YPOG Briefing:
Non-Compete Clauses in Venture Capital Transactions

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In start-ups and scale-ups, the founders typically play a key role in the economic success of the company. They often combine various value-creating factors, such as business-related know-how and the industry-relevant network. If founders turn away from the company and work for a competitor instead, this potentially poses a significant risk to the company's success. Protecting the company from competition from its own founders is therefore an essential aspect for successful corporate financing. For this reason, it is standard market practice in venture capital transactions in Germany to subject founders to strict non-compete clauses. This is usually in the interest not only of the investors, but also of the company and the co-founders.

Typically, non-compete clauses are included in the shareholders' agreement, under which the founders are not only prohibited from working for competitors as long as they hold shares in the start-up, but also for a certain period of time after leaving their shareholder position (the so-called post-contractual non-compete clause). Furthermore, the managing director or employment contracts of the founders often contain an additional non-compete clause. This is not tied to the shareholder position, but to the founders' operational roles within the company. Here, too, it is common for the non-compete clause to remain in effect for a certain period after the founders' operational activities have ended. The post-contractual non-compete clauses in the shareholders' agreement and in the employment contract can differ in duration, in particular due to the different applicable starting points.

Under German law, the use of post-contractual non-compete clauses is permitted within certain limits (see I.). In the US, on the other hand, the Federal Trade Commission (FTC) has issued a controversial regulation intended to prohibit post-contractual non-compete clauses in the US across a wide range of areas (Non-Compete Clause Rule (NCCR) see link). Whether, when and in what form the NCCR will come into force remains unclear – especially after the Republican victory in the 47th US presidential election (see II.). Nevertheless, the FTC's initiative is already influencing the legal policy debate in Europe and has, in practice, led to increased scrutiny of post-contractual non-compete clauses in German financing rounds, with reference to developments in the US. To better understand these discussions, it is worth taking a closer look at developments in the US (see III.).

I. Legal Limits of Non-Compete Clauses under German Law

Non-compete clauses not only restrict the constitutionally guaranteed professional freedom of founders, but they can also conflict with the public interest in preserving undistorted competition (protected by antitrust law). From the perspective of competition authorities, non-compete clauses can unduly hinder former employees from founding new start-ups, potentially harming the venture capital (VC) ecosystem. As a result, non-compete clauses are only permissible within narrow legal limits.

1. Recipients

Non-compete clauses tied to the shareholder status of founders are generally permissible if the founders can exert significant influence on the company. In contrast, non-compete clauses are usually inadmissible for minority shareholders who hold only a capital interest without control rights. If the founders (as sole shareholders without an active role in the company) hold only a minority stake, a non-compete clause tied to their shareholder position can only be justified in exceptional cases – such as due to special know-how,

unique industry knowledge, or privileged access to the company's information. However, the legal standards for such clauses are disputed in detail. If the founders sell their company shares (in the course of an exit), a non-compete clause can also be included in the share purchase agreement (SPA) for a period of two years (or, in exceptional cases, three years) to protect the buyer.

If the non-compete clause is tied to the founders' role as employees of the company, the limits imposed on post-contractual non-compete clauses under labor law must be observed when drafting the contract (such as the requirement of compensation (see below) or the time limit of two years). The same applies to non-compete clauses that are tied to the founders' position as managing directors, where the legal standards of employment law are also indirectly relevant.

2. Material and Geographical Scope of Application

Non-compete clauses may not extend beyond the markets in which the start-up itself is active or specifically plans to become active (e.g., in preparation for the market launch of new products), neither in terms of subject matter nor geography. Furthermore, it should be noted that non-compete clauses only prohibit the founders' competitive activities where there is at least a risk that they could exploit special know-how or other company information. Founders may generally not be prohibited from holding purely financial investments or minority stakes for capital purposes, as long as they do not have decisive influence over the strategic business decisions of competitors. In practice, non-compete clauses often reference certain participation thresholds (e.g., 3%, 5%, or 10%, sometimes limited to listed companies). However, it should be noted that rigid percentage limits are generally not feasible, as the scope of minority rights can vary depending on the specific case. Ultimately, founders can only be prohibited from acquiring a significant ("decisive" or "competitively significant") influence on a competing company. If specific percentage limits are mentioned, it should be made clear that these are merely rebuttable presumptions and that in individual cases, higher shareholdings may also be permissible, provided they are not accompanied by a relevant influence on the competing company.

