Non-Compete Clauses in China: New Rules

Recent interpretations by the PRC Supreme People's Court clarify a number of issues on implementation of Chinese labor laws. Arguably the most important clarifications are related to the compensation for and termination of non-competition clauses. Companies are strongly advised to review whether they have taken all necessary measures to ensure compliance and protection under the law.

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The Judicial Interpretation IV of the Supreme People's Court on Several Issues Concerning the Application of Law in Hearing Labor Dispute Cases ("Interpretation IV") are effective as of 1 February 2013.

Under the Chinese Labor Contract Law, employers can sign non-compete clauses with key employees (legally limited to the employer's senior management, senior technicians and other personnel with a confidentiality obligation). In such a clause, for a maximum period of 2 years as of termination of the employment relationship (for whatever reason), the former employee cannot work for a competitor. In return for this commitment and during its performance (i.e. during the period of non-competition), the former employer must pay compensation to its former employee, even if this is not specifically agreed in the employment contract.

Determining Compensation for Non-competition

The Chinese Labor Contract Law does not determine the amount of compensation to be paid, and until now this has been left to rules and interpretations adopted at local levels. In Shanghai for example, the parties are free to determine the level of compensation; but if no such compensation was agreed upon, a bandwidth has been set at between 20% and 50% of the average monthly salary over the 12 months before termination.

Many employment contracts fail to mention the compensation or the compensation amount. Under the new judicial interpretations, if no agreement is reached on the amount of compensation, then it is determined that the employer shall pay compensation at 30% of the employee's average salary for the 12 months before termination, or the applicable minimum wage (whichever is higher).

This provides useful guidance to companies who have signed non-competition agreements with some employees, but could not reach an agreement on the amount of compensation. Moreover, this level of compensation may well become the norm in the future.

Termination of Non-competition Clauses

As payment for compensation is a pre-condition to the obligation to not compete, it follows that if a company fails to pay its former employee due compensation, then the employee can either claim for such compensation, or terminate the obligation and start working for a competitor.

The new judicial interpretations for the first time set a clear timeframe for the right to terminate the obligation of non-competition: if the former employer has failed to pay

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compensation for three months as of termination of the employment for reasons due to the employer.

In addition, the employer's right to terminate an agreement for non-competition is held to new standards. A company can still unilaterally terminate such an agreement to avoid having to further pay compensation. However, this will subject the former employer to a penalty of 3 months' compensation, payable to the former employee. This in fact is a major diversion from current practice. In Shanghai for example, unilateral termination has so far not been subject to penalties, and only one month advance notice was to be observed.

A related point that the judicial interpretation does not clarify, however, is whether a company's unilateral termination of the obligation of non-competition during the employment is subject to a penalty or notice. At the very least, the above rule makes it more likely that arbitration tribunals and courts will take the side of the employee in such a situation. In response, companies could draft their non-competition clauses in a very deliberate way to minimize the impact.

Conclusions

The new interpretations that relate to non-competition clauses are a welcome clarification to current laws, and may help to establish more standardized practices. They do put seemingly new obligations on employers, which makes it even more important for companies to ensure that their non-compete clauses are written in a way that fully protects the interests of the company.

On the other hand, many questions related to this important issue remain unanswered or vague. For example, can an employer waive the non-compete obligation at termination of the employment, and would it help if this was agreed in the employment contract? What levels of liquidated damages can be demanded from former employees that breach their obligations of non-competition? And how to deal with the burden of evidence to prove a situation of non-competition?

On these and many other issues, clear and smart drafting of non-competition clauses or, preferably, independent confidentiality and non-competition agreements, will continue to be the best protection that a company can have.

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