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Non-Competes Under PRC Employment Law Regime

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NON-COMPETES UNDER PRC EMPLOYMENT LAW REGIME

A. Introduction

Non-competes refer to post-termination obligations imposed on employees preventing them from joining companies or conducting any business that competes with his/her original employer following the employment termination. Driven by the increasingly fierce climate of market competition, employers are paying more attention to enforcing employees' post-termination non-compete covenants. Meanwhile, the employees are also becoming more aware of their possible legal defenses to protect themselves from claims, leading to a more complicated dynamic in non-compete labor disputes.

In this article, we will introduce the basic legal requirements regarding non-competes under the PRC employment laws, and discuss the hot topic issues regarding non-compete labor disputes, including the scope of non-compete covenants, obligations of reporting employment status, and alternative forms of non-compete compensation.

B. Basic legal requirements regarding non-competes

Non-competes restrict employees' freedom of employment to protect the employer's competitive advantage associated with the employers' trade secrets and confidential information. To balance the interests of the employers and the employees, the PRC employment laws require the employer to pay compensation for non-competes, in addition, set other restrictions on non-competes, including the scope of personnel who may be subject to non-competes, the geographical scope and term of non-competes, etc. Below is a brief introduction to the basic legal requirements.

1. Personnel who may be subject to non-competes

According to the *PRC Employment Contract Law*, personnel who can be subject to non-competes include senior management personnel, senior technical personnel, and other personnel with confidentiality obligations. In defining "other personnel with obligations of confidentiality", generally, elements including but not limited to the nature of the position, work content, and the possibility of accessing confidential information should be considered. If an employee challenges the validity of non-compete covenants arguing that his/her position and work content do not involve confidential information, where the employer fails to prove the employee is under confidential obligations by the employer, non-compete covenants with such employee can be deemed invalid and unenforceable.

2. The geographical scope of non-competes

The geographical scope of non-compete can be agreed upon by the employer and employee while such stipulations shall also be reasonable and fair. The general understanding is that the geographical scope shall be determined according to the influence of the employer's business, and the agreed geographic scope shall be limited to the scope that can form an actual competitive relationship.

3. Term of non-competes

According to the *PRC Employment Contract Law*, the term of non-competes can be agreed upon by the employer and the employee but shall not exceed 2 years after employment termination. Even if the employer and the employee voluntarily agree on the performance of non-competes for more than 2 years after employment termination, the period exceeding 2 years after employment termination should be deemed as invalid and unenforceable.

4. Compensation for non-competes

The employer and employee can agree on the specific standard of non-compete compensation subject to mandatory requirements by statutory regulations (if any). There are no nationwide regulations on mandatory standards for compensation for non-competes while some local regulations set mandatory standards. For example, in Jiangsu, the monthly non-compete compensation shall be no less than one-third of the employee's average monthly salary for the twelve months preceding employment termination; in Shenzhen, the monthly non-compete compensation shall be no less than half of the employee's average monthly salary for the twelve months preceding employment termination.

Where the parties agree on non-competes without specifying the specific standard of compensation for non-competes, it is generally understood that the non-compete covenants are still valid and enforceable, and the employee should be entitled to compensation for non-competes if he/she performs the non-compete obligations. In such circumstances, the *Judicial Interpretations* issued by the Supreme People's Court ("***Interpretations***") sets the default rule for monthly non-compete compensation standard as 30% of the employee's average monthly salary of the twelve months preceding employment termination. In addition to the foregoing default national rule, some local regulations set different standards of compensation for non-competes in the absence of agreement on the specific standard of compensation for non-competes. For example, in Beijing, non-compete compensation can be between 20% and 60% of the employee's monthly salary of the year preceding employment termination; in Shanghai, the standard is 20% to 50% of the employee's normal salary.

C. Hot Topic Issues Regarding Non-competes

1. Scope of non-compete covenants

How to determine competitive relationships

In non-compete labor disputes, whether there is a competitive relationship between the ex-employer and the new employer is always a focus of dispute. In judicial practice, the court will generally review whether the registered business scope of the two companies overlap, whether the new employer is specified as a competitor in the non-compete covenants, etc. In recent non-compete labor disputes, judicial authorities tend to review the competitive relationship substantively going beyond the aforesaid factors and taking more factors into consideration, including actual business, target customers of product/service, employee's position in the new employer, industry practice, etc.

