CHINA: NON-COMPETE CLAUSES IN THE TRANSACTIONAL CONTEXT

BY ADRIAN EMCH[1]

1 Adrian Emch is partner at Hogan Lovells in Beijing. The views expressed in this paper are personal, and do not reflect those of Hogan Lovells or its clients. The author thanks Prof. Liyang Hou, Qing Lyu and Hazel Yin for their comments on earlier drafts. Anti-Monopoly Law of the People's Republic of China, [2007] Presidential Order No. 68, Aug. 30, 2007.

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I. INTRODUCTION

Non-compete clauses in agreements between competitors can be problematic under antitrust rules. China is no exception. A large part of the enforcement cases brought by Chinese antitrust regulators since the Anti-Monopoly Law ("AML")[2] came into effect close to 12 years ago concerned agreements where competitors decided not to compete on certain parameters of competition (such as price), or not to compete at all. Before Chinese courts too, a good number of cases concerned cartel agreements,[3] even though there are the odd cases where judges greenlighted seemingly hardcore cartel conduct.[4]

A sub-set of non-compete arrangements between competitors – those entered into within the context of a structural transaction (using the AML's terminology, a "concentration between business operators") – has received very little attention by legislators and regulators in China. There is a lack of explicit rules as to whether and how non-compete obligations can be justified in the transaction context.

In contrast, foreign antitrust laws provide some guidance. In the European Union, for example, the European Commission issued the Notice on restrictions directly related and necessary to concentrations ("Ancillary Restraints Notice").[5] As its title indicates, the notice states that those restrictions that are directly related – i.e. economically related to a "concentration" and intended to allow a smooth transition to the changed company structure post-concentration – and necessary – in the sense that the concentration could not be implemented, or only with considerably higher uncertainty, cost or difficulty – are automatically covered by the European Commission's decision on the concentration.[6] These directly related and necessary restrictions – dubbed "ancillary restraints" – are among others meant to protect the value transferred or to enable the start-up of a new entity.[7] Non-compete clauses are explicitly mentioned as ancillary restraints, both for acquisitions and joint ventures. The general rule is that non-compete obligations on the seller (in an acquisition) and on the joint venture and its controlling parent companies (for a joint venture) are ancillary, if their scope does not exceed what is required in terms of duration, geography and products.[8] The duration is three years for acquisitions and

2 Anti-Monopoly Law of the People's Republic of China, [2007] Presidential Order No. 68, Aug. 30, 2007.

3 Around one third of allegations concerned horizontal agreements, although some of them were clearly without proper reasoning or factual basis.

4 *Hui'erxun Co., Ltd. v. Shenzhen City Pest Control Association*, Guangdong High People's Court, [2012] Yue Gao Fa Min San Zhong Zi No. 155, December 2012; *Niannian Red Brick Factory v. Zhang Daoxian*, Hubei High People's Court, [2017] Yue Min Zhong No. 402, Jun. 22, 2017.

5 European Commission Notice on restrictions directly related and necessary to concentrations, [2005] OJ C 56/24.

6 *Id.* paras. 10-13.

7 *Id.* para. 13.

8 *Id.* paras. 20 and 36.

the lifetime of the joint venture.[9] The European Commission decision in *Siemens/Areva* follows the same approach for non-compete obligations imposed on a controlling parent company exiting the joint venture.[10]

In China, as noted, there are no explicit rules on ancillary restraints on the books. Against this background, in the following section, I will attempt to analyze ancillary restraints under the existing *general* antitrust framework.

II. ANALYSIS WITHIN EXISTING LEGAL FRAMEWORK

Below, I will attempt to assess ancillary restraints first under the existing merger control rules and then under the monopoly agreement rules.[11]

A. Merger Control Rules

The AML's merger control rules do not address the situation of ancillary restraints head-on. However, one could argue that the antitrust authority – the State Administration for Market Regulation ("SAMR") – in *practice* includes ancillary restraints in its clearance decisions.

The reasoning goes as follows: if a non-compete obligation is directly related and necessary for the merger under review, it would typically be included in the transaction agreement (e.g. Sale and Purchase Agreement or Joint Venture Agreement). Since the merging parties are required to submit the transaction agreement as part of their notification to SAMR, SAMR should consider the agreement as part of its review of the transaction.

