Interpretation and scope of a non-competition clause in a share purchase agreement and judicial reduction of an excessive penalty

SID HEMETT

This Federal Supreme Court decision concerns a dispute arising from the breach of a non-competition clause in a share purchase agreement between two companies. The court confirmed the breach but upheld a reduction of the contractual penalty on the grounds that it was excessive.

Judgment of the Federal Supreme Court of 24 September 2024

Case Reference : 4A_202/2024, 4A_212/2024

Facts

B. (the "Plaintiff") is a company specializing in human resources, management, strategy and planning. It operates under multiple brands, including "Construction21".

On December 11, 2020, the Plaintiff and A. (the "Defendant"), Chairman of the Board of Directors of the newly founded Arkadium company, together (the "Parties"), jointly notified the clients of Construction21 that Arkadium would assume responsibility for all employees and ongoing recruitment processes previously managed by Construction21.

A week later, on December 18, 2020, the Parties entered into a share purchase agreement that included a non-competition clause. This clause prohibited the Defendant and all affiliated entities from using the name components "Prime", "GetTemp", "Construction", "Care" and "21" to compete with the Plaintiff. A contractual penalty of CHF 100,000. per breach was stipulated.

On January 11, 2021, the Defendant sent a letter to all Construction21's experts (workers that are to be placed in construction industry companies) informing them that Arkadium had taken over Construction21's operational activities as well as all current employment contracts. The letter featured "CONSTRUCTION21" logo in the header and included the Plaintiff's name next to the defendant's signature.

Claiming this communication violated the non-competition clause, the Plaintiff filed a claim in the Court of first instance seeking CHF 100,000 as a penalty. The initial claim was dismissed. However, on appeal, the Cantonal Court partially granted the Plaintiff's claim and awarded CHF 10,000. Both Parties appealed to the Federal Supreme Court: the Defendant sought either complete dismissal or a reduction to CHF 1,000, while the Plaintiff sought full payment of the CHF 100,000.

Issue

Two issues had to be addressed by the Federal Supreme Court:

1. Whether the Defendant's letter to the experts constitutes a breach of the non-competition clause; and
2. If so, what were the legal consequences of said breach.

Decision

The Federal Supreme Court found the language in the Defendant's letter , specifically its reference to a "retroactive takeover of Construction21's operational business"[1] problematic regarding the non-competition clause. The earlier letter to clients mentioned a "retroactive takeover of placement processes of Construction21 candidates",[2] and there was no legitimate reason to change that phrasing in the second letter regardless of the fact that the two statements are equally correct.

The Federal Supreme Court interpreted the wording change as an attempt by the Defendant and Arkadium to distance themselves distinguish themselves from both the Plaintiff and Construction21, thereby violating the non-competition clause. Mentioning the takeover of Construction21's business twice in the letter was unnecessary, and it would have been enough to simply inform the candidates that they would now need to contact Arkadium due to organizational changes. In that context, the Defendant was also not allowed to use the "CONSTRUCTION21" logo in the letterhead or to place the name of the Plaintiff below his signature.

A further breach of the non-competition clause was found in the letter, when Arkadium stated that "as a leading headhunter in the construction & property sector, [Arkadium] acts as a source of information for the experts" and "Arkadium specializes in the construction and property sector and focuses exclusively on the following sectors: architecture, civil engineering, construction logistics, building services engineering, energy sector, property, asset and real estate management, lean construction and digitalization". Both these statements were clearly advertisement (the Defendant did not deny it) and using them alongside the Construction21 trademark only shed more light on the breach of the non-competition clause.

The Federal Supreme Court then had to analyze the consequences of said breach. Under Swiss law, and according to art. 163 paras. 1 and 3 of the Swiss Code of Obligations (SCO), parties may freely stipulate the amount of a penalty, however, the courts are authorized to reduce it if it is manifestly excessive. Importantly, the penalty remains payable even if no if no financial loss has occurred (art. 161 para. 1 SCO). If the judge considers that a reduction is necessary, restraint must be shown as to not infringe too much on contractual freedom. Such a reduction is justified in particular if there is a blatant disproportion between the amount agreed upon and the loss suffered from the contractual breach.