In a high-profile case released in 2023 between a leading Chinese quantitative hedge fund company and its former trading strategist, the ex-employee who is under non-compete obligations joined an IT company (an affiliate of another renowned quantitative hedge fund company) as a quantitative strategy

researcher after he left his ex-employer. In this case, the court found that there is a competitive relationship between the ex-employer and the new employer despite that the registered business scope of the new employer (IT development) does not overlap with that of the ex-employer (investment management). In coming to such a conclusion, the court considers the following factors:

- the ex-employer's reasonable explanation that it has IT development activities in actual operations, and IT development is the core competitive edge of the quantitative investment management;
- industry practice is that different functions are assigned to affiliates of an investment company, but overall support the investment business (software developed by the new employer is mainly about quantitative trading and its affiliate is a direct competitor to the ex-employer);
- the position taken by the ex-employee in the new employer is also quantitative strategy researcher, which is the same as that in the ex-employer.

Similar logic can also be seen in the No.190 guiding case released by the PRC Supreme Court in 2022, where the court does not limit its examination to the overlap of the registered business scope of the ex-employer and the new employer, but also considers the overlap of their actual business activities, customers/potential customers, and the corresponding market.

Whether the scope of non-competes can be expanded to affiliates

When defining the scope of non-competes, two common stipulations in practice are: "the employee is not allowed to join a new employer that the new employer itself or the new employer's affiliates compete with the current employer", and "the employee is not allowed to join a new employer that competes with the current employer and the current employer's affiliates". The reasoning for such stipulation usually relates to the situation that an employee's work may involve affairs of the affiliates of the employer. Yet, practically, it means the scope of non-competes goes beyond the employer itself and is expanded to affiliates.

It remains uncertain whether the judicial authorities will find a breach of non-compete obligations based on such stipulations. Some courts view that, as it is explicitly agreed in the non-compete covenants, if an employee is proven to have prohibited behaviors, it constitutes a breach of non-compete obligations. Other courts may view such stipulations as overbroad and unfair to employees, and where there is no other evidence indicating the existence of actual competitive relationship between the two companies, the former employer's claim on the ex-employee's breaching the non-compete obligations may not be supported solely relying on such stipulations. In other words, the key point still falls to the determination of an actual competitive relationship between the affiliates and the former/current employer.

Summary

To sum up, the judicial authorities tend to conduct substantive reviews considering multiple factors comprehensively to determine competitive relationships in recent non-compete disputes. An employer may stipulate non-compete covenants which expand the scope of non-compete obligations to affiliates. However, despite such stipulations, the judicial authorities may take a substantive review of whether there is an actual competitive relationship, rather than merely relying on such stipulations.

2. Obligation to report employment status

In practice, an employee's competitive behaviors can be conducted in a covert manner, and thus employers always face challenges in tracking ex-employees' status of fulfilling non-compete obligations, especially with the increasing protection of personal information and privacy in China. In recent years, more and more employers have stipulated in the non-compete covenants that an employee is obligated to report employment status to the ex-employer during the non-compete period by providing information about his/her new employment contract, social insurance contributions records, individual income tax withholding records, and other supporting materials ("**Reporting Obligations**").

By requiring an employee to fulfill the Reporting Obligations, employers hope that it can become a mechanism to effectively track and manage whether the ex-employees have joined competitors. Some employers even take a step further to stipulate that failure to fulfill the Reporting Obligations will be deemed as a breach of non-compete obligations. In general, judicial authorities tend to uphold the validity of agreeing on the Reporting Obligations, however, the legal consequences for failing to perform the Reporting Obligations remain disputable in practice.

(1) Validity of agreeing on Reporting Obligations

There are no provisions regarding Reporting Obligations under the PRC employment laws, and Reporting Obligations are generally subject to contractual agreements. In judicial practice, the judicial authorities tend to uphold the validity of stipulations on Reporting Obligations agreed by the parties.

For example, in the No.190 guiding case, the court ruled that "according to the non-compete agreement, the employee shall report his employment status to the former employer on time so that the former employer can have access to know whether he has violated the non-compete agreement. The employee shall strictly abide by such obligations in good faith." Similarly, in another case in Beijing, the court ruled that "although Reporting Obligations is not a statutory obligation, it is one of the obligations agreed by the parties, and thus the employee shall still abide by such obligations".

(2) Legal consequences of failure to fulfill the Reporting Obligations

- Whether it is equivalent to a breach of non-compete obligations

Where both parties explicitly agree on the Reporting Obligations but the employee does not report his/her employment status as agreed, the employer may want to claim that the employee's failure to fulfill the Reporting Obligations equals to a breach of non-compete obligations, and therefore claim for liabilities for breach. However, it is commonly seen that judicial authorities view that an employee's failure to fulfill Reporting Obligations alone is not equivalent to a breach of non-compete obligations.