In addition, a SAMR implementing rule requires the merging parties to lay out the horizontal or vertical cooperation agreements in the relevant market, such as those relating to R&D, patent licensing, joint production or distribution, and long-term information exchanges.[12] That rule does not appear to be limited to agreements between the merging parties only. However, to the extent that the merging parties do list agreements of the types mentioned in the provision, they would appear to be (at least potentially) ancillary to the concentration. In short, this provision seems to provide a venue for merging parties to list ancillary restraints.

The substantive benchmark for SAMR's merger review is to assess whether the "concentration between business operators has or is likely to have the effect of eliminating or restricting competition."[13] Given that SAMR's mandate is to consider the concentration as a whole, it is arguable that its clearance decision includes all parts of the concentration which are directly related and necessary for its conclusion and implementation. In that regard, Article 28 of the AML stipulates that SAMR can clear a concentration "if the business operators can prove that the positive impact of such concentration clearly outweighs the negative impact." Even though in all likelihood this wording is meant as a possibility for the merging parties to argue efficiencies and the burden of proof lies with the parties, the wording appears to acknowledge that SAMR clearance can be granted even when certain aspects of a concentration restrict competition, as could arguably be the case for non-compete clauses.

As a final point, in practice, SAMR's unconditional clearance decisions do not explicitly state that the concentration does not restrict competition. They merely say, in one way or another, that SAMR does not object to the concentration being implemented. However, the decisions also state that "matters relating to the concentration between business operators other than the anti-monopoly review should be conducted in accordance with the relevant laws." A reading *a sensu contrario* would suggest that all matters relating to the anti-monopoly (i.e. merger) review are covered by the SAMR decisions – which would suggest a broad scope of coverage.

Since the merger of the previous three antitrust authorities in 2018, a single authority (SAMR) is now in charge of enforcing the merger control and monopoly agreements rules. In practice, this should mean that it is (much) less likely that SAMR would seek to apply the monopoly agreements rules to a concentration it previously approved under merger control rules.

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9 *Id.* paras. 10-13. If the acquisition only involves goodwill but no knowhow, then only two years' non-compete arrangements are covered by the Ancillary Restraints Notice.

10 *Siemens/Areva*, Case COMP/39736, June 18, 2012.

11 The term used in the AML to describe anti-competitive agreements is "monopoly agreement" or "monopolistic agreement."

12 Guiding Opinion on the Documents and Materials for the Notification of Concentrations between Business Operators, AMR Anti-Monopoly Bureau publication, September 29, 2018, http://gkml.samr.gov.cn/nsjg/fldj/201907/t20190726_305196.html, art. 7.

13 AML, arts. 3(3) and 28.

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B. Monopoly Agreements Rules

The above analysis under merger control rules can only apply to concentrations which are notified to SAMR. If a concentration is not reviewed by SAMR, then there is no clearance decision which could give coverage to ancillary restraints.

Against this background, it is necessary to examine ancillary restraints under the general monopoly agreements rules in the AML. The relevant provisions are the prohibition of anti-competitive horizontal agreements (Article 13) and the exemption mechanism (Article 15).

As a first step, it seems clear that a non-compete clause between competitors may breach one or more of the provisions in Article 13(1), in particular the market-partitioning prohibition. The second step of the analysis is more interesting – whether the transaction context can provide a legitimate justification for applying the exemption mechanism.

Article 15 lists a number of circumstances which can justify the disapplication of the prohibition at Article 13, including improving technology or R&D, improving product quality, reducing costs, efficiencies in standardization or specialization processes, etc. Unfortunately, there are no detailed rules on how to implement Article 15.[14] The question then becomes whether the pro-competitive nature of the main transaction – the concentration – can be sufficient ground for a finding of efficiency or other pro-competitive effects.

An additional requirement by Article 15 is that the agreement (here, the non-compete clause) does not significantly restrict competition in the relevant market and allows consumers a share of the resulting benefit.[15]

In short, at least for those concentrations which do not need to file with SAMR under the merger control rules, the AML's monopoly agreements framework does not provide clear guidance on non-compete clauses in the transactional context. There is still considerable uncertainty for these concentrations. In the next section, I will show that this concern is not merely hypothetical.

III. RECENT COURT CASES

During the course of 2019 and 2020, there were some cases before Chinese courts which show how they struggle with (the absence of guidance on) non-compete clauses in the transaction context. This section will describe four relevant court cases.

A. Xin Jilong v. Hefei Xuegong

On March 23, 2019, the Shenyang Intermediate People's Court rendered its judgment in *Xin Jilong v. Hefei Xuegong*.[16] That case concerned the establishment of a green-field joint venture between an individual (Xin Jilong) and a company (Hefei Xuegong).

