

A Study of the Normalization of Discretionary Reductions in Severance Non-compete Liquidated Damages

Yulin Wang

School of Law, China Jiliang University, Hangzhou, China

Abstract: *Focuses on the legal attributes of non-competition liquidated damages, this paper points out the current controversy in the academic community over the nature of compensatory and punitive liquidated damages, and puts forward the necessity of standardizing the discretionary reduction of liquidated damages. Analyzing the legal framework and judicial practice, it points out the current situation of the Court's discretionary reduction of liquidated damages and the premise of applying the discretionary reduction rule. In order to achieve a fairer and more reasonable adjustment of the liquidated damages for non-competition, it is proposed that special discretionary rules should be constructed, guided by the principles of fairness, honesty, and good faith and that judges should take into account the employer's actual losses, the worker's economic situation and the degree of fault in his/her duties when dealing with this kind of cases, to promote a balance of the interests of both the employer and the employee.*

Keywords: *Separation from employment, Non-compete liquidated damages, Judicial discretion, Compensatory liquidated damages, Punitive liquidated damages*

1. Introduction

Restriction of non-competition is an adequate adjustment of the relationship between enterprises and workers, the protection of the corporate trade secrets system; in recent years, the core controversy in the academic community focuses on the non-competition liquidated damages, which discretionary issue is the key to the practical operation, but also to deal with the difficulties. Specifically, there are two challenges: one is the lack of a clear definition of its legal attributes; second, the courts around the trial of the liability for damages arising from the discretionary reduction of the liquidated damages of the adjudication standards are different, resulting in the emergence of a class of cases different judgment phenomenon. Therefore, whether the non-competition liquidated damages should be reduced by judicial discretion, and if so, what principles and methods should be followed urgently need to be explored in depth. Concerning the civil law discretionary factors of liquidated damages, combined with the cases and the characteristics of liquidated damages, improve the relevant reasonableness review and reconstruct the rules of judicial discretionary considerations to make them more standardized and systematized.

2. Determination of Liquidated Damages for Separation from Service

2.1 Determination of The Nature of Non-compete Liquidated Damages for Separation from Service

2.1.1 Punitive Damages

Punitive liquidated damages are a private law sanction created by the parties by the principle of freedom of contract. On the punitive liquidated damages in the "punitive," Professor Dong Bao Hua, from its functional point of view, said that the liquidated damages are designed to ensure the performance of contractual obligations, and the defaulting party is to impose an additional burden to show discipline. If you deny the nature of the punitive, the liquidated damages will be reduced to the amount of pre-determined damages; its role is to fill the loss and the loss of the function of prevention and punishment of the breach of contract. There is also the loss of the function of preventing and disciplining behavior, but this kind of view is not common in judicial practice. In addition, there is also the view that the enterprise, through the setting of punitive liquidated damages, can effectively restrain

the departure of employees engaged in unfair competition activities, not only having a deterrent effect but also reducing the cost of future dispute resolution. The academic and practical circles have not yet formed a unanimous opinion. They are more inclined to emphasize the pressure and deterrent effect that non-competition liquidated damages may embody under specific conditions.

2.1.2 Compensatory Damages

Compensatory liquidated damages are intended to compensate for actual losses caused by one party to the other due to a breach of contractual obligations. As to its nature, there are views that it only has the function of compensation and should not have the nature of punishment, and the liquidated damages in the non-competition agreement should be limited to compensating the actual loss of the damaged party. They should not have the nature of punishment to not cause substantial unfairness. Secondly, the principle of separation of functions: analyzed from the perspective of the function of liquidated damages, the punitive liquidated damages may unduly increase the burden of responsibility of the defaulting party. According to the basic principle of civil liability, civil liability mainly undertakes the compensatory function, while the punitive function is realized by administrative or criminal liability. Third, to protect the freedom of choice of employment of workers: the right of workers to freely choose their employment is guaranteed by the Constitution. It should not be unreasonably restricted in any form. Therefore, the liquidated damages for non-competition can only be compensatory, and the parties' agreement on liquidated damages clauses of a punitive nature is legally ineffective.

2.1.3 Nature of Non-compete Liquidated Damages on Separation from Service

The nature of the liquidated damages for non-competition should first refer to the discretionary liquidated damages rule of Article 585 of the Civil Code. Prof[1]. Han Shiyuan argues that the parties may agree on punitive liquidated damages, presumed to be compensatory if the agreement is unclear and shall not exceed 20% of the subject matter of the main contract. Prof. Wang Hongliang, on the other hand, argued that compensatory liquidated damages are intended to pre-determine the total amount of damages and alleviate the difficulty of proving the loss, which belongs to the system of damages rather than liquidated damages and should be applied to the rules related to damages. Secondly, the nature of the determination should also be combined with the characteristics of the non-competition agreement, which is attached to the labor contract, with personal dependence, the mainstream social jurisprudence that the main embodiment of the nature of compensation, aimed at compensating for the actual loss, but also may have the function of punishment.