The rationale is mainly that, the main contractual obligation of the employee under non-compete covenants shall be non-compete obligations itself, and the Reporting Obligations are generally regarded as obligations incidental to the main obligation, and therefore a breach of such incidental obligation (rather than the main obligation) is not equivalent to a material breach of the contractual obligations.

In this light, if an employer fails to prove that an employee has indeed violated the non-compete obligations, judicial authorities usually will not find a breach of non-compete obligations or hold the employee liable for breach merely based on the employee's failure to perform the Reporting Obligations.

- Whether it entitles an employer to suspend payment of non-compete compensation

Another common scenario is that some employers may cease to pay non-compete compensation if the employee breaches the Reporting Obligations as agreed, as the employers view the employee's failure to fulfill Reporting Obligation as a breach of non-compete obligations.

However, as stated above, judicial authorities tend not to establish a breach of non-compete obligations solely relying on a breach of the Reporting Obligations. In addition, judicial authorities tend to view that non-compete compensation is in consideration of restriction on freedom in choosing employment due to the performance of non-compete obligations, rather than the performance of Reporting Obligation. For example, in a case tried by Shanghai First Intermediate People's Court, the employer suspended paying non-compete compensation due to the employee's failure to fulfill the Reporting Obligations. The court held that the employee's failure to fulfill such obligations does not equal to a breach of non-compete obligations and thus should not become a basis for the employer to stop paying non-compete compensation.

Moreover, if the employer suspends payment of the non-compete compensation for more than three months, it may face the risk that the employee can request to be released from the non-compete obligations. According to the *Interpretations*, if the employer fails to pay non-compete compensation for 3 months due to reasons on the employer's part, the court shall support the employee's request to terminate the non-compete covenant and the employee will be released from the non-compete obligations. In the same case mentioned above, the court found that the non-compete covenants had been terminated due to the employer's failure to pay non-compete compensation for more than 3 months, and therefore did not support the employer's claim of ex-employee's breach of non-compete obligations.

To sum up, it is commonly seen that courts view that an employee's failure to fulfill the Reporting Obligation alone is not equivalent to a breach of non-compete obligations. In this sense, if the employer stops paying non-compete compensation for 3 months or more on this basis, the employee can request to terminate the non-compete covenants, and as a result, the employer would be unable to claim breach of non-compete obligation after such termination.

(3) Other implications of failure to fulfill the Reporting Obligations

Although employers may not rely on Reporting Obligations itself to claim for a breach of non-compete obligations, it may have other implications that could be helpful for employers to enforce non-compete obligations.

- Provide a reasonable doubt that the employee may have violated non-compete obligations

As stated above, although failure to fulfill the Reporting Obligations alone is difficult to be regarded as equivalent to a breach of non-compete obligations, it may provide reasonable doubt for the employer that the employee may have violated the non-compete obligations. If the employer can further provide preliminary evidence of violations, and the employee fails to prove otherwise or provide justifications, he/she may be found to be in breach of the non-compete obligations.

For example, in a case in Guangdong, the employer claimed that an ex-employee violated non-compete

obligations, and the employee's failure to fulfill the Reporting Obligations was presented as evidence. The court ruled that "the employee has the burden of proof in respect of his employment status during the non-compete period. In this case, the employee failed to provide a reasonable explanation for his failure to fulfilling the Reporting Obligation. As a result, an adverse inference is drawn from the employee's failure to prove his employment status, for which the employee shall bear the adverse consequences."

Note that, local judicial practice may vary on whether violating the Reporting Obligations alone is sufficient to provide reasonable doubt. In some cases (like the case in Guangdong above), it is viewed that employee's failure to fulfill the Reporting Obligations is sufficient for the employer to have reasonable doubt, while in some other cases, it may require that the employers provide additional substantive evidence of competitive behaviors. In any case, Reporting Obligations can at least serve as an "alarm" for the employer of an employee's possible violation of non-compete obligations, and the employers can then try to collect and preserve more evidence regarding such violation.

- Affect the court's determination of the severity of the breach and the corresponding liabilities for the breach

As a contractual obligation, failure to fulfill the Reporting Obligations itself can be deemed as a violation of good faith, which could aggravate the court's determination on the severity of the breach, the degree of the employee's subjective fault, and can correspondingly affect the liabilities for breach (e.g. amount of liquidated damages).