The joint venture was set up to manufacture and sell starch adhesives in certain designated regions in Northern China. The joint venture was green-field, with Hefei Xuegong providing the technology and Mr. Xin injecting cash. The exact shareholdings and the "controlling rights" in the joint venture do not become apparent from the judgment. Although Mr. Xin was allegedly the main shareholder and actual controller of the joint venture, the judgment does not give clear indications whether the joint venture was joint controlled in a merger control sense.

The joint venture agreement included a non-compete obligation on the joint venture and Mr. Xin (as its alleged actual controller): they committed not to sell, or partner with third parties regarding, starch adhesives outside the joint venture's geographic scope. The goal was of this

14 One of SAMR's predecessor authorities – the antitrust unit within the National Development and Reform Commission – had published a draft guideline on the Article 15 exemption. *See* State Council Anti-Monopoly Commission Guideline on the General Conditions and Procedure for the Monopoly Agreement Exemption (Draft for Comments), May 12, 2016. However, that guideline only focused on procedural aspects, and gave no guidance on the substantive criteria in Article 15.

15 In *Yutai*, the Supreme People's Court distinguished two types of agreements with a different burden of proof for SAMR in enforcement cases: those "per se" illegal and those which are not (the latter essentially requiring a "rule of reason" type of analysis). See *Hainan Yutai Technological Fish Feed Company v. Hainan Price Bureau*, Supreme People's Court, [2018] Zui Gao Fa Xing Shen No. 4675, Dec. 18, 2018. The court allocated market-partitioning agreements between competitors to the "per se" box, without detailed discussion. However, as noted, while a non-compete clause in a concentration may look like a market-partitioning agreement on its surface, there is a specific background: the concentration. It is not clear how this specific fact pattern would fare under the *Yutai* criteria.

16 *Xin Jilong v. Huefei Xuegong Adhesives Technology Group Co., Ltd.*, Shenyang Intermediate People's Court, [2019] Liao 01 Min Zhong No. 3318, Mar. 23, 2019.

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non-compete obligation was to protect Heifei Xuegong, seemingly active mainly in Southern China, which had shared its technology with the joint venture.

However, from 2015 to 2016, the joint venture *did* sell into territories outside the designated scope. As a result, Heifei Xuegong brought a lawsuit for breach of the joint venture agreement and sought compensation for damages from Mr. Xin.

At first instance, the Dadong District People's Court ruled for the plaintiff.[17] In his defense, Mr. Xin counter-argued that the non-compete obligation (i.e. not to sell outside the designated territory) was akin to a market-partitioning cartel, as Hefei Xuegong and the joint venture were competitors. However, the first-instance court held the non-compete obligation on Mr. Xin to be valid on the grounds that the defendant was Mr. Xin — not the joint venture — and that Mr. Xin and Hefei Xuegong were both shareholders of the joint venture, not competitors.

As a result, the Dadong District People's Court ruled that Mr. Xin had breached his non-compete obligation by allowing the joint venture to sell outside the designated geographic scope. At second instance, the Shenyang Intermediate People's Court simply upheld that ruling without further analysis.

If we were to examine this case by reference to the EU's Ancillary Restraints Notice, we would first need to examine whether Hefei Xuegong had joint control over the joint venture company, given that the notice's coverage only applies to obligations imposed on controlling parents. If so, then it would seem lawful to impose a non-compete obligation on the joint venture and the other joint controller (Mr. Xin) not to compete in Hefei Xuegong's reserved territory. The key idea behind is that Hefei Xuegong might not have shared its technology with the joint venture, absent protection of its existing business, which in turn suggests the non-compete obligation was instrumental for Hefei Xuegong to agree to set up the joint venture in the first place.

B. Li Sheng v. Shi Hailiang

On June 18, 2019, the Gongzhuling District People's Court in Jilin Province issued its judgment in *Li Sheng v. Shi Hailiang*.[18] That case involved the acquisition by one individual (Shi Hailiang) of a truck and a dish washing business from another individual (Li Sheng). In the transfer agreement, Mr. Li as the seller committed not to operating any dish washing business in the same town in the future.

However, not before long, Mr. Li sued Mr. Shi before court. He claimed that Mr. Shi had not made full payment for the acquired business. In return, Mr. Shi alleged that Mr. Li continued to offer dish washing services and thereby breached his non-compete obligation.

