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Arbitrability of employment contracts and contractual penalties

In two landmark decisions, the Federal Tribunal has put an end to an open debate about the validity of certain clauses in employment contracts. The decisions require a review of some clauses in existing employment contracts.

Use of arbitration in employment disputes

In FTD 4A_7/2018 of 18 April 2018, the Federal Tribunal analyzed in detail whether and to what extent employment contracts can validly require the parties to resolve their disputes through an arbitration process.

By way of background, Swiss law prohibits the use of jurisdiction clauses in relation to employment matters before a dispute has arisen, i.e. clauses that purport to specify which courts or other bodies may adjudicate on a dispute. The Federal Tribunal has now confirmed that this restriction applies only to state court proceedings. It is therefore possible to choose arbitration to resolve employment disputes at any time, including before a dispute arises.

The Federal Tribunal further clarified that the arbitrability of domestic employment matters is limited to non-mandatory rights and obligations, which the parties can freely dispose of. Mandatory rights and obligations on the other hand, such as unfair dismissal claims, are subject to state court litigation in domestic matters. By contrast, in international employment matters international arbitration is possible with regard to any monetary claim arising from the employment relationship. Among legal scholars, it was very controversial, whether parties may choose international arbitration also for domestic employment matters, thereby opting for the broader scope of arbitrability. The Federal Tribunal denied this.

We recommend reviewing arbitration clauses in employment contracts in accordance with the new jurisprudence of the Federal Tribunal.

Contractual penalty and disciplinary action

In FTD 4A_579/2017 of 7 May 2018, the Federal Tribunal commented on the question whether and to what extent it is permissible to agree on a contractual penalty to sanction a breach of contract.

The disputed contract clause stated that *"in the event of any violation of contractual obligations, in particular of the non-competition or confidentiality obligation, the employee has to pay a contractual penalty of CHF 50,000 per contract violation"*.

The Federal Tribunal pointed out that the employee's liability, as provided by Art. 321e Swiss Code of Obligations, may not be increased unilaterally or by mutual agreement. Therefore, contractual penalties with compensation character should reflect the actual damage potential and the employee's degree of fault. A contractual penalty, which is payable regardless of fault, is null and void. Null and void are also contractual penalties, which are payable irrespective of a damage incurred by the employer, or contractual penalties that exceed the actual damage.

While it is generally possible to apply contractual penalties as a disciplinary sanction, the Federal Tribunal specified that

Authors



Monika McQuillen
Partner



Dr. Michel Verde
Senior Associate

- (i) the action/omission to be sanctioned must be clearly defined, and
- (ii) the amount of the penalty must be defined and proportionate in relation to the misconduct.

The court held that the disputed contract clause cited above increased the employee's liability in violation of the law, did not apply to specified actions/omissions, and was in addition disproportionate. Therefore, the entire contract clause was considered to be null and void.

In the light of this judgment, contract clauses, which provide for contractual penalties or liquidated damages should be reviewed and adapted, if necessary.

For further information, please contact



Monika McQuillen
LL.M., Partner
Head of Employment Practice Group
T: +41 44 204 90 90
monika.mcquillen@eversheds-sutherland.ch



Dr. Michel Verde
Senior Associate
Employment and Insurance Law
T: +41 44 204 90 90
michel.verde@eversheds-sutherland.ch

eversheds-sutherland.ch

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