CORRS
IN BRIEF

MARCH 2010

FOREIGN INVESTMENT COMPANIES IN CHINA: NON-COMPETITION CLAUSES

The ambiguities in China's non-competition laws have made it difficult for Australian investors and other foreign investment enterprises doing business in China to practically comply with their legal obligations as employers in China and understand the enforceability of non-competition clauses in their employment contracts in China.

A significant difference between PRC and Australian laws is that employers in China are required to pay a monthly compensation to their employees during a post-employment restraint period. Such payment is a factor in determining the enforceability of a non-competition clause beyond the term of the employment relationship. This article will discuss the law of restraints in Australia and outline the developments in China regarding employment restraints in the past year.

INTRODUCTION

With the US and Europe struggling in the current economic downturn, the world is looking to Asia as the new engine room of the global economy. Many companies have positioned themselves to take advantage of business opportunities in China, including the benefits of preferential investment policies and a cheaper labour force.

Foreign investment enterprises doing business in China have generally enjoyed the benefits afforded by China's economic growth, however, there has also been much unrest among those who are employers in China. This is a result of the introduction of the new laws and regulations in relation to the PRC Labour Law in the last few years, in particular, the PRC Labour Contract Law (effective 1 January 2008) (**LC Law**) and its regulations (effective 18 September 2008) (**Regulations**).

One area of concern is the ambiguity in the enforceability of non-competition provisions in contracts governed by PRC law. The LC Law requires employers in China to pay a monthly compensation to their employees during the post-employment restraint period, however it is silent on the amount of compensation that must be paid for the non-competition provision to be enforceable. An Opinion[1] issued by the Shanghai People's High Court on 30 March 2009 (**Opinion**) has provided greater certainty around the enforceability of non-compete restrictions and the compensation required to be paid to employees.

This article aims to assist legal advisors, Australian investors and other companies looking to do business in China grapple with the differences between non-competition provisions in both jurisdictions. It will revisit the law in Australia and outline the current non-competition issues arising in China.

BACKGROUND

Origin of non-competition provision?

The restraint of trade doctrine applied by the Australian courts today has its roots in medieval England[2]. The doctrine originally arose in the context of apprenticeships where the master would attempt to restrain an apprentice from trading in competition with the master after the end of the apprenticeship.

The courts found that these restraints were unenforceable by the master because they effectively prevented the apprentice from earning a livelihood after the end of the apprenticeship period[3]. The courts consider that the right to earn a livelihood is a fundamental right deserving of protection[4].

Consequently, the doctrine of restraint of trade arose and courts expressed that restraint of trade provisions are presumed void unless the party seeking to rely on the restraint proves that it is reasonable in the circumstances. This presumption will override any contractual arrangements to the contrary.

Non-competition provisions today

The Australian courts continue to apply the presumption of

invalidity today because they advocate a freedom of trade and free market. Over the years, there has been a shift on the types of agreements under which the doctrine is applied.

Nowadays, it is common to find restraint provisions in documents other than employment contracts, such as business sale agreements, franchise agreements and supply or manufacture agreements. There is also a growing number of restraint of trade disputes involving technology consulting companies because of restraints in relation to anti-poaching or protection of customer or other confidential information.

Restraint provisions are also sometimes used in licence agreements where a licensor grants a licensee certain intellectual property subject to limitations in its use to a certain geographic area or within a specified timeframe. It is also seen in assignment of intellectual property, such as a patent, where the assignor relies on a restraint on the assignee not to use the patent in competition with the assignor or its business.

Restraint of trade provisions in agreements generally protect the company requiring the restraint (covenantee) by restricting the person being restrained (covenantor) from revealing confidential information belonging to the covenantee, using specialised knowledge particular to the covenantee's business to compete with it or soliciting the covenantee's employees, customers or other contacts.

NON-COMPETITION PROVISIONS IN AUSTRALIA

Under the doctrine, it is important to ensure that the restraint is reasonable both with reference to the interest of the parties and the public interest, to prevent the restraint from becoming void and unenforceable.