2.2 Justification for Discretionary Reductions in Severance Non-compete Liquidated Damages

The judicial discretion of the liquidated damages of non-competition means that the judge exercises judicial discretion on the content of the agreement of the parties, which is actually to intervene and adjust the private law autonomy agreement of the parties with public power. When the amount of liquidated damages agreed upon in the non-competition agreement does not match the actual loss of the employer, and the gap between it and the worker's salary and non-competition compensation is too large, the fulfillment of the agreement will seriously affect the worker's right to life. Despite the emphasis on freedom of contract, this imbalance will favor the protection of the employer's interests when the economic status of the employer is superior to that of the worker, and there is a need to make judicial discretionary reductions of the non-compete liquidated damages to rectify the inequality between the two parties. As early as in the Roman law period, the liquidated damages system appeared in embryonic form; the liquidated damages discretionary system, from the historical point of view, has experienced a tortuous development process, from unrestricted to the gradual introduction of restrictions, and ultimately established the judicial discretionary legal technology; compared with the direct application of the principle of good faith and the principle of fairness, the judicial discretionary is more appropriate. Therefore, it is necessary to determine whether the liquidated damages are "too high" and, on the premise of confirming the agreement's validity, to ensure that the liquidated damages clause does not affect the agreement's effectiveness as a whole.

3. Status of Liquidated Damages Discretion in Separation from Service

3.1 Prerequisites for the Application of the Discretionary Rule on Liquidated Damages

3.1.1 Establishment of liability for breach of contract in non-competition agreement

First, there should be a legally valid non-competition agreement. The non-competition agreement is a double contract between the worker and the employer on the obligation of non-competition, whereby the latter pays economic compensation, and the former fulfills the obligation of restriction. The agreement constitutes the basis of the rights and obligations of both parties. Its signing and content, especially the liquidated damages clause, must align with the relevant provisions of the Civil Code and the Labor Contract Law. Secondly, there shall be a breach of the separation non-competition agreement. Breach of contract refers to the process of contract performance; one party does not fulfill its obligations or the performance of obligations does not meet the agreed requirements, mainly manifested in the refusal to perform, incomplete performance, and delayed performance of the three forms of restriction on the main body, behavior, area and time and other aspects of the specific provisions of the Tongxin.

3.1.2 The Amount of Liquidated Damages for Non-compete Agreements is Agreed to be Too High[2]

The assessment of liquidated damages for non-competition should be based on a comprehensive standard of equity. Given that such liquidated damages are similar to those in civil law, it is difficult to set a uniform "excessive" standard. According to Article 29 of the former Interpretation II of the Contract Law, the quantitative standard of "significantly exceeding the actual loss" is more than 30%. However, applying this standard is limited because it is not easy to quantify the loss. During the legislative period of the Labor Contract Law, the draft proposed that the maximum amount of liquidated damages for workers be capped at three times the amount of compensation for non-competition, and this principle has been generally followed in practice.

3.1.3 Application of Parties to a Separation from Service Non-competition Agreement

The subject of initiation of discretionary proceedings varies in national (regional) legislation. Generally, it includes two modes: initiation by the parties on application and initiation by the court ex officio. Our legislation adopts the mode of initiation by the parties on application. The Court has a "negative, neutral" role in the judicial organs, and whether to take the initiative to apply the system of discretionary liquidated damages is controversial. In principle, the judiciary must remain neutral during the litigation process to ensure the fairness of the judgment. The exception is that, in practice, when the parties do not apply for an adjustment of the liquidated damages, the Court may take the initiative to explain that the basis for the discretionary reduction should follow the principles of fairness, honesty, and good faith, to prevent the abuse of the employer's rights.

3.2 Status of the Court's Liquidated Damages Discretion

The "judicial adjustment" of liquidated damages for non-competition should semantically cover both upward and discretionary reductions of liquidated damages. However, due to the practice of both parties to the contract generally tend to agree on a high amount of liquidated damages, so in the judicial practice of the vast majority of cases involved in the Court at the request of the parties to the amount of liquidated damages for discretionary reductions, and request for upward circumstances are extremely rare. China's civil legislation has only made principle and directional provisions, and the labor legislation also refers to civil law practice. When workers' non-performance of non-competition obligations causes losses to the employer, if the parties claim that the agreed liquidated damages are too high than the actual losses, the Court shall decide based on the actual losses, taking into account other relevant factors[3]. An analysis of the results of judicial adjustment of non-compete liquidated damages cases shows that most cases are based on discretionary reductions to safeguard workers' rights and interests. However, the lack of systematic and scientific consideration of factors and the significant regional variations indicate the challenges in judicial adjustment.

4. Reinventing the Separation Non-compete Discretionary Rule

4.1 Guided by the Principles of Fairness and Good Faith

4.1.1 Equity Principle

The principle of equity is a guiding principle for the parties when concluding a contract, especially when determining the content of the contract, and emphasizes the need to ensure reciprocity of rights and obligations in the "determination of the content of the contract" during the contracting process. However, such agreements may make it difficult for workers to switch to other occupations in the short term, violating the freedom of choice of employment and the right to life. Employers often provide pre-drafted form contracts, which, although the autonomy of both parties concludes them, reflect the will of one of the parties more than the other. The principle of fairness should be limited in scope based on respecting the autonomy of meaning, and the principle of fairness should be used to constrain the autonomy of meaning when necessary. In cases dealing with non-competition liquidated damages, judges are required to limit the liquidated damages to a reasonable range by the principle of fairness after examining each case's discretionary elements to ensure that both parties' interests are balanced after the discretionary reduction.

