of two years corresponds to the management employees, as well as for employees with execution functions.

According to article 21 paragraph 1 of the Labour Code, the non-competition clause forces the employee that, after the termination of employment contract, a certain period not to provide in his own interest or of a third party an activity that is in competition with that carried out by the employer. In this respect, the regulations relating to the non-competition clause constitute an exception to the mandatory provisions of article 38 of the Labour Code “Employees may not renounce their rights recognized by law. Any transaction by which it is aimed to the renunciation of the rights of the employees recognized by law or the limitation of these rights is deemed to be invalid”, in the sense that an employee is legally allowed to accept certain legal restrictions of his labour freedom, after the termination of employment contract, in exchange for obtaining material advantages, consisting of non-competition indemnity that the employer undertakes to pay him.<sup>10</sup>

The regulations of the Labour code of 2003 obliged the employer to pay the employee a monthly indemnity that could not be less than 25 % of the salary, compared with the current form of the Labour code, Article 21 paragraph 3 “the monthly indemnity for non-competition due to the employee is not related to the salary, it is negotiated and it is at least 50% of the average gross salary income of the employee in the last 6 months preceding the date of the termination of the individual employment contract or, if the individual employment contract duration was less than 6 months, of average gross monthly salary income due to him/her for the duration of the contract”. The non-competition indemnity shall be paid monthly to the former employee, from the moment when the employment contract is terminated, and not from the moment this clause

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<sup>10</sup> Ion Traian Stefanescu, *Theoretical and practical treaty of employment law*, Legal Universe Publishing House, 2012, page 321

was signed, as shown in the article 21 paragraph 1, where it is mentioned that the indemnity shall be paid during the whole non-competition period, more precisely after the conclusion of the individual employment contract.

The non-competition clause must be expressly stipulated in the individual employment contract, this failing to be implicit or deducted in any situation, the written form of the clause being required *ad validitatem*, otherwise the clause will be subject to absolute invalidity. The non-competition clause can be inserted in the individual employment contract exclusively by negotiations between the parties, employer and employee respectively.

A condition of validity of the non-competition clause lies in the practical establishment of third party employers in favour of which it is prohibited the provision of activities subsequent to the moment of the conclusion of contract. This requirement is difficult to be achieved due to the current conditions of the market, a market in which traders appear and disappear with a relatively high frequency.

Another condition of the validity of the non-competition clause is the sphere of activities prohibited to the employee. Thus, according to article 21 paragraph 1 of the Labour code, the prohibited activities for the employee may not be than those that are really in competition with those provided by the employee for the employer, and not others. The clause cannot have the effect of absolutely prohibiting exercising the occupation of the employee or the specialization that he/she holds. Otherwise there would not be about a non-competition clause, but about an exclusivity clause, clause forbidden in Romanian legislation. If by inserting an exclusivity clause, the employee would be absolutely prohibited to perform any other “work” outside the employer, even having no connection with the object of its activity, this clause would be void, by the insertion of such a clause being violated the principle of labour freedom.<sup>11</sup>

The geographical area where the employee will be forbidden to operate in his/her own interest or of a third party, an activity that is in competition with that carried out by the employer, must be expressly stipulated by the non-competition clause.

With regard to the geographical area within which the non-competition clause will produce its effects, legal literature notes that it should be confined to the space in which “the employee may be in real competition with the employer”<sup>12</sup>. In determining the geographical area, we have to keep in mind the surfaces, the territories where the employer does not have outlets for its products or services. The geographic area may not enclose the entire territory of the country, in which case the employee would be practically forbidden to practice his/her profession, occupation.

There are situations in practice when, although the individual employment contract is terminated due to its invalidity, the non-competition clause no longer produce its effects “as a result of an absolute invalidity of the individual employment contract, from the date on which the invalidity was acknowledged by the consent of both parties or by a final court decision”, article 56 letter d. Thus, the Romanian author I.T. Stefanescu thinks that the cause of invalidity might be the very guilty deed of former employee. In these conditions, though guilty, the former employee, part of a void contract is not liable to comply with the non-competition clause. The legislature may have reached to such a conclusion, because a void contract, regardless of the cause of its invalidity, cannot produce any legal effect in the future.<sup>13</sup> In this case it would have been natural to be maintained the effect of the non-competition clause, since it would be inadmissible that a fault of the employee produce unjustified and irrevocable damages to the employer.

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<sup>11</sup> Ion Traian Stefanescu, *Theoretical and practical treaty of employment law*, Legal Universe Publishing House, 2012, page 336

<sup>12</sup> *Idem*, page 323

<sup>13</sup> *Idem*, page 326

If the former employee violates the obligation of not competing with the employer, as a result of the insertion within the individual employment contract of the non-competition clause, according to art. 24 of the Labour Code, he/she can be forced to refund liability and, if necessary, to the damages corresponding to the prejudice caused to the employer.

The conflicts which may occur in what regards the stretching of the non-competition clause or, implicitly, its non-observance by any of the parties of the individual employment contract, represent the individual labour conflicts.

In judicial practice, there appeared confusions in classifying this type of conflict, as being a civil dispute. But for a proper qualification of this conflict, we have to start from the origin of the conflict, which is in this case, the non-competition clause, and not the subsequent phases of the initiation of the conflict, namely the competitive activities carried on by the parties of the individual employment contract, in this case the former employees and the plaintiff employer.

Being a clause that produces its effects after the termination of the employment contract, the disciplinary liability may not be discussed. When the non-competition clause is introduced in individual employment contract, it establishes rights and obligations of its parties, the clause having the same juridical nature with that of the individual employment contract. The non-competition clause is a “clause specified” through rules deliberately provided by the Labour code, so it is a clause of the Labour law, and cannot have a civil nature.

If the employer cannot evidence the injury suffered, it can ask the Court only the refund of non-competition indemnity. But, if the guilt of the former employee has been proven, he/she is bound to pay the damage directly, that has “causal connection with the violation of the non-competition clause”.<sup>14</sup> The prejudice, guilt and causal connection between these are factors which involve a high degree of difficulty as an evidentiary matter.

If it is the employer who does not comply with the obligation, more specifically it does not pay the monthly indemnity or he pays it diminished, the employee “shall be considered released from the obligation of not to do, assumed by that clause, pursuant to the exception *non adimpleti contractus*”<sup>15</sup>, exception that, either, may not be invoked by the employee for the duration of the execution of the individual employment contract. Such a situation, in which the employer does not honour the obligation to pay former employee the non-competition indemnity, is not regulated by the Labour code.

In conclusion, in addition to the ideas expressed in this article, we must also mention that there are areas of activity on the market that are out of the fight of economic agents. In cases where there are constituted derogations from the principles of freedom of commercial competition, the prohibitions should be grounded either by explicit legal provisions, interpreted narrowly, either by inserting agreed valid clauses in contracts. Prohibitions arising from the will of both employers and investors produce the similar effect of eliminating the competitive practices on the corresponding segment of the market where they carry out their activity. In this case any act of competition committed in this area leads to, by the insertion of the non-competition clause, the employee’s liability together with the corresponding sanctions.

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<sup>14</sup> Ion Traian Stefanescu, *Theoretical and practical treaty of employment law*, Legal Universe Publishing House, 2012, page 327

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