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An Initial Examination of Some Legal Issues in Non-Competition

By Tomy Xia

Recently, competition for talent has become a major trend as a result of increasingly fierce competition among enterprises. As employees change jobs more frequently, many enterprises have to enter into non-competition agreements with their employees or place non-competition provisions in their employment agreements to prevent their confidential information or trade secrets, from being disclosed to competitors or otherwise misused. China currently does not have a unified legal system to regulate non-competition issues.[1] The currently applicable provisions are dispersed among departmental, local and other rules and regulations. And there is no unified standard for non-competition in judicial practice. As a result, disputes between employers and employees arise frequently. The author, based on his experience, will analyze some legal issues relating to such non-competition problems.

I. The Definition of Non-Competition

Generally, non-competition means an employer restricts or forbids some of its employees, while employed or after leaving employment, to operate or be employed by any business competing with it. Non-competition obligations can be divided into statutory and agreed obligations. Statutory non-competition is based on laws and regulations, for example under the PRC Company Law (2005 revision), without the consent of the shareholders, no director or senior manager may use his position to seek business opportunities for himself or any other person, or operate for himself or for any other person any business competing with his current company. Another example is found in the PRC Partnership Business Law, which forbids partners from being involved, solely or jointly, with other businesses that compete with the partnership's business. Agreed non-competition is based upon an agreement between the parties. Without agreement, there are no non-competition obligations. Non-competition can additionally be divided into during-employment non-competition and post-employment non-competition.

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This article will primarily focus on problems in post-employment non-competition agreements. Under such agreements, employers pay compensation to employees in return for the employees' promise to not work in or operate any business competitive with the employer for a set period of time after their employment ends. Such agreements may be entirely separate from or embedded within a labor contract.

II. The Obligor of Non-Competition

The author has found that in many cases enterprises have entered non-competition agreements with all of their employees. According to Article 2 of the *Circular on Some Problems with Employee Movement of Enterprise* enacted by the Department of Labor, businesses, by paying a fixed amount of compensation, can prescribe their currently-employed workers who have come into contact with trade secrets shall not be employed in or carry on any business which produces the same products or conducts the same business for a period of up to 3 years after the termination or expiration of the employment agreement. According to Article 16(1) of the *Labor Contract Regulations of Shanghai Municipality*, if the employee is required to keep the employer's trade secrets confidential, the parties may agree upon non-competition clauses in the labor contract or a separate confidential agreement so that when the labor contract is ended or terminated, the employer should pay economic compensation in return for such non-competition.

Obviously, according to the above regulations, non-competition obligations are only placed on employees who obtain confidential information or other trade secrets, rather than all employees. We can therefore conclude that non-competition agreements are intended to keep confidential information from being disclosed or misused by employees and to prevent competitors from using its trade secrets to gain a competitive advantage. Consequently, only specific employees in special posts who come into contact with trade secrets or other confidential information need to execute non-competition agreements. Marketing, administrative staff and other such personnel who have no contact with confidential information do not need non-competition agreements. Because the obligors under non-competition obligations are specific, when drafting non-competition agreements, the employers must make it clear that the employee's job will allow him or her to learn or bring him or her into contact with trade secrets. Otherwise when a dispute arises, the employer may be unable to produce sufficient proof that the employee is the obligor of such obligations, resulting in the invalidation of the agreement by the arbitration body or court, and the employee being freed from any obligations thereunder.

III. Consideration for Non-Competition

- Whether Payment of Compensation is a Condition Precedent for Non-Competition Agreements.

  Non-competition obligation is a restriction on employee's ability to choose work and obtain payment from such work, particularly in their area of specialty. Such obligations inevitably impact the employee's income and quality of life. Therefore, the relevant regulations clearly require that when employers negotiate post-employment non-competition agreements, they must pay their employees economic compensation as consideration for non-competition. According to one school of thought, the consideration of non-competition, without which the non-competition agreement will be null and void, is the condition precedent of the non-competition agreement.[2]

In the author's view, this point of view is in great doubt. The applicable regulations have no definite provision stating that compensation is a condition precedent for non-competition agreements. Non-competition agreements are legally binding upon the parties after execution. And the lack of a compensation provision or the employer's failure to pay agreed compensation will not affect the non-competition agreement's legally binding force. The employee can exercise his Right of Advance Demurrer by finding other work, by refusing to perform the non-competition obligation or by requiring the enterprise to pay economic compensation. Under the applicable rules and regulations, employers can only require their employees, who have the Right of Advance Demurrer, to perform non-competition obligations if the employer has already paid its economic compensation.

According to Article 4 of *Notice II of the Shanghai Municipality, Labor Contract Implementing Regulations* (**Notice II**) enacted by the Shanghai Urban Labor & Social Security Bureau, if an employer and his/her employee agree upon an economic compensation standard and payment method in their non-competition agreement, such provision should be enforced. Under Notice II, if the employer fails to pay compensation according to the non-competition agreement, the employee may terminate the agreement if the employer still refuses to pay after the employee's request. Notice II further stipulates that if the compensation standard and payment methods are not specified in the agreement, the employee may still require the enterprise to pay compensation. Obviously, the view point that compensation is a condition precedent to enforceability of non-competition agreement is not adopted by Notice II.

In practice, if, after termination or expiration of his employment, an employee abides by a non-competition agreement and a dispute arises, it would be unfair to the employee for the court or arbitration body to invalidate the agreement for lack of a compensation clause or the employer's non-performance of the compensation clause. Moreover, if payment of compensation is a condition precedent, such a policy would entitle the enterprise to unilaterally decide whether or not the non-competition agreement is effective. Employees are usually in a relatively weak position at the time labor contracts are signed and unable to write the compensation provisions as they wish. Allowing the employer to unilaterally decide the effectiveness of the non-competition agreement would increase the unfairness of this situation.

- Methods of Compensation

In practice, because employees often end their employment on bad terms with their employer, the two sides frequently cannot agree on a compensation amount for their non-competition agreement. Therefore, companies frequently designate a percentage of monthly salary or a set monthly payment during the course of employment as compensation for non-competition.

The author has dealt with a case in which the company and the employee agreed that 10% of the employee's salary would be designated the employee's compensation for the non-competition provision of the employment agreement. After termination of this employment agreement, the employee requests labor arbitration, claiming the non-competition provision is void, and requesting the company to pay compensation. In fact, the compensation is paid by installment in advance of the post-employment non-competition agreement which will come into effect after the termination or expiration of the employment agreement. In the author's view, such installment payments are not forbidden by applicable laws and regulations. For example, Notice II indicates that if the employer and his/her employee agree upon a compensation standard and payment method (here, designation of a portion of salary as compensation), such provisions should be complied with. Special attention should be paid to ensure that employees obtain full compensation. In the case above, the agreed non-competition period was 2 years, however the employee only received six months' compensation because of the employment agreement terminated after half a year. Under such circumstances, if the company asks the employee to abide by non-competition restrictions for 2 years, it should pay additional compensation to cover the remaining eighteen months of non-competition restrictions.

Additionally, if the agreement only stipulates that a portion of the employee's salary is compensation for non-competition, but does not specify any definite proportion or amount, the arbitration body or the court may decide that the enterprise has not paid compensation due to the ambiguity of the agreement.

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1 According to Articles 16 and 41 of the Draft Labor Contracts Law, non-competition issues have been addressed at the level of a national law for the first time.

2 Wan E'xiang. Ed. *Research on Theory and Judicial Practice of Civil and Commercial Law*, People's Court Publishing House, 2003, p.322.