Forfeiture for competition clauses: are they restraints of trade?

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Can 'forfeiture for competition' clauses be categorised as restraints of trade under English law? And how does this position compare to that in other jurisdictions?

Background

Whether a restriction on an ex-employee following termination of employment will be a restraint of trade is often obvious; for example, express restrictions prohibiting the ex-employee from commencing employment with a competitor or soliciting certain clients/employees will obviously be subject to the restraint of trade doctrine.

There are, however, other restrictions (sometimes called 'indirect' or 'atypical' restrictions) where it is less obvious. One particular form of such restriction is a 'forfeiture for competition' clause, which essentially provides that, although the ex-employee is not prohibited from joining a competitor in a defined period following termination, if he/she chooses to do so, he/she will forfeit payments or benefits which might otherwise have vested or been payable. Such clauses are increasingly common in deferred remuneration and other incentive arrangements for senior management, particularly in private equity, fund management and other financial services areas.

Pension/commission forfeiture cases

There have been several older English law cases which have examined whether forfeiture provisions would amount to a restraint of trade. Most of these older cases concerned forfeiture provisions in the context of pension and commission arrangements. In broad terms, the theme of most of these older cases is that, in deciding whether such provisions should be seen as a restraint of trade, the courts will look at their substance and practical effect rather than its form.

Pension cases

Wyatt concerned an agreement by an employer to pay a pension by monthly instalments to an ex-employee, provided he did not compete with the employer. The Court of Appeal held that this provision was a restraint of trade. Similarly, *Bull* concerned a rule in a pension scheme which provided that a retired employee's pension rights would be cancelled if the individual engaged in competitive activity. The High Court followed *Wyatt* and held that the provision was a restraint of trade and unenforceable. Both cases emphasised that there was, in practice, little distinction between an express covenant prohibiting competitive activity and one under which certain benefits would be discontinued if the employee chose to take up such work.

Commission cases

Stenhouse concerned an insurance agent whose employment contract provided for continuing commissions following the termination of employment but which would cease to be payable if he provided services to competitors. Following *Wyatt* and *Bull*, the High Court held that the provision was a restraint of trade since, to receive the post-termination commission, the employee had to give up some freedom which he would have otherwise had, namely the freedom to commence employment in whatever field he chose. The provision was therefore a direct financial incentive to limit his activities and a restraint of trade.

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Phillips concerned a settlement agreement under which an ex-employee agreed that, for five years following termination, he would pay 50% of any commission he received from doing business with clients of his former employer. The Privy Council noted, that although there was no express prohibition on competition, the provision would be likely to cause the employee to refuse business which he might otherwise take and was held to be a restraint of trade. Similarly in *Marshall*, a (self-employed) agent's right to ongoing renewal commission payments following termination was conditional on not competing with the company for one year. The High Court held this to be a restraint of trade, as it was a financial incentive not to carry on business in specified fields. Again, the court held that there was no relevant difference between a provision prohibiting someone from engaging in competition and one which, if the individual does not do so, he will receive some benefit to which he would not otherwise be entitled.

The above cases were also followed in the Irish High Court decision in *Finnegan*, in which part of an employee's remuneration was deferred for a year, but it was specified that he would forfeit the deferred portion if he left to join a competitor during that period (but he would remain entitled to it if he left to join a non-competing employer). The Irish High Court held this was a restraint of trade, on the basis that it tied him to the employer and effectively prevented him from commencing with a competitor during that period.

More recently, the case of *X-R Touring* concerned a commission arrangement of an employee of X-R Touring LLP, a concert booking agency for music artists. His employment contract contained a provision under which he agreed, following termination, to pay all sums obtained on certain bookings being made (by him or any entity with which he was then associated) to X-R, and to ensure that such bookings were instead made with X-R. The High Court held that this arrangement was a restraint of trade as it operated as a strong disincentive to him to work for any employer that had clients in common with X-R.