In its judgment, the Gongzhuling District People's Court ruled that Mr. Shi's acquisition led to Mr. Li's exit from the dish washing market and Mr. Shi's market entry. Without any in-depth analysis, the court held the arrangement to amount to market-partitioning in breach of the AML and held the entire transfer agreement to be invalid.

Using the EU's Ancillary Restraints Notice as benchmark again, a non-compete obligation on the seller in an acquisition would not be unlawful if limited to a period of three years (or two years if there is no knowhow involved). In this case, however, it seems there was no time-limit on the non-compete obligation, which seems to go beyond what is necessary to protect the value of the assets to be transferred to the buyer.

C. Li Yangzhong v. Yang Daba

On November 4, 2019, the Yuanjiang Autonomous County People's Court decided the *Li Yangzhong et. ali v. Yang Daba* case.[19] This case involved a partnership to operate a dish washing business in Yuanjiang, a county in Yunnan Province.

The partnership included eight individuals (the seven plaintiffs and the defendant, Yang Dada). The partnership agreement prohibited a partner from operating a dish washing business in Yuanjiang after leaving the partnership. However, after his exit from the partnership, Mr. Yang poached four employees from, and started competing with, the partnership by offering dish washing services in the same county.

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17 *Huefei Xuegong Adhesives Technology Group Co., Ltd. v. Xin Jilong*, Dadong District People's Court, [2017] Liao 0104 Min Chu No. 11405, Mar. 23, 2019.

18 *Li Sheng v. Shi Hailiang*, Jilin Gongzhuling District People's Court, [2019] Ji 0381 Min Chu No. 1634, Jun. 18, 2019.

19 *Li Yanzhong et al. v. Yang Daba*, Yuanjiang Autonomous Country People's Court of the Hani, Yi and Dai Nationalities, [2019] Yun 0428 Min Chu No. 965, Nov. 4, 2019.

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As a result, the other seven partners sued Mr. Yang before court requesting compensation for damages. They alleged that Mr. Yang's breach of the non-compete obligation caused significant damage to the partnership: prior to Mr. Yang's partnership exit, the partnership was the only dish washing operator in town, and subsequently Mr. Yang managed to poach 20 percent of its customers. In defense, Mr. Yang argued that the non-compete obligation was unlawful under the AML.

In its judgment, the Yuanjiang Autonomous County People's Court ruled that the non-compete clause was designed to protect fair and reasonable competition and to prevent unfair competition. The court reasoned that as a partner in the partnership's business, Mr. Yang was familiar with the partnership's work streams, business models, and customer data. He was also found to have a fiduciary duty which is reflected in the non-compete clause. The court held that the non-compete cause was compliant with all laws and regulations.

On the facts, the court found that Mr. Yang started competing with the partnership within five months after his departure, and thereby caused damages to the partnership. As a result, the court found a breach of contract, and ordered Mr. Yang to pay RMB 300,000 compensation to the plaintiffs.

Under the EU's Ancillary Restraints Notice, this case would be assessed as a joint venture scenario. Non-compete obligations would be lawful during the lifetime of the joint venture under that notice, and for a period of up to three years after exit from the joint venture under *Siemens/Areva*. As noted, the coverage by the Ancillary Restraints Notice only extends to controlling parent entities of a joint venture. In this case, it is not clear whether Mr. Yang had a controlling stake. Since the joint venture in this case was a partnership and generally partners are meant to put most or all of their efforts into the partnership, it is likely that Mr. Yang's role was, in practice, that of a controlling parent.

Assuming that Mr. Yang had joint control, according to the *Siemens/Areva* decision, a non-compete obligation can be accepted as reasonable for departing joint venture parents, if limited to three years.[20] In this case, there was no time-limit for the obligation even after Mr. Yang's departure. At the same time, however, Mr. Yang started competing with the partnership already within five months of his departure – which is still within the three years' period outlined in *Siemens/Areva*.

D. Lei Qiang v. Shi Qinghua

On May 20, 2020, the Dazhou Intermediate People's Court ruled in the ***Lei Qiang v. Shi Qinghua et. ali*** case.[21] This case pitched an individual (Lei Qiang) against the other shareholders of a joint venture whole-selling pre-packed flour in Dazhou, a city in Sichuan Province.