In determining if a restraint is reasonable, the courts consider the activities being restrained, the time limits imposed in the restraint, the geographical constraints and the consideration for the promise. The assessment of reasonableness is a balancing exercise and involves the interplay of all of these factors. It is impossible to predict with any certainty the decision a Court would reach in the event that the restraint is litigated.

It is also important to note that the covenantee would bear the onus of proof of establishing that the restraint goes no further than is reasonable to protect its legitimate interest[5], which issue is considered against the facts and circumstances at the time the restraint was agreed to, not at the time the covenantee seeks to enforce it or claim damages for breach[6].

Recent cases such as *EzyDVD Pty Ltd v Lahrs Investments Qld Pty Ltd*[7] and *Blockbuster Australia Pty Ltd v Karioi Pty Ltd*[8] indicate that the Courts, in determining reasonableness, may consider whether an agreement already has adequate alternative contractual mechanisms to protect the covenantee's intellectual property, in addition to a restraint provision. In *EzyDVD Pty Ltd v Lahrs Investments Qld Pty Ltd*, a franchisor applied for injunctive relief to enforce a restraint provision in a franchise agreement against the franchisee. The restraint prevented the franchisee from conducting a competing business in the same area during the six months following expiration or termination of the franchise agreement. The Court considered that the restraint was unreasonable given the period during which the information was required to be kept confidential and that the franchisee had returned or destroyed the relevant records in accordance with its contractual obligation.

Activities being restrained

The restraint of trade provision should strike a balance between, on the one hand, the covenantor having an unfair competitive advantage against the covenantee by virtue of having worked in or with the covenantee's business and on the other hand, the covenantee having a more than adequate protection of its business which unduly disadvantages the covenantor.

Time restraints

Whether a time restraint is reasonable depends on the circumstances surrounding the relationship between the covenantor and the covenantee. The restraint must not be longer than necessary to protect the interest of the covenantee. For example, if the covenantee's genuine estimate of the time necessary for the covenantor's connections with the covenantee's customers or clients will fade in six months or one year, then it would be unreasonable to extend the time restraint beyond that period.

Geographic restraints

What geographic area is a reasonable restraint would commonly depend upon the extent of the covenantee's business activities. In *Cream v Bushcolt Pty Ltd*[9], the Court found that the restraint area set out in the agreement, being the whole of Western Australia was too broad and therefore unreasonable because the covenantee's business only had significant presence in one part of the State. Therefore, generally (but not in all cases) where a covenantee's business activities are limited to a particular area, the restraint area should be limited to that area.

NON-COMPETITION PROVISIONS IN CHINA

In modern times, the law in China has been a complicated fusion of traditional Chinese and Western methodologies which are constantly undergoing reforms aimed at strengthening the legal system in China.

One such reform is, of course, the introduction of the LC Law, which has the intention of protecting the interests of employees. A recent edition of *Lawyers Weekly* reported that since the adoption of the LC Law,

> *"employees have been successful in more than 90 per cent of disputes decided by Chinese labour tribunals, often irrespective of the merits of the case – serving only to reinforce the importance of instituting robust hiring practices."* [10]

As discussed above, the restraint of trade doctrine in Australia can also be said to protect employees, however the doctrine's application is much broader in scope in that it has a close review of the interplay of different factors in determining reasonableness.

To whom does the LC Law apply?

In China, the LC Law governs non-competition provisions found in employment arrangements between an employer in China, including foreign investment companies, and their employees working in China. Article 2 of the LC Law refers to the application of the LC Law as follows:

> ***Article 2:*** *The establishment of employment relationship between enterprises, individual economic organizations, non-enterprise private entities and other entities (hereinafter referred to as the employers) and the workers thereof, as well as the conclusion, performance, alteration, discharge or termination of labor contracts therebetween shall be governed by this Law. This Law shall also apply to the state organs, public institutions, social organizations and workers bound up by labor contracts concerning the conclusion, performance, alteration, discharge or termination of labor contracts.*

[English translation[11]]

It is uncertain from an analysis of Article 2 whether it is necessary for a traditional employment relationship to exist or whether it would cover other circumstances such as where a worker is seconded from another entity (for example, an Australian corporation) to work in China and therefore does not have a direct contractual relationship with the employer in China. In fact, it is unclear whether such secondment arrangements are contrary to the LC Law. This is because ambiguity in the LC Law is further complicated by special rules which apply to "labour secondment arrangements" set out in Chapter 5 Section 2 of the LC Law and Chapter 4 of the Regulations. These arrangements entail the hiring of an employee by a service agency, who then places that employee with an employer.