In contrast to the above was the case of *Sweeney* which concerned a salesman who was entitled to commission on business he placed for the employer. Commission payments were stated to be payable to him only if he was in employment with the employer at the end of the month when the commission payments would normally be payable by the client. The EAT held that, in contrast to *Marshall*, this was not a restraint of trade. In *Marshall*, it was clear that the commission payments ceased if the individual worked in competition with the employer. In this case, however, there was no such condition, and the individual was free, on leaving the employer, to work for whomever he wished (despite the financial disincentive to leaving employment) and, accordingly, it did not amount to a restraint of trade.

More recent English case law

More recent UK decisions also strongly indicate that English courts are likely to follow the older case law.

Tullet concerned provisions which provided that the employees would be required to repay all or some of a sign-on bonus if they did not commence employment or left employment within a certain period. The High Court rejected the argument that these were effectively restraints of trade, relying heavily on the decision in *Sweeney*. It noted that the provisions did not affect the employees' ability to work after leaving and that they were substantial sums paid to highly paid employees for loyalty.

The recent case of *Steel* concerned a bonus arrangement under which the employee's discretionary annual bonus was conditional on remaining in employment for three months from the date of payment and not having given or received notice of termination during that period. The contract gave the employer a right of clawback if the employee gave or received notice during that period. The EAT held that, although the bonus clawback provision operated as a disincentive on the employee to resign, nonetheless that did not turn such a provision into a restraint of trade. As was the case in *Sweeney* and *Tullet*, the provision did not impose any restriction on where the individual might work following termination and, accordingly, could not be seen as a restraint of trade. The *Steel* decision did not of course concern a forfeiture for competition provision but nonetheless it remains relevant because of how it contrasted 'payment for loyalty' provisions (such as in the *Steel* case itself and in *Tullet* and *Sweeney*, where such provisions where found not to be restraints of trade) as against cases

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such as *Marshall* (where the fact that the commissions were stated to be conditional on not providing services to a competitor meant it effectively restricted the individual's freedom to carry on a trade after termination of employment and was therefore a restraint of trade).

Marshall, *Finnegan*, *Tullet* and *Steel* consequently strongly suggest that a forfeiture for competition clause would be treated by UK courts as a restraint of trade. Nonetheless, to date there have been no cases in the UK which have analysed whether a forfeiture for competition provision in a share or incentive plan would be categorised as such and there remains a significant degree of uncertainty as to how UK courts would treat such provisions.

Cases in other common law jurisdictions

It is, however, worth noting a Singapore case *(Singh)* which directly concerned a forfeiture for competition provision in a management incentive plan. The plan provided that any deferred incentives which had been awarded but not yet distributed would be forfeited if the individual engaged in competing activity in the two years after termination. At first instance, the court held that this provision was not a restraint of trade and applied the US 'employee choice' doctrine (see below), concluding that the provision was not in restraint of trade as it did not prohibit the ex-employee from competing but merely provided a financial disincentive against doing so.

On appeal, this decision was overturned by the Singapore Court of Appeal (SCA). The SCA undertook a thorough analysis of the relevant case law relying in particular on English case law such as the decisions in *Wyatt*, *Marshall*, *Peninsula*, *Bull* and *Tullett* (and the Irish decision of *Finnegan*) referred to above. In their view, the provision was a restraint of trade as it effectively governed what the employee could and could not do following termination (as was the case in *Wyatt* and *Marshall*), whereas a 'payment for loyalty' clause (of the type in *Sweeney* and *Tullet*) did not provide any such restriction and was not categorised as a restraint of trade. The SCA was also influenced by whether the rights that were being forfeited were vested rights or not, a point that was not particularly the focus of the prior English case law. The *Singh* decision is, of course, not binding on UK courts but, given its heavy reliance on English case law, may be seen as persuasive.