3. Post-Contractual Non-Compete Clauses

In practice, it is oftentimes considered including non-compete clauses for the founders not only during their membership in the company but also for a certain period after they leave.

In terms of time, the Federal Court of Justice (*Bundesgerichtshof*) has repeatedly deemed post-contractual non-compete clauses to be permissible for a maximum period of two years. In terms of subject matter and territory, the scope of post-contractual non-compete clauses must be limited to the business area of the company at the time of the shareholder's exit. For managing directors, however, the scope of the post-contractual non-compete clause should not be defined in relation to the company but in relation to the specific activity they performed. The clause must be limited to the activity the managing director was engaged in at the time of their departure. (In this context, there is sometimes misleadingly reference to a so-called "janitor clause." ("*Hausmeisterklausel*")

Finally, with regard to post-contractual non-compete clauses, it should be noted that, although the obligation to pay compensation under post-contractual non-compete clauses (which is based on the protection of agents under labor law) does not directly apply to managing directors, the principles under labor law must also be taken into account with regard to managing directors according to the case law of the Federal Court of Justice.

In the case of post-contractual non-compete clauses tied to the shareholder position, a case-by-case assessment is necessary: while customer protection clauses are generally permissible without compensation, extremely far-reaching post-contractual non-compete clauses (equivalent to a complete ban from the

profession), may require appropriate compensation. If, on the other hand, freedom of occupation is merely restricted, a non-compete clause may also be permissible without compensation.

If non-compete clauses are included in both the shareholders' agreement and the managing director's employment contract, it may be possible to avoid a (non-mandatory) compensation obligation for the non-compete clause by making the post-contractual non-compete clause in the employment contract conditional on the founders not already being subject to a non-compete clause due to their shareholder position.

4. Legal Consequences of Overly Far-Reaching Non-Compete Clauses

If contractual non-compete clauses go beyond the legally permissible limits, the legal consequences are subject to debate: If a contractual (post-contractual) non-compete clause (only) exceeds the permissible time limits, there is widespread agreement that the application of the clause will by law be reduced to the extent still permissible in order to preserve its validity. If the scope of the non-compete clause is too broad in terms of territory, person, and/or subject matter, the prevailing opinion assumes the principle of overall nullity of the non-compete clause. This is because the parties should not be relieved of the risk of nullity, as otherwise maintaining such excessively broad clauses (to the extent legally permissible) would create an incentive to include them in the first place.

II. New Trends from the United States: Stricter Standards for Post-Contractual Non-Compete Clauses?

In the US, the longstanding market practice of post-contractual non-compete clauses for founders has come under pressure. On May 7, 2024, the FTC published the NCCR, which is intended to significantly restrict the use of post-contractual non-compete clauses in the US (see 1. below). However, due to substantial political and legal resistance, the NCCR has not yet come into effect, contrary to the FTC's intentions, and its future remains uncertain (see 2. below).

1. Scope of the NCCR

The NCCR applies to agreements between 'employers' and 'workers'. The term 'worker' is broadly defined. It includes (in addition to employees, independent contractors and sole proprietors) senior executives who – similar to the founders of a start-up – can influence the strategic decisions of the company (i.e., those in a policy-making position).

The term "non-compete clause" is also to be understood broadly and includes any provision that: (i) prohibits the worker from engaging in certain activities; (ii) penalizes the worker for doing so; or (iii) serves to prevent the worker from seeking or accepting a competing position with another employer or running a competing business in the US after the end of his employment. The prohibition is intended to cover all clauses that have a corresponding effect (functional test), regardless of their designation as non-compete clauses. Depending on their form, non-disclosure agreements and non-solicitation agreements may also be covered by the NCCR.