As an aside, it is useful to know that foreign companies with a representative office in China are prevented by the Regulations from directly contracting with employees in China – such employment arrangements must be arranged through a designated foreign service agency or for companies in Shanghai, the Beijing Foreign Enterprise Human Resources Service Shanghai Co., Ltd. (commonly known as 'Shanghai FESCO')[12]. The Opinion states that such employees who have a dispute concerning the terms of their employment have standing to directly initiate a labour dispute arbitration against the foreign company's representative office[13]. The law is unclear however, on whether this right to initiate arbitration can be exercised by the employer as well.

Notwithstanding the above ambiguities, Article 10 clarifies that the LC Law applies to an employment relationship regardless of whether a written labor contract is in place. It states that an employment relationship can be established without a written labor contract, however, such written contract must be signed between the employer and employee within one month of the employee's commencement of work for the employer.

Articles 23 and 24 of the LC Law

Article 23 and 24 of the LC Law sets out the main sections in respect of non-competition and read as follows:

> ***Article 23:*** *Employers and workers may stipulate such issues as keeping confidential the business secrets and intellectual property of the employer in the labor contract. With respect to a worker who has the obligation of keeping secrets, the employer may stipulate limitation of competition clauses with the worker in the labor contract or in the confidentiality agreement and stipulate that economic compensations shall be given to the worker within the period of limitation of competition in terms of months after the labor contract is discharged or terminated. Where the worker is in violation of the stipulation on limitation of competition, he shall pay a penalty for breach of contract to the employer.*
>
> ***Article 24:*** *The personnel under limitation of competition shall be limited to senior mangers, senior technicians and other personnel who have the obligation to keep secrets in the entity. The range, geographical scope and time limit for limitation of competition shall be stipulated*

by the employer and the worker. The stipulation relating to limitation of competition shall not violate any law or regulation. After the discharge or termination of a labor contract, the period of limitation of competition for any of the persons referred to in the preceding paragraph to work for any other employer producing or engaging in products of the same category or conducting business of the same category as this employer shall not be more than two years.

[English translation[14]]

Non-competition limited to senior employees with confidentiality obligations

A restraint provision under the common law doctrine in Australia may be drafted in a contract for a number of reasons, including, to keep confidential the trade secrets of an employer, prevent poaching of employees and protect customer or other confidential information. Similarly, the LC Law has the same intent, however, there is no direct requirement of reasonableness.

Articles 23 and 24 differ from the doctrine in that the application of non-competition provisions in Chinese employment contracts cannot extend beyond senior management, technicians and other senior employees who have knowledge of the employer's trade secrets or are subject to obligations of confidence.

Activities, time and geographic restraints

Similar to the doctrine, the LC Law also applies certain restrictions regarding non-competition provisions. Namely, the LC Law specifies that:

(a) the period of post-termination restraint must not exceed two years after termination of the relevant employment contract; and

(b) the employee is restrained from:

  (i) employment by a competing company that produces the same type of products or is in the same type of business as his or her current employer; and

  (ii) establishing his or her own business to produce products or engages in business competing with his or her current employer's products or business.

Employer required to pay financial compensation

The LC Law requires the employer to pay a financial compensation to its employee on a monthly basis during the period of the restraint of trade beyond the term of the employment relationship, however, it is silent on the amount of compensation that must be paid for the restraint provisions to be enforceable. Interestingly, the LC Law is silent as to whether a non-competition provision can apply during an employment contract without additional compensation. Presumably this is permitted, however, there is no commentary or regulations supporting this.

To date, there have been no uniform laws or regulations nationally regarding the amount of compensation, however, some municipalities or provinces have released guidelines. In March 2009, the Opinion was issued, providing that any non-competition provision that did not specify the amount of compensation (or if the exact amount was unclear) would still be held binding on both parties[15]. In such circumstances, the parties may negotiate the amount of the compensation, failing which the compensation shall be 20% to 50% of the employee's original base salary.