Nonetheless, it remains uncertain how a UK court would treat such a forfeiture for competition provision, particularly in contexts such as private equity and fund management. For example, the Scottish case of *Greck* concerned an LLP agreement under which a member who left and joined a competitor would be deemed to be a bad leaver and forfeited rights to future carried interest. Although the Outer House of the Court of Session (OHCS) was not required to decide whether that provision was a restraint of trade (as the case was confined to the issue of whether a good leaver provision had been triggered factually) it indicated that:

(i) it might be arguable that such a forfeiture provision would not be a restraint of trade if the new employer (particularly in an area such a private equity) would be willing to pay the employee a 'make whole' sign-on payment to cover the forfeited compensation (on the basis that such a make whole payment would effectively negate any restrictive effect);

(ii) there might be 'considerable difficulties in applying a two-dimensional view of restraint of trade principles to a multi-party agreement' such as an LLP agreement; and

(iii) it was possible that, in considering whether the provision was a restraint of trade, a different conclusion could be reached with respect to individual carried interest partners, depending on their individual circumstances.

The United States

The position under English law set out above can be contrasted to that in many US states. For example, in Delaware, the Delaware Supreme Court recently confirmed in *Cantor Fitzgerald* that a forfeiture for competition provision in a limited partnership agreement (under which certain post-termination payments to a departing partner after leaving were conditional on the partner not competing) was not a restraint of trade but was

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instead subject to the 'employee choice' doctrine (under which an employee has the choice to either abide by post-employment covenants and maintain their contractual rights to post-employment benefits or to compete and forfeit such rights).

More recently, the Delaware Supreme Court confirmed in *LKQ Corporation* that the principle established in *Cantor Fitzgerald* is not confined to partnership agreements only and could apply to forfeiture for competition provisions in a range of agreements, including restricted stock award agreements. In doing so, the court emphasised that Delaware law does not review forfeiture for competition provisions for reasonableness so long as the employee voluntarily terminates their employment. A similar position exists under New York law, where the courts generally recognise the employee choice doctrine if the employee leaves voluntarily and the employer is willing to continue the employment. Other US states, such as Florida, treat a forfeiture for competition clause as only applying to unvested benefits, while the same clause would be reviewed under the traditional reasonableness standard when applied to vested benefits.

Conclusion

It is odd that there are no reported English law decisions on the use of forfeiture for competition provisions in the context of management incentive arrangements. Perhaps the reason for that is that, in practice, in many cases, the new employer of the employee that has forfeited the benefit in question may simply make the employee whole for the loss which he/she has incurred so the issue is never litigated. Despite that, as set out above, the case law suggests that, if and when the issue is decided on by a UK court, such forfeiture for competition clauses are likely to be viewed as indirect or atypical restraints of trade.

KEY:

Wyatt	*Wyatt v Kreglinger and Fernau* [1933] 1 KB 793
Bull	*Bull v Pitney-Bowes Ltd* [1967] 1 WLR 273
Stenhouse	*Stenhouse and Sadler v Imperial Life Assurance Co of Canada Ltd* [1988] IRLR 388
Philips	*Stenhouse Australia Ltd v Phillips* [1974] AC 391
Finnegan	*Finnegan v J & E Davy* [2007] IEHC 18
X-R Touring	*X-R Touring LLP v Javor* [2024] EWHC 562 (KB)
Marshall	*Marshall v NM Financial Management Ltd* [1996] IRLR 20
Tullet	*Tullet Prebon v BGC Brokers LP* [2010] EWHC 484
Sweeney	*Peninsula Business Service v Sweeney* [2004] IRLR 49
Steel	*Steel v Spencer Road LLP* [2023] EWHC 2492 (Ch)
Singh	*Mano Vikrant Singh v Cargill TSF Asia Pte Ltd* [2012] SGCA 42
SCA	Singapore Court of Appeal
Greck	*Greck v Henderson Asia Pacific Equity Partners* [2008] CSOH 2
OHCS	Outer House of the Court of Session
Cantor Fitzgerald	*Cantor Fitzgerald LP v Ainslie* 312 A.2d 674 (Del. 2024).
LKQ Corporation	*LKQ Corporation v Robert Rutledge* No 23-2330, slip. op (Del. 18 December 2024)