

Understanding the Use and Validity of Non-compete Agreements under PRC Law

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With growing global competition and interconnection, protecting the Trade Secrets of any company is key to their continued innovation and survival. Especially, the protection of IP Rights and safeguarding of confidential and sensitive information against competitors is high on the agenda of most foreign companies in China where staff turnover is generally higher and infringement more prevalent.

In the following, we will explain the use and validity of non-compete agreements according to PRC Law and related regulations and provide some important answers to commonly asked questions about non-competition restrictions.

Non-Competition

For the purpose of protecting a company's trade secrets such as client lists and intellectual property, most companies require their employees to sign an employment contract containing non-compete clauses or a separate "non-compete agreement" which is one of the most important ways to prevent the disclosure of trade secrets by current and former employees.

A "non-compete agreement", also known as a "competition restrictive covenant", is an agreement under which an employee who is subject to such a special obligation shall not operate, either on his/her own or on behalf of any other person, the same or any similar business as that of the employer during his/her employment and/or for a certain period after the end of the employment relationship.

PRC Laws and Regulations Regarding Non-Competition

In China, there are statutory non-competition obligations expressly stipulated by law which mainly impose non-compete obligations on special groups such as directors, senior management personnel, partners or founders of companies.

According to **Article 148 in the Company Law of the PRC:**

"A director or senior management personnel shall not: (5) abuse his/her duties and powers to seize commercial opportunities of the company for himself/herself or others or engage in similar business as the company on his/her own or with others without the consent of the board of shareholders or a shareholders' general meeting;".

In the following, we will mainly focus on contractual non-compete agreements between employees and employers according to the Labor Contract Law of the PRC ("LCL").

According to **Article 23 in the LCL:**

"An employer and an employee may agree on keeping the confidentiality of the employer's trade secrets and confidential matters in relation to intellectual property in a labor contract.

Where an employee is obliged to keep confidentiality, the employer may agree with the employee in an employment contract or confidentiality agreement to a non-compete agreement where upon the rescission or termination of the employment contract, the employer shall grant the employee economic damages on a monthly basis during the non-compete agreement period. Where the employee has violated the non-compete agreement, he/she shall pay a default penalty to the employer pursuant to the agreement."

Moreover, according to **Article 24 in the LCL:**

"Personnel subject to a non-compete agreement shall be limited to the employer's senior management personnel, senior technical personnel and other personnel who are obliged to keep confidentiality. The scope, geographical region and duration of a non-compete agreement shall be agreed to between the employer and the employee; the non-compete agreement shall not violate any provisions of laws and regulations.

Upon rescission or termination of a labor contract, the non-compete agreement period, in which the above mentioned personnel shall not be employed by another employer that engages in the production or business of the same type of products or provisions of the same type of services as the employer and shall not engage in own production or business in the same type of products or provision of the same type of services as the employer, shall not exceed two years."

Non-Competition Subjects

Some companies believe that signing a non-compete agreement with all its employees will provide them with the fullest protection of their trade secrets. However, non-competition obligations should only be imposed on employees who have access to and are subject to confidential information requirements.

There is no guarantee that all such agreements will be supported by the People's Court. Moreover, any such practices will only add extra costs as the company is required to pay economic damages to every employee who is subject to a non-compete agreement.

Non-Competition Period

The above stated Article 24 of the LCL only expressly states that the period of the non-compete agreement shall not exceed two (2) years following the termination or rescission of the employment relationship.

The current applicable laws do not prevent the parties from agreeing on imposing non-competition obligations on the employees during the employment period but does not clarify if a signed non-compete agreement will automatically apply to the employee's employment period.

Some companies assume that the non-competition obligation will only apply to the period after the termination or rescission of an employment relationship while others think that any non-competition obligations apply to both during and after the employment period.

In practice, the interpretations by different People's Courts varies. If the parties wish to agree on a non-compete agreement covering both during and after the employment period, it is suggested to expressly specify both in the non-compete agreement.

Economic Damages

The LCL stipulates that the employer shall pay economic damages during the non-compete agreement period. In general, the parties can agree on any amount of economic damages which should not be too low to support the employee's basic daily life according to the local standard where the employment contract is performed.

If the parties have not agreed on any specific amount in a non-compete agreement but the employee has performed non-compete obligations and then requests the employer to pay economic damages, the People's Court will support such a request. See below answer to question B.

In practice, the People's Courts generally do not uphold any economic damages for the employment period as it is commonly accepted that the employee's non-compete obligations during his/her employment originate from the employee's **duty of fidelity** which shall be complied with during the employment period.