Some commentary on this issue have argued that although this Opinion provides greater certainty, there is still a need for the employer to determine the exact range between 20% and 50% that would be deemed valid in the circumstances. Other commentary interpreted the Opinion to mean that the Court would step in to nominate an appropriate compensation between 20% and 50% of the employee's original base salary where the parties fail to agree on the amount of compensation.

It is important to note that the guidelines and opinions in each municipality or province in China may differ in the interpretation of the LC Law. The Opinion discussed above applies only to Shanghai. By way of comparison, in Jiangsu Province, the employee must pay a yearly compensation of no less than 30% of the employee's total income from the employer in the last 12 months prior to termination of the labor contract . In Shenzhen Province, the requirement under article 17 of the *Regulations of Shenzhen Special Economic Zone on the Protection of Technical Secrets of Enterprises* is that the yearly compensation must not be less than two-thirds[17], and according to article 44 of the *Regulations on Zhongguancun Science Park* (which regulates the Haidian Zone, Fengtai Zone, Changping Zone, Electronic City Zone, Yizhuang Science & Technology Zone and other areas in Beijing) the compensation must not be less than half the employee's total income during the last year of employment[18]. Other jurisdictions in China may issue their own opinions in due course, which may take a difference stance. Given this, it would be wise to seek legal advice in China to understand the requirements of the municipality or province in question to ensure that an enforceable non-competition provision is in place and appropriate compensation is paid.

REMEDIES IN AUSTRALIA

The most common and probably effective means for the covenantee to protect its goodwill is to act quickly as soon as it is aware of a breach of restraint by a party it has contracted with. The sooner action is taken, the more likely the covenantee would be able to obtain an injunction on the other party to comply with the restraint and therefore protect the goodwill of its company.

In a recent sale of business case, *TSV Holdings Ltd v Evans* [19], the Court granted an injunction in favour of the applicant because there was a real risk that the respondent would continue unauthorised contact with the applicant's customers.

Other remedies commonly available to a covenantee include damages to compensate the covenantee for any loss that it may have suffered as a result of the breach of restraint of trade and an account of any profits made by the covenantor who was in breach.

REMEDIES IN CHINA

Within the context of a breach of non-competition restraint by an employee, the remedies available to the covenantee in China are similar to the Australian position above. Remedies in China include protection under article 92 of the LC Law which deems the employee liable for damages if he or she:

(a) terminates the employment contract contrary to LC Law; or

(b) breaches any obligations of non-competition or confidentiality under the employment contract,

provided that such termination or breach causes the covenantee to suffer loss[20].

There is no commentary or guidance to date in relation to what extent of loss is required or whether the employer is required to mitigate its loss.

CONCLUSION

In Australia, the presumption of invalidity regarding restraint of trade provisions continues. There is no single element of restraint that provides certainty and ensures enforceability of restraint of trade provisions in agreements, however, there is case law guiding the options available to overcome enforceability issues on a restraint and numerous remedies that are available if there is a breach.

Conversely, in China non-competition provisions found in written employment contracts are regulated by the LC Law. The non-competition provisions apply only to senior employees with confidentiality obligations and is not to exceed two years from termination of employment. Employers are required to pay compensation to their employees every month for the restraint period, however there is no certainty as to what amount is sufficient for the restraint to be enforceable. Foreign investment companies, especially those companies with significant intellectual property, know-how and technology in China should take extra care to ensure appropriate compensation is paid to prevent an employee being relieved of his or her restraint of trade obligations. It may be prudent for an employer to compromise with an employee as much as commercially possible regarding a compensation amount to ensure enforceability of a non-competition provision.