In February 2018, Mr. Lei decided to merge his flour business into the joint venture. As part of this deal, Mr. Lei acquired a 5 percent shareholding in the joint venture in exchange for a payment of RMB 1 million and two non-compete commitments: (1) not to operate a competing flour business in Dazhou (which I will call "narrow non-compete clause") and (2) to "restrict" Liu Deping's flour business ("broad non-compete clause"). Liu Deping was Mr. Lei's former business partner. Their previous joint venture was terminated in 2018, when Mr. Lei joined the defendants' joint venture. According to the agreement Mr. Lei signed with the new joint venture, a breach of the commitments could be sanctioned.

Mr. Lei duly paid the capital for his shareholding in the joint venture, but in August 2018 the board of the company found him to be in breach of his non-compete commitments. In particular, the board found that Liu Deping (Mr. Lei's prior business partner) continued to operate a flour business under a different name after Mr. Lei had become a shareholder of the joint venture. As a result, the board decided to impose a penalty of RMB 400,000 on Mr. Lei and reduced his shareholding to 3 percent. Mr. Lei sued the other shareholders before the Tongshun District People's Court in Dazhou, alleging that the broad non-compete clause (not the narrow non-compete clause) inter alia breached the AML's abuse of dominance rules.

At first instance, the Tongshun District People's Court dismissed the AML claim, finding that the joint venture was not dominant.[22] The court went further and held that the arrangement between Mr. Lei and the other shareholders did not amount to a monopoly agreement either. The court's key argument was the broad non-compete clause was a unilateral expression by Mr. Lei, not an agreement between shareholders

20 If Article 15 of the AML were invoked, the exemption would only be available if the agreement does not significantly restrict competition. In this case, the plaintiffs themselves stated in their filings that they were the only marketplayer in town, so the non-compete clause arguably eliminated all competition.

21 *Lei Qiang v. Shi Qinghua et ali*, Dazhou Intermediate People's Court, [2020] Chuan 17 Min zhong No. 111, May 20, 2020.

22 *Lei Qiang v. Shi Qinghua et ali*, Tongshun District People's Court, [2019] Chuan 1702 Min Chu No. 1060, Aug. 8, 2019.

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to restrict the conduct of a third party, Liu Deping. In the court's view, Liu Deping's conduct was not impacted and there was no exclusion of competition from third parties.

On appeal, the Dazhou Intermediate People's Court upheld the first-instance decision. The court focused on Mr. Lei's specific claim (i.e. abuse of dominance) and held that he did not provide evidence on the joint venture's market share, market conditions, pricing power etc. to prove it is dominant.

In short, in *Lei Qiang v. Shi Qinghua et. ali*, the plaintiff only challenged the broad non-compete clause under the AML's abuse of dominance and the courts (at least the second-instance court) only responded to this specific plea. The case is somewhat of a missed opportunity, as the narrow non-compete clause would have raised interesting questions under the monopoly agreements rules.

If we were to apply the logic of the EU's Ancillary Restraints Notice, as noted, non-compete obligations can only be imposed on controlling shareholders of a joint venture. From the judgment it does not become clear, but it is unlikely that Mr. Lei obtained joint control in the sense of Chinese merger control rules (with a shareholding of only 5 percent). From that angle, leaving aside the question of ex officio application of rules (without allegations by the parties), the narrow non-compete clause would appear questionable.

In short, I hope my description of the four judgments in 2019 and 2020 – in particular the different outcomes against similar factual backgrounds – shows that Chinese courts are struggling in this area. My conclusion is therefore that, beyond concentrations that are filed with SAMR under merger control rules, the existing AML framework does not provide sufficient guidance for non-compete clauses in the transactional context.

IV. CONCLUSION

The AML and its implementing rules do not contain explicit guidance on how to deal with non-compete clauses and other ancillary restrains in the transaction context. Nonetheless, the four judgments from 2019 and 2020 described in this paper show that the lack of guidance leads to uncertainty for market players.

The existing legal framework provides for some comfort if the concentration is notified to, the non-compete clause is reviewed by, and the concentration receives clearance from, SAMR. Where this not the case, the AML's monopoly agreements rules do not provide sufficient guidance.

Against this background, it would be advisable for the legislator to provide guidance in the ongoing AML revision or – perhaps more feasible in practice – for SAMR to issue AML implementing rules on this point. An alternative would be for SAMR to establish a visible case practice, for example on how to interpret and apply Article 15 of the AML. After all, non-compete clauses and other ancillary restraints are a business reality in and outside China. As the country is in the process of recovering from the COVID-19 crisis and M&A activity is expected to rebound, Chinese regulators should provide a clearer legal framework on non-compete clauses in the transactional context.

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