Questions & Answers

Below we will provide you with some answers to commonly asked questions about non-compete agreements.

A. Shall an employee be released from his/her non-competition obligations if the employer does not pay any economic damages?

A non-compete agreement will not automatically be invalid or terminated if the employer does not pay the agreed economic damages to the employee. In this situation, the employee is entitled to request a termination of the non-compete agreement and shall only stop his/her non-competition obligations upon the termination of the non-compete agreement.

After the performance of his/her obligations under the non-compete agreement, the employee is entitled to claim economic damages from the employer.

B. What is the standard economic damages amount for a non-compete agreement?

- 1) If both parties have agreed on a specific amount, the agreement shall be followed. Local rules may vary from place to place but normally the agreed amount shall be sufficient to support the employee's basic living where the employment contract is performed.
- 2) If the parties have not agreed on any specific amount of economic damages, the employer shall pay economic damages on a monthly basis based on 30% of the average salary of the employee during the 12-month period preceding the rescission or termination of the employment contract. Regardless, the monthly economic damages shall not be less than 30% of the official minimum salary at the place of performance of the employment contract.

C. Can the employer or employee unilaterally terminate a valid non-compete agreement without legal cause?

The employer is entitled to unilaterally terminate the non-compete agreement while the employee cannot. However, upon the rescission by the employer of the non-compete agreement, the employee can request the employer to pay an additional three-month's of economic damages which shall be supported by the People's Court.

D. If an employee has violated his/her obligations under a valid non-compete agreement but has paid compensation to the employer for breach of contract, is the employee still required to continue performing his/her non-competition obligations?

As long as the employer performs its obligation of paying economic damages to the employee, the employee shall continue to perform his/her obligations under the non-compete agreement.

E. Is it valid to instead apply non-competition restrictive clauses stated in the employer's internal policies (i.e. employee handbook or confidentiality handbook)?

Some cases have been supported by the People's Courts and others not. This inconsistent practice may cause unnecessary confusion. In practice, other aspects will be considered such as whether this can be considered as the employer's unilateral actions, whether the internal policy has been signed by the employee and whether the referred policy applies to all employees.

However, the employer will face potential risks if all the employees request economic damages based on the company's internal policies. It is therefore better to sign a separate non-compete agreement where needed.

F. Does a non-compete agreement apply to an employee's employment period?

If an existing non-compete agreement only expressly states that the employee shall be under a non-compete obligation after his/her employment with the employer without mentioning any non-compete obligations during the employment, some People's Courts have upheld this while other People's Courts have ruled the opposite.

The former argue that the employee's non-compete obligations during his/her employment follows the employee's duty of fidelity which shall always be complied with during the employment period.

The latter argue that certain personnel are subject to mandatory non-competition obligations under the Company Law of the PRC whereas regular employees have no such mandatory obligations.

Moreover, non-competition obligations during the employment period are not addressed in the PRC Labor Law or PRC Labor Contract Law. Therefore, any regular employee who undertakes non-compete obligations during the employment period shall be expressly stipulated in the agreement.

If an existing non-compete agreement expressly states that the non-compete agreement period also includes the employment period, the People's Courts will in most cases uphold this as valid as no legal limits exist that a non-compete agreement can only cover the post-employment period.

G. Is the employee liable for the losses sustained by the employer due to his/her breach of contract?

Where an employee violates the non-compete agreement and causes damages to the employer, the employee shall bear compensation liability as stated in Article 90 of the LCL.

Moreover, the employee shall pay liquidated damages to the employer pursuant to the agreement, if any as stated in Article 23 of the LCL.

In theory, the parties can agree on any amount of liquidated damages for breach of contract. However, if the agreed liquidated damages are excessively high compared with the losses sustained by the employer, the employee may request the People's Court to lower the amount.

H. What supporting documents shall be provided by the employer to prove the employee's violation of the non-compete agreement?

Common evidence such as the signed employment contract between the employee and the new employer (that operates in the same or similar industry as the current employer), payment record of social insurance by the new employer for the employee, tax payment record by the new employer for the employee, profile of the employee shown on the new employer's official website or brochure, and witnesses. Please note that most of such documents shall be notarized for the purpose of litigation.

Extra Line of Defense

When a company decides to sign a non-compete agreement with an employee to protect its trade secrets, it is important to clearly define e.g. any restricted professions, activities and investments of the employee both during and after the employment period including the methods of calculating the compensation, and the amount of liquidated damages for breach of contract.

With the intense competition for the best minds in China, the lack of or use of a flawed non-compete agreement can threaten company competitiveness and earnings.

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