However, garden leave agreements, in which employees continue to be employed – similar to a post-contractual non-compete clause with compensation in Germany – and continue to receive remuneration, but have no access to the company during the leave phase, would not be covered.

The FTC's proposed rule provides for a narrow exception for non-compete agreements entered into in transactions involving the sale of a business entity, an interest in a business entity, or all or substantially all of a business entity's operating assets (sale-of-a-business exception).

2. Entry into Force of the NCCR

According to the FTC's proposal, the NCCR should enter into force retroactively on September 4, 2024. An exception would only apply to senior executives earning more than USD 151,164 anually and having influence over the company's strategic business decisions.

However, on August 20, 2024, a federal court (District Court for the Northern District of Texas) ruled that the FTC had exceeded its authority with the NCCR proposal and found the NCCR to be arbitrary and capricious, meaning it could not be enforced by the FTC (*Ryan LLC v. Federal Trade Commission*, Case 3:24-cv-00986-E). Although the FTC has appealed the ruling it is currently unclear whether and to what extent the NCCR will come into force. Other legal proceedings against the NCCR are also pending.

Finally, political support for the NCCR could decline further following the Republican victory in the US presidential election. In particular, Donald Trump has already replaced the former chairwoman (Lina Khan) of the FTC appointed by Joe Biden (with Andrew N. Ferguson) and will appoint additional FTC members, thereby shifting the FTC majority in favor of the Republicans. This could lead to the FTC not pursuing legal proceedings against the NCCR, repealing it, or at least weakening the NCCR.

III. Outlook

Despite the FTC's judicial and political setbacks, post-contractual non-compete clauses remain under critical attention in the US. In addition to private (antitrust) lawsuits, the FTC could leverage its existing powers (in particular Sec. 5 of the FTC Act) to take action against allegedly overbroad non-compete restrictions (see Sec. 4 of the (new) Antitrust Guidelines for Business Activities Affecting Workers jointly issued by the FTC and the U.S. Department of Justice on January 16, 2025 (link)). Even if a nationwide ban on post-contractual non-compete clauses in the US (in the form of the NCCR) does not prevail, individual states (such as California recently demonstrated) could enact stricter regulations. State legislatures have shown a growing interest in new proposals to ban or limit non-compete agreements. It remains to be seen whether this trend will continue after the Republican victory in the presidential elections.

Developments in the US should also be considered when investing in German start-ups, as these developments are likely to shape legal policy discussions and practices "across the pond". For instance, stricter rules on non-compete obligations are already being discussed in the UK (see, for example, section 4.3 of the Department for Business & Trade's policy paper "Smarter regulation to grow the economy" dated May 10, 2023 (link)).

The legal policy discussion in the US (and Europe) could have at least indirect implications for the German VC market. When negotiating with investors, founders might attempt to negotiate narrower limits for post-contractual non-compete clauses than are currently customary under German market standards, referencing the FTC's stance. At the same time, investors are confronted with the question of whether the (post-contractual) non-compete clauses customary in Germany – the effectiveness of which is anything but certain under German competition law – will be more frequently challenged in the future, either in contract negotiations or in court. In the case of a US flip, founders and investors should also consider the question of whether the FTC's position poses risks for the start-up's protection against competition. The developments in the US are of direct significance for German companies that use employment contracts governed by US law. There are therefore several reasons for both founders and investors to pay even closer attention to the legal boundaries when negotiating non-compete agreements in the future.

However, it should be noted that the FTC's initiative is not primarily targeted at the VC sector from a competition policy perspective. Rather, post-contractual non-compete clauses are also widely used in the low-wage segment in the US, such as for employees of fast-food chains. The FTC argues that non-compete

clauses hit such employees particularly hard, economically depriving them of the ability to leave their jobs. The interests involved in these employment relationships are not necessarily comparable to the interests of VC-financed companies, where protecting competition is often an essential prerequisite for investment in the company and the long-term success of the company – and thus, ultimately, in the interests of the founders themselves.