Such a blatant disproportion existed in the case at hand, according to the Federal Supreme Court. It considered the violations of the non-competition clause to be extremely minor, and took into account the fact that the Plaintiff did not suffer any quantifiable loss from them. On that basis, it upheld the lower court's decision to reduce the penalty from CHF 100,000 to CHF 10,000.

Key Takeaway

Interpretation and scope of the non-competition clause in a share purchase agreement

Art. 18 para. 1 SCO establishes that the contract must be interpreted according to the real and common intention of the parties rather than being limited to the wording used. This principle, which is essential in contract law, can be broken down into two stages: subjective interpretation and objective interpretation.

Application and reduction of the penalty clause (art. 163 SCO)

While penalty clauses are permitted, art. 163 para. 3 SCO allows the court to reduce an excessive penalty clause when there is a clear imbalance between the agreed sum and the actual harm.

When a court reduces a penalty clause, restraint is required in order to respect the principle of contractual fidelity and freedom of contract (art. 163 para. 1 SCO).

In this judgment, the Federal Supreme Court upheld the reduction of the penalty clause.

Comment

The Federal Supreme Court's decisions 4A_202/2024, 4A_212/2024 concern a non-competition clause contained in a share purchase agreement concluded between two companies.

The parties were bound by a contract (business-to-business contract). They never challenged its conclusion (art. 1 seq. SCO) or its validity (art. 11 seq. of the Swiss Civil Code (SCC), arts. 11-16 SCO, arts. 19-20 SCO, art. 21 and arts. 23-24 SCO). Instead, the parties were disputing the interpretation and enforcement of a specific contractual clause and the proportionality of the associated penalties.

The primary issue was whether the defendant had actually breached the non-competition clause in the contract.

In addition, the contract contained a penalty clause applicable in case of such a breach, which could be reduced if the amount was deemed excessive. While the Federal Supreme Court confirmed that the clause had been breached, it ruled that the contractual penalty was excessive and upheld its reduction under art. 163 para. 3 CO.

This commentary will analyze three core themes:

1. Freedom of contract and the general principles of contract law (arts. 19 and 20 SCO).
2. Contractual interpretation and the will of the parties (art. 18 para. 1 SCO).
3. The application and judicial reduction of the penalty clause (art. 163 paras. 1 and 3 SCO).

1. General principles of contract law: freedom of contract

A. Foundations and scope of freedom of contract

Although this Federal Supreme Court's decision does not call into question the validity of the contractual clause, it is nonetheless important to recall the legal framework that such a clause must respect before analyzing its scope.

The fundamental principle of Swiss contract law is based on freedom of contract, enshrined in art. 19 para. 1 SCO, which allows the parties to freely determine whether or not to enter into a contract, with whom, and under what terms and conditions. This principle is a corollary of respect for private autonomy, which is supported in several constitutional and legal guarantees.[3]

While freedom of contract is a fundamental principle, it is not absolute. Art. 19 para. 2 SCO imposes general restrictions, specifying that contractual clauses must not be unlawful, immoral or contrary to public policy. Furthermore, Art. 20 para. 1 SCO provides for the nullity of contracts that relate to an impossible, illicit or immoral object.

However, additional limitations may apply to specific contracts. For example, art. 340 et seq. SCO imposes strict limitations on non-competition clauses included in an employment contract, particularly with regard to their duration, geographical and material scope, in order to protect the employee's economic freedom.

B. Application to non-competition clauses in a share purchase agreement

Non-competition clauses in share purchase agreements are not governed by any specific provision of the SCO and are subject to the general principles of the law of obligations. Unlike non-competition clauses in an employment contract (art. 340 et seq. SCO), they are assessed exclusively according to arts. 19 and 20 SCO.