For example, in a case in Beijing, the employee failed to report his employment status and joined a competitor of the former employer. The employee argued that the liquidated damage standard stipulated in the non-compete agreement was too high and sought for reduction. The court viewed that the employee's behavior was in serious breach of good faith considering the facts of the employee's joining a competitor as well as refusing to perform the Reporting Obligations, and therefore rejected the employee's request in reducing the amount of the liquidated damages.

Summary

To sum up, it can be helpful for employers to stipulate Reporting Obligations with the employees in the non-compete covenants to track the employees' employment status as a signal of possible breach of non-compete obligations, yet failure to fulfill the Reporting Obligations alone does not necessarily constitute breach of non-compete obligations. The employers shall therefore also be cautious about ceasing to pay non-compete compensation as it may result in the termination of the non-compete covenants. Nevertheless, where an employee fails to fulfill the Reporting Obligations, it can be served as a reasonable doubt that the employee is in breach of the non-compete obligations, and employers are also suggested to collect and preserve other evidence regarding the breach.

3. Alternative Forms of Non-compete Compensation: Non-competes and Incentives

In recent years, an increasing number of employers have been implementing incentive plans for employees as a motivating measure with tools such as restrictive shares, shares options, etc. Some employers have linked such incentives with non-compete obligations, stipulating that the incentives serve as the consideration for performing non-compete obligations, and the employer does not need to

pay non-compete compensation separately in the traditional monetary manner as provided by law, or in other words, using incentives as an alternative form of non-compete compensation.

Compared with monetary compensation, equity shares have particularities in many aspects, including the nature, form, and substantive rights the employee is entitled to. For example, subject to the specific incentive plans, the incentives may be in the form of shares or options of the employer or sometimes its affiliated companies, and there may be specific requirements for granting, vesting, and disposing of the equities, which may lead to uncertainties on whether, when and how much the employee can actually receive the earnings. As the PRC employment laws set requirements and/or rules regarding non-compete compensation (including that the employer shall provide non-compete compensation to the employee on a monthly basis, the standard of the non-compete compensation, etc.), whether agreements on using incentives as an alternative form of non-compete compensation can be supported remains disputable in judicial practice.

In a case in Shenzhen, the parties agreed that 1) stock options provided to the employee during his employment serve as non-compete compensation and 2) the employee must return all the earnings obtained from such options and pay liquidated damages if he violates non-compete obligations. The employee obtained earnings from the options during his employment. The employee later joined a competitor during the non-compete period and the employer requested that the employee bear the liabilities for breach, including returning the earnings previously obtained from the options. The court held that “since the parties clearly agreed to use stock options as consideration of non-compete obligations and the employee obtained actual earnings from the stock options granted, the employee shall return the earnings obtained and pay the liquidated damages according to the agreement for breaching the non-compete obligations.”

However, in another case in Beijing, the court did not support agreement on using options as non-compete compensation. In that case, the options used as non-compete compensation are from the parent company of the employer, and the parent company is an unlisted company. The court found the agreement invalid in that – the intention that the law provides compulsory requirement on non-compete compensation to be paid monthly is to solve the living difficulties that may be caused by limitations on employee’s freedom of employment. Yet, the price of shares of unlisted companies provided in this case is uncertain and shares/options of unlisted companies may lack the liquidity to be sold or disposed of. Compared with the provisions set by law, it is more disadvantageous to the employee to use such options of an unlisted company as non-compete compensation, and thus such stipulations shall not be valid and binding.

Summary

To sum up, the validity of using incentives as non-compete compensation remains disputable in the current judicial practice. The court may review the stipulations comprehensively based on factors including whether the agreement is more disadvantageous to the employees than the legal requirements, whether it’s explicitly agreed that the incentives are consideration of the non-compete obligation, whether the legislative intention of non-compete compensation can be realized, etc.

D. Conclusion

With the development of technology and increasingly fierce market competition, non-compete has been

attached with more and more importance by employers to protect its competitive advantages associated with the trade secrets and confidential information of the companies.

Regarding stipulating non-compete covenants and enforcing the non-compete obligations, it is suggested to pay attention to the legal requirements and key issues discussed above in this article, including the scope of non-compete obligations, whether to have Reporting Obligations and how to implement such obligations in practice, and contemplate on the alternative forms of non-compete compensation to be adopted.

With the wider implementation of non-competes and rapid development in practice, it is also expected to see developed judicial practices in response to relevant issues regarding non-compete labor disputes. Employers are advised to pay close attention to such dynamics in judicial practice, so as to be guided on better management and utilization of non-competes to protect their legitimate interests, and at the same time, better protect their positions in non-compete-related disputes.

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