In any event, a key to management of any business is by being aware of the risks associated with restraint provisions, and proactively managing those risks. Due to the complexity and uncertainty surrounding the non-competition provisions, legal advice is paramount – 預防勝於治療! [21]

Author:

Rosena Yau
Lawyer
Tel +61 7 3228 9870
rosena.yau@corrs.com.au

This article was first published in Issue 79 of the IPSANZ *Intellectual Property Forum.*

For further information, please contact:

Eddie Scuderi
Partner, Brisbane
Tel +61 7 3228 9319
eddie.scuderi@corrs.com.au

Hilary Goodier
Partner, Brisbane
Tel +61 7 3228 9807
hilary.goodier@corrs.com.au

1 Shanghai People's High Court and Shanghai Labor Arbitration Commission, *Opinions on Several Issues Concerning Application of the Labour Contract Law No.73* (2009)

2 JD Heydon, *The Restraint of Trade Doctrine* (3rd ed, 2008) 6

3 JD Heydon, *The Restraint of Trade Doctrine* (3rd ed, 2008) 9

4 *Mitchel v Reynolds* (1711) 1 P Wms 181 at 193-4; [1558-1774] All ER Rep 26 at 31-2

5 *Mason v Provident Clothing and Supply Co Ltd [1913] AC 724 at 733 and 741; Herbert Morris Ltd v Saxelby [1916] 1 AC 688 at 700, 706-07 and 715;* JD Heydon, *The Restraint of Trade Doctrine* (3rd ed, 2008) 33

6 *Prenn v Simmonds* [1971] 3 All ER 237 at 239; JD Heydon, *The Restraint of Trade Doctrine*, 3rd ed (2008) at 45

7 [2009] QSC 227

8 [2009] NSWSC 1089

9 [2004] WASCA 82

10 Christopher Betts, 'Careful Handling Vital for China' (Pt 456) [2009] Lawyers Weekly 13 at 13-14

11 The Labor Contract Law of the People's Republic of China (2008) Foreign Direct Investment,

Ministry of Commerce of the People's Republic of China ‹http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=82499› at 22 October 2009

12 Unknown, China Enacts Implementing Regulations for Labor Contract Law (2008) Vinson & Elkins LLP ‹http://www.vinson-elkins.com/resources/pub_detail.aspx?id=11830› at 27 October 2009

13 Opinion, above n 1, article 22

14 The Labor Contract Law of the People's Republic of China (2008) Foreign Direct Investment, Ministry of Commerce of the People's Republic of China ‹http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=82499› at 22 October 2009

15 Opinion, above n 1, article 13.

16 Andy Yeo, 'The PRC Labour Contract Law: Taking Stock Six Months On' (2008) Hong Kong Lawyer ‹http://law.lexisnexis.com/webcenters/hk/Hong-Kong-Lawyer-/The-PRC-Labour-Contract-Law-Taking-Stock-Six-Months-On›; Jason Tian, 'Newsletter on several issues about China labor law' (2009) Zhon Yin Lawyers ‹http://www.sh148.org/English/UploadFiles_8829/200906/20090628233029438.pdf› at 27 October 2009

17 Regulations of Shenzhen Special Economic Zone on the Protection of Technical Secrets of Enterprises (1996) AsianLii ‹http://www.asianlii.org/cn/legis/gd/laws/rossezotpotsoe928/› at 2 November 2009

18 Regulations on Zhongguancun Science Park (2000) Beijing Municipal Science & Technology Commission ‹http://www.bjkw.gov.cn/n244495/n244634/2659755.html› at 2 November 2009

19 [2008] VSC 157

20 The Labor Contract Law of the People's Republic of China (2008) Foreign Direct Investment, Ministry of Commerce of the People's Republic of China ‹http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=82499› at 22 October 2009

21 English translation: "an ounce of prevention is worth a pound of cure!".

SYDNEY
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Tel +61 2 9210 6500
Fax +61 2 9210 6611

MELBOURNE
Bourke Place
600 Bourke Street
Melbourne VIC 3000
Tel +61 3 9672 3000
Fax +61 3 9672 3010

BRISBANE
Waterfront Place
1 Eagle Street
Brisbane QLD 4000
Tel +61 7 3228 9333
Fax +61 7 3228 9444

PERTH
Woodside Plaza
240 St George's Terrace
Perth WA 6000
Tel +61 8 9460 1666
Fax +61 8 9460 1667

CORRS CHAMBERS WESTGARTH lawyers