The main question put to the Federal Supreme Court here concerns the interpretation of the scope of the non-competition clause and enforceability of the agreed sanction.

Accordingly, the Federal Supreme Court's analysis initially focused on the contractual interpretation of the non-competition clause in order to determine its scope (art. 18 SCO) and whether the alleged conduct constituted a breach .

2. Contractual interpretation and the intention of the parties

A. Interpretation of the contract

Art. 18 para. 1 SCO establishes that the interpretation of a contract must be done according to the true and common intent of the parties rather than merely limiting it to the wording used. This principle, which is essential in contract law, can be broken down into two stages:

1. Subjective interpretation: The court seeks to establish the true and common intent of the parties by relying on contextual elements such as previous negotiations or the parties' post-contractual behavior (ATF 144 III 93, para. 5.2.2).
2. Objective interpretation: If the parties' common will cannot be ascertained, the court must resort to normative (or objective) interpretation, i.e. seek out their presumed will by determining the meaning that, according to the rules of good faith, each of them could and should reasonably attribute to the declarations of will of the other. This is an interpretation in accordance with the principle of trust, itself deduced from art. 2 para. 1 CC. The determination of the objective will of the parties, according to the principle of trust, is a question of law, which the Federal Supreme Court examines freely; to decide it, however, it is necessary to base oneself on the content of the expressions of will and on the circumstances, which are a matter of fact (ATF 144 III 93, para. 5.2.3).

B. Interpretation means and maxims

When interpreting a clause, the court uses various means of interpretation. The text of the contractual clause is the primary means of interpretation (ATF 148 III 57, para. 2.2.1). However, others include but are not limited to contextual (ATF 148 V 70, para. 5.1.1), historical (ATF 77 II 154 para. 4), teleological (ATF 144 V 84 para. 6.2.1), commercial usages (ATF 132 III 460, para. 4.3).

With regard to maxims of interpretation, some legal authors, with whom we agree, consider that the wording of a clause does not take precedence over other means of interpretation.[4] Consequently, the wording of the disputed clause is merely an indication of the parties' intentions, in the same way as the other means of interpretation. For the Federal Court, this lack of primacy of the text applies both to subjective interpretation (4A_290/2017, para. 5.4) and to objective interpretation (4C.94/2000, para. 2c).

In this decision, the Federal Supreme Court largely relied on the literal wording of the non-competition clause in order to determine its scope. On this basis, it found that the defendant had breached the non-competition clause (4A_202/2024, 4A_212/2024, paras. 4.2.1 – 4.2.5).

As one might expect, this practice is not necessarily contrary to the practice of the Federal Court, in its ATF 136 III 186 para. 3.2.1, the Federal Supreme Court points out that '*there is no reason, however, to depart from the literal meaning of the text adopted by the parties when there is no serious reason to believe that it does not correspond to their wishes.*'***[5]*** Furthermore, although the Federal Supreme Court does not express this directly in its ruling, the weight of the contractual clause may be reinforced by the fact that the contracting parties are professionals (business-to-business contract).

3. Application and reduction of the penalty clause (art. 163 SCO)

A. Nature and function of the penalty clause

The parties are free to determine the amount of the penalty clause. However, if said amount is found to be excessive, the court may reduce it as it sees fit (art. 163 paras. 1 and 3 SCO). The penalty is due even if the creditor suffered no actual damage (art. 161 para. 1 SCO).

A penalty clause is an accessory contractual undertaking that sanctions the non-performance or breach of an obligation.[6]

It fulfils two functions:

1. Repressive: It deters the obligated party from breaching its contractual obligation; and
2. Compensatory, restorative: It compensates for the loss suffered in the event of a breach without the creditor needing to prove any damage.

In the case under review, the penalty clause served to guarantee the effectiveness of the non-competition clause by imposing a financial penalty in the event of a breach.

Excessive penalty clauses must be reduced by the courts. However, this does not mean that the court must intervene *ex officio*. The burden of proof lies with the debtor, who bears the consequences of failing to allege the conditions justifying a reduction, and of failing to prove them. However, the allegation need not be formulated in a particularly rigorous manner. The debtor need not explicitly request a reduction in the contractual penalty: it is sufficient for him/her to conclude, by way of exception, that the action has been dismissed in its entirety and to invoke facts, whether established or contested, that justify a reduction. The creditor may be required to indicate their loss and to contest with supporting reasons the allegation that the loss is non-existent or insignificant; they are not, however, required to prove their interest with supporting figures.[7]

B. Legal grounds for judicial reduction of excessive penalties

Art. 163 para. 3 SCO allows the court to reduce an excessive penalty clause if it clearly exceeds the damage suffered.

When a court reduces a penalty clause, restraint is required in order to respect the principle of contractual fidelity and freedom of contract (art. 163 para. 1 SCO). Judicial intervention in the contract is only justified where the agreed penalty exceeds the reasonable threshold compatible with law and equity (ATF 133 III 201, para. 5.2 ; ATF 133 III 43, para. 3.3.1).

A reduction in the penalty clause is particularly justified where there is a clear disproportion between the agreed amount and the creditor's interest at the time of the breach of contract. This assessment must be based on the specific circumstances of each individual case.

Factors to be taken into account include: the nature and duration of the contract; the seriousness of the fault and breach of contract; the creditor's interest in compliance with the clause; and the economic situation of the parties, particularly that of the debtor of the obligation.

Other relevant factors include any dependencies arising from the contractual relationship and the commercial experience of the parties. A reduction is more easily justified when an economically weaker party is involved, rather than in a contract concluded between partners of equal economic strength and experience in business (ATF 133 III 201, para. 5.2 ; ATF 133 III 43, para. 3.3.2)

In this judgment, the Federal Supreme Court upheld the reduction of the penalty clause for several reasons:

- The minor nature of the breach;
- The absence of proven or potential damage;
- The previous court had already reduced the penalty clause to CHF 10,000 on the grounds that the initial amount was disproportionate.

The Federal Supreme Court upheld this reduction, considering that this sum constituted an adequate penalty that is both proportionate and dissuasive.

This ruling illustrates the rigorous approach of the Federal Supreme Court to apply the principles of contractual interpretation in commercial matters, as well as its measured use of judicial discretion in reducing penalty clauses. It underscores the importance of contractual clarity in a business-to-business context and shows that the Swiss courts will intervene sparingly to modify a penalty clause, except in cases of manifest disproportion.

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[1] The letter reads as follow in the original German version: "Rückwirkenden Übernahme des operativen Geschäfts der Construction21".

[2] The letter reads as follow in the original German version: "Rückwirkende Übernahme Vermittlungsprozesse von Kandidaten der Construction21".

[3] Guillod Olivier/Steffen Gabrielle, art. 19-20, no. 1-5, *in*: Thévenoz Luc/Werro Franz (éd.), Commentaire romand du Code des obligations I, 3 éd., Bâle (Helbing Lichtenhahn) 2021, (hereinafter: CR-CO-I-Auteur).

[4] D. Oppliger, Interprétation contractuelle – Poids du texte du contrat et clause d'intégralité, *in* Aktuelle Juristische Praxis – Pratique Juridique Actuelle (AJP/PJA), 2022, p. 1054 ss.

[5] In French : « *Il n'y a cependant pas lieu de s'écarter du sens littéral du texte adopté par les intéressés lorsqu'il n'existe aucune raison sérieuse de penser qu'il ne correspond pas à leur volonté* » (ATF 136 III 186 para. 3.2.1).

[6] CR-CO-I-Mooser, art. 163, no. 4.

[7] CR-CO-I-Mooser, art. 163, no. 6.

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