Reforming non-compete clauses: radical change ahead?

As part of the government's intention to support businesses in recovering from the economic effects of the COVID-19 pandemic, the Department for Business, Energy & Industrial Strategy (BEIS) is consulting on reforming the law on post-termination non-compete clauses in employment contracts. If these proposals ultimately lead to the introduction of statutory regulation into this area of employment law, this will mark a radical change from the current common law framework.

The government decided not to take action following BEIS's May 2016 call for evidence on how non-compete clauses are used in the UK, and their perceived benefits and disadvantages (*www.gov.uk/government/consultations/non-compete-clauses-call-for-evidence*). However, the consultation reflects the fact that the COVID-19 pandemic has had a profound impact on the labour market, creating a need to boost innovation, increase competition and create new jobs. BEIS considers that non-compete clauses may act as a barrier by preventing individuals from working for or establishing a competing business. It also observes that non-compete clauses are barely used at all in certain jurisdictions where tech start-ups have thrived.

The consultation was published on 4 December 2020 and closes on 26 February 2021.

Current legal framework

Non-compete clauses are just one type of post-termination restrictive covenant that an employer may seek to include in a contract of employment; for example, employment contracts may also include non-solicitation, non-poaching and non-dealing covenants. In general, employers use non-compete clauses to restrict the employee's ability to work for a competitor, or set up their own competing business, for a specified period of time after their employment ends (*see feature article "Employee restrictive covenants: enforcement, challenge and trends", www.practicallaw.com/w-024-8474*).

Non-compete clauses, and post-termination restrictions more generally, are currently governed by the common law. The underlying principles have been developed by the courts over time and on a case-by-case basis. In broad terms, post-termination restrictions are enforceable only if they are no wider than is reasonably necessary to protect the employer's legitimate business interests, which will include, for example, its confidential information and customer connections (*Office Angels v Rainer-Thomas and O'Connor [1991] IRLR 214*). If a court deems a post-termination restriction to be either too wide, or unnecessary or unreasonable in the circumstances, it will be unenforceable.

While the consultation indicates that the government is considering several options for reform, it largely focuses on two main alternatives:

- Making post-termination non-compete clauses in employment contracts permissible only where the employer provides compensation for the period during which the individual will be prohibited from working for a competitor or starting their own competing business.
- Making all post-termination non-compete clauses in employment contracts void and unenforceable.

Mandatory compensation

The government is particularly interested in hearing views on the mandatory compensation option, noting that this approach is taken in several countries including Germany, France and Italy. BEIS suggests that this could have various advantages including:

- Discouraging employers from inserting non-compete clauses into contracts indiscriminately and limiting their use to where they are truly necessary.
- Ensuring that employees receive a fair settlement if they are to be restricted from joining or starting a competing business.
- Disincentivising an employer from applying a non-compete clause for an unnecessary period, as this would generate additional costs.
- Reducing litigation, as former employees may feel less inclined to breach a potentially enforceable restriction if they have been financially compensated for the duration of the restricted period.

Regarding the appropriate level of compensation, the consultation seeks views on whether this should be set as a percentage of the employee's pre-termination average weekly earnings: asking whether this should be 60%, 80%, 100% or some other amount. Opinions are also sought as to whether employers should have the option to waive a non-compete clause early, thereby releasing the individual from the restriction and the employer from the obligation to

Complementary measures

The consultation outlines two further measures in relation to the mandatory compensation option:

- Creating transparency by requiring an employer to disclose the exact terms of the non-compete agreement to the employee in writing before the start of the employment relationship. Failing to do so would render the clause unenforceable.
- Placing a statutory restriction on the duration of non-compete clauses. The Department for Business, Energy & Industrial Strategy suggests that this would have the advantage of certainty and prevent businesses from using non-compete clauses that are unreasonably long. The consultation seeks views as to whether the clauses should be limited to three months, six months, 12 months or some other period after termination.

It is not clear how the first of these measures would differ from the current practice of providing an individual with the contractual terms in question as part of an offer of employment.

continue to pay compensation (*see also box "Complementary measures"*).

Total ban on non-competes

On the second main option, BEIS says that banning all non-compete clauses in employment contracts may:

- Provide greater certainty for the parties. However, BEIS recognises that the scope of any ban would need to be clearly defined and consideration would need to be given as to whether there should be any exemptions.

- Make it easier for individuals to start new businesses, therefore enabling the diffusion of skills and ideas between companies and regions, and increasing labour mobility.

BEIS notes that this type of approach has been taken in Israel and California, each of which is home to some of the world's most innovative organisations and where, respectively, non-compete clauses either have limited enforceability or are void. However, BEIS acknowledges the arguments against prohibiting the use of non-compete clauses altogether, including that they may help to protect legitimate business interests and prevent harm to an employer through, for example, the misuse of confidential information.

Practical implications

Many employers will be concerned about the prospect of a total ban on non-compete clauses, although it seems relatively unlikely that the government will opt to go down that controversial route. It is common practice for employers to use non-compete clauses as a tool to protect themselves from damaging competitive activity. Organisations responding to the consultation are therefore likely to emphasise the value of these clauses. Businesses may be deterred from investing in research and development in the first place if they feel that the fruits of their labour will be not be protected. This outcome would undermine the government's principal objective of removing barriers to innovation and economic activity.

If reform is to take place, changes along the lines of the mandatory compensation option would seem to be the more likely outcome. If so, some employers may experience a benefit, albeit with a price tag attached, as employees who previously may have decided to breach a non-compete clause may be more inclined to remain out of the market with the confidence that a defined income will be secure.

It is important to note that this is the beginning of a lengthy process: BEIS emphasises that a decision to progress any of the proposals would require careful consideration of the benefits and risks. It is likely that a significant amount of time will pass before any changes come into force.

While the government is focusing specifically on non-compete clauses, the consultation asks whether similar reform should be applied to other types of post-termination restrictions, such as non-solicitation, non-dealing and non-poaching clauses. Therefore, a broader overhaul of the law on restrictive covenants cannot be ruled out.

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The consultation is available at www.gov.uk/government/consultations/measures-to-reform-post-termination-non-compete-clauses-in-contracts-of-employment.
