Dentons

Competition Newsletter

JULY 2020

More flexible approach to non-compete clauses related to investments in startups

On June 19, 2020, the Hungarian Competition Authority adopted a decision providing guidance for financial investors and startups.

The decision was a result of a follow-up proceedings related to an acquisition of joint control by capital funds over CodeCool Kft., an undertaking involved in the development of innovative educational methods (the "**CodeCool Case**")[1]. In the decision, the authority examined the non-compete clause binding upon the former controlling entity and the minority shareholders, who were also founding owners of the startup. The findings of the decision concerning the ancillary restrictions of competition may mitigate the risks associated with investments in the innovative sectors and thereby facilitate the market entry of startups and stimulate growth.

Below we provide a summary of the principles applicable to ancillary restrictions under competition law, the relevant case law of the Hungarian Competition Authority ("**GVH**") and the main elements of the decision adopted in the CodeCool Case.

1. Ancillary restrictions of competition in general

When assessing non-compete agreements, the GVH adopts its decisions on a case-by-case basis, taking into consideration the control structure prior to and following the transaction, as well as the nature of the goods and services.

Act LVII of 1996 on the Prohibition of Unfair Trading Practices and the Restriction of Competition ("**Competition Act**") stipulates a general prohibition for agreements restrictive of competition. However, restrictions of competition, typically non-compete clauses, necessary for the merger of undertakings and *directly and closely* related to the given concentration constitute an exemption from the general prohibition. These so-called ancillary restrictions of competition generally stipulate non-compete obligations for the seller. The non-compete clause is intended to ensure that the seller's conduct does not threaten the return on the buyer's investment implemented through the concentration, and to prevent the seller from competing with the target company/part of the undertaking for a certain period of time, namely, to prevent the seller from carrying out an activity identical with or related to the activity of the target company in the geographical area and for the period specified in the agreement.

The exemption provided by law from the prohibition of agreements restrictive of competition applies only to non-compete clauses that are *absolutely essential* for protecting the value of the investment for a specific period. However, non-compete clauses that go beyond such provision are deemed agreements restrictive of competition under Section 11 of the Competition Act and may entail fines. An example of the foregoing is a non-compete clause applicable to the buyer, which may qualify as ancillary restrictions only within a very narrow scope.

According to the case law of the GVH, as a general rule, a non-compete agreement shall qualify as an ancillary restriction and thus lawful, if

- *it does not go beyond the area of activity of the target company* either in terms of the goods and services concerned, or the relevant geographical area; or
- *it is limited in time,* i.e. applies to a period not exceeding three years.

When assessing non-compete agreements, the GVH adopts its decisions on a case-by-case basis, taking into consideration the control structure prior to and following the transaction, as well as the nature of the goods and services.

2. **Previous GVH case law in respect of joint control by financial investors**

According to general case law, in the case of the acquisition of joint control or the establishment of a joint venture, a non-compete obligation that restricts competition between the undertakings exercising joint control and the joint venture may be lawfully undertaken *for the entire period of the existence of the joint control*. However, *following the termination of joint control,* and in the case of exit from the company by one of the owners as seller, case law generally does not consider any further restriction of competition justified. Furthermore, the non-compete obligation cannot be lawfully undertaken by minority co-owners with no right of control.

Nevertheless, in the case of joint control, the GVH decisions[2] made a distinction between the non-compete arrangements applied by financial investors and those applied by professional market players. Financial investors, not having any professional expertise in the given market, may acquire a stake in a company and exercise joint control over the company together with the persons, having professional and market knowledge, who originally exercised control. In the case of the termination of joint control, the financial investor's investment may lose value due to a lack of professional expertise if the professional investor exiting the undertaking utilized the knowledge as a competitor in the same market. In such case, the non-compete obligation binding upon the professional investor is considered lawful *for a period of two years from the termination of joint control,* as opposed to the general practice that considers the non-compete obligation legitimate only during the existence of joint control.

3. The main elements of the CodeCool Case

As opposed to previous case law, in its decision adopted in the CodeCool Case the GVH considered that the stipulation of a non-compete obligation was permissible not only in the case of the seller, but also in the case of the minority owners of the startup.

As set forth by the GVH in its assessment, it is typical for most startups that minority owners, in many cases the founding owners, have the specific professional expertise that essentially determines the value of the target company. The minority owners of startups may be in possession of the innovative solutions, technology and the required know-how to combine them. Since, in the case of startups, the value of the company usually and primarily depends on actual professional knowledge, the non-compete obligation may extend to all persons who may have such knowledge and have a stake in the company, thus also to the minority owners. Consequently, the GVH considers that to acquire the full value of the startup, it is necessary that not only the seller losing control, but also other minority owners undertake not to compete with the company, and thus such obligation could constitute an exception to the prohibition of the restriction of competition.

In light of the foregoing, the GVH considers it acceptable if, in addition to the seller, minority owners are also prohibited: (i) from acquiring direct or indirect ownership in companies carrying on an activity that is in competition with the activity of the target company, and (ii) from establishing any employment related legal relationship with and providing advice to competitors.

Based on the CodeCool Case, minority owners may be subject to the non-compete obligation during the period of their minority ownership or for two years after the termination of their minority ownership, but only until any of the financial investors has control over the startup. If none of the financial investors has control over the startup, the restriction of competition between the startup and its minority owners cannot, by definition, be associated with the protection of the interests of the financial investor, therefore no exemption from the prohibition of the restriction of competition may be applied.

The GVH also examined the geographical scope of the non-compete obligation. The CodeCool Case is a step forward also in this context: in addition to the actual activity of the startup, the GVH also assessed further plans for market entry going beyond the scope of previous case law. In the CodeCool Case the startup company did not implement actual investments for the purpose of its expansion beyond the already established, although limited presence in the region, however, the financial investor provided the capital increase, at least in part, for the purpose of further expansion of the company. According to the GVH, the foregoing justified the geographical extension of the non-compete obligation also to areas which, according to previous practice, would not necessarily have fallen within the scope of the exemption. It seems that the GVH expressly took into account the circumstance that one of the purposes of the investment was international expansion, which could not be achieved without the investment and which was also key in terms of achieving the return on investment expected by the investors.

It is to be noted that – although it had no relevance in the CodeCool Case – the non-compete obligation may also be extended to activities that can be implemented with the aid of the capital provided by financial investors based on similar logics.

The decision of the GVH may contribute to the mitigation of risks associated with investments into the startup sector, which would make it more attractive for market participants to invest in and finance startups.

4. **Conclusion**

The CodeCool Case may serve as a significant point of reference upon determining the content of restrictions of competition related to the acquisition of control for investment purposes.

Where the market success of an undertaking – typically a startup – is grounded in the knowledge and intellectual capital possessed by and personal to its founders and frequently owners, the non-compete obligation may be considered lawful if stipulated for the founders that remain with the company as minority owners and if it does not exceed the period of their minority ownership and for the maximum of two years thereafter. Moreover, the scope of the non-compete obligation may be further extended based not only on the actual activity of the startup and its existing investments, but also on market expansion – if reasonably practicable - rendered possible by the involvement of financial investors.

Consequently, by extending the personal and geographical scope of contractual provisions qualifying as ancillary restrictions of competition, the decision of the GVH may contribute to the mitigation of risks associated with investments into the startup sector, which would make it more attractive for market participants to invest in and finance startups.

One of the advantages of being a client of a global law firm is that you have access to our '**COVID-19 (Coronavirus) Hub**'. It has a range of articles and other information written by Dentons lawyers all over the world, which will be of interest, especially should you have operations in other parts of the globe. You can find the Hub here.

Contacts

Tihamér Tóth
Of Counsel, Co-Head of Competition practice
tihamer.toth@dentons.com

Tünde Gönczöl
Counsel, Co-Head of Competition practice
tunde.gonczol@dentons.com

Anita Horváth
Partner, Co-Head of Corporate and M&A practice
anita.horvath@dentons.com

Dentons

1061 Budapest
Andrássy út 11.
T +36 1 488 5200
F +36 1 488 5299

ABOUT DENTONS

Dentons is the world's largest law firm, connecting talent to the world's challenges and opportunities in more than 75 countries. Dentons' legal and business solutions benefit from deep roots in our communities and award-winning advancements in client service, including Nextlaw, Dentons' innovation and strategic advisory services. Dentons' polycentric and purpose-driven approach, commitment to inclusion and diversity, and world-class talent challenge the status quo to advance client and community interests in the New Dynamic.

dentons.com