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Employment – Penalty Clauses (Konventionalstrafen) under Threat

Many companies, including start-ups, use employer-friendly penalty clauses in their employment agreements to secure performance and compliance of the employee. Such clauses typically provide that the employee has to pay a pre-defined amount (a penalty) to the employer in case of a breach of certain obligations. Depending on the wording, the penalty either replaces the original obligation or is to be paid in addition to any proven damage or performance owed.

This spring, the Swiss Federal Supreme Court **(FSC)** rendered an important decision on such penalty clauses in employment agreements – with far-reaching implications.

The penalty clause in dispute read: *"In the event of an infringement of this [employment] agreement, particularly of the non-compete clause or confidentiality undertaking, the employee shall owe a contractual penalty of CHF 50,000 per infringement."*

In essence, the FSC held that this clause lead to a liability without fault and damage, thereby violating mandatory law (art. 321e CO). Said article provides that an employee is only responsible for the damage he/she intentionally or negligently causes to the employer. A deviation to the employee's detriment, i.e. an increase in his/her liability by lowering the liability threshold, is prohibited. Under such circumstances, the contractual penalty violates art. 321e CO and is, according to the latest FSC ruling, null and void (art. 362(2) CO). The employment agreement itself remains in force. Under previous case-law, the penalty was merely subject to a reduction at the discretion of the judge.

The FSC held that a contractual penalty results in an unlawful increase in liability if it is not purely punitive in nature *(Strafcharakter)*, but (wholly or partially) aimed at compensating the employer for financial disadvantages – in other words, if it has a compensatory function *(Ersatzcharakter)*. If this is the case, the penalty clause is null and void.

Even if the penalty is punitive in nature, for the penalty clause to be valid it must still be verified whether the requirements for disciplinary measures under labour law are met. The relevant offence and the penalty amount must be precisely regulated or quantified (so-called principle of certainty, *Bestimmtheitsgebot*); the amount of the penalty must be proportionate. If the amount is substantial, chances are that the penalty is not only of a punitive nature but has a compensatory function and is at risk of being null and void. What maximum amount a contractual penalty may reach to still qualify as a disciplinary measure remains unclear. A compensatory function may, however, only be excluded if the penalty amount has the effect of a slap on the wrist and does not represent a substantial amount for the employer (e.g. penalty of CHF 50 for smoking in the office).

As far as (widely-used) penalties in connection with *post-contractual* non-compete clauses with a compensation function are concerned, they are expressly permitted by law (art. 340 CO) and not restricted by art. 321e CO. The case is somewhat less clear for post-contractual confidentiality undertakings, although there are good arguments for dealing with them in the same way. When drafting penalty clauses, contractual and post-contractual obligations should be treated separately to exclude the risk of the latter being affected by the potential nullity.

In light of the above, start-ups are well advised to properly review their existing employment agreements.

walderwyss attorneys at law

Facts and Figures, Contact

Organization	Walder Wyss AG
Foundation	1972
Employees	290
Postal Address	Seefeldstrasse 123, P.O. Box, CH-8034 Zürich
Contact Person	Sarah Schulthess Attorney at Law
E-Mail	sarah.schulthess@walderwyss.com
Phone	+41 58 658 52 74
Webpage	www.walderwyss.com www.startuplaw.ch

SARAH SCHULTHESS
ATTORNEY AT LAW