4.1.2 The Principle of Honesty and Credit

The principle of honesty and good faith, as outlined in the Labor Contract Law, is consistent with the principles of the Civil Code[4]. The conclusion of an employment contract shall follow the principle of honesty and good faith by Article 3 of the Employment Contract Law. It shall be interpreted systematically in conjunction with Article 29 of the Employment Contract Law so that the principle is carried through the entire process of the labor relationship[5]. As a party to a non-competition agreement, the non-competition rules are set up to balance the interests of the employer and the laborer, to maintain the normal employment order, and to prevent vicious competition among enterprises. In order to ensure that the principle of honesty and good faith permeates the labor relationship throughout, it is necessary to establish a system of discretionary non-competition liquidated damages to support the workers and limit the dominant position of the employer. The system adjusts unreasonable amounts of liquidated damages through judicial discretion to ensure that the non-competition clause protects the employer's legitimate rights and interests without impeding the worker's legitimate rights and interests. Therefore, it is reasonable and necessary to use discretion appropriately to ensure that the amount of liquidated damages for non-competition is reasonable and fair.

4.2 Combined Consideration of Liquidated Damages Discretionary Factors

When the Court accepts a case of discretionary liquidated damages for non-competition based on the worker's request, after determining that the liquidated damages need to be discretionary, it shall comprehensively assess the amount of liquidated damages agreed upon by the parties and relevant factors. First of all, it should respect the autonomy of both parties and fully recognize the free will of the non-competition agreement. A certain degree of punitive nature is reasonable, helps urge the contract's performance, and protects the employer's trade secrets[6]. Only when the rights and obligations of both parties in the agreement are imbalanced, and it is necessary to adjust the liquidated damages should they be separated from the non-competition liquidated damages for discretionary reduction.

4.2.1 Employer's Losses

The employer's loss is the primary consideration in the discretionary reduction of non-compete liquidated damages, which refers to the benefits that the employer should protect according to the law, which the laborers do not obtain due to violating non-compete obligations. Understanding the "loss" from the perspective of the corresponding "benefit," Li Yongming argues that these benefits mainly include competitive interests and trade secrets; Taiwan scholar Wei Chien-feng points out that they include freedom from customer loss, disclosure of business secrets, and employer's investment in employee training. In actual cases, it is often difficult to determine such losses; unlike civil law, where actual losses can be determined by factors such as the market price of the subject matter, non-compete cases mainly involve intangible losses such as trade secrets, which are difficult to quantify[7]. The United States can draw on the practice of first determining the actual benefits obtained by the worker due to the non-compete; if it is not possible to determine, and then based on other considerations, a

comprehensive judgment of discretionary reductions.

4.2.2 The Economic Situation of Workers

The worker's economic situation can directly reflect whether he or she can bear the consequences of paying high liquidated damages. This is mainly done by examining the worker's income and the amount of economic compensation, which can be treated as a multiple. Suppose the difference in comparison is too great, and the employer fails to prove the loss suffered. In that case, the reasonableness of the liquidated damages should be carefully assessed, given the economic subordination in the labor relationship.

The income level of the worker at the time of employment reflects the consideration for the fulfillment of the worker's duty of loyalty, which is not only a key factor in determining the amount of liquidated damages for non-competition but is also related to the compensation for non-competition after separation from service, which reflects the consideration for the fulfillment of the obligation of the worker during his/her period of employment[8]. Suppose the amount of liquidated damages far exceeds the remuneration of the laborer. In that case, the non-competition agreement may be virtually null and void. It not only fails to constitute an actual burden and pressure on the laborer but also fails to effectively guarantee the safety of the employer's trade secrets and loses its guarantee and deterrent effect[9]. Economic compensation refers to the compensation given by the employer to the laborer with non-competition obligations during the non-competition period to protect the basic living standard of the laborer. Although the prohibited obligation in the agreement is not a direct restriction on the freedom of choice of employment, it is equivalent to conceding part of the right to employment as the worker cannot fully utilize the advantages of his or her own experience and skills. The cost of employment increases, and employment opportunities are indirectly reduced.

4.2.3 Fault in the Worker's Duties

China has set certain boundaries for the subjects of non-competition agreements. According to Article 24(1) of the Labor Contract Law, the subjects of non-competition agreements mainly include high-level technical personnel involved in enterprise secrets and other personnel responsible for keeping secrets. Employers usually require workers to sign the contract in a uniform format, regardless of their occupation, but there are differences by position. Workers in higher positions usually have access to more centralized trade secrets and receive relatively higher remuneration, which is fully considered in the evaluation process. They sign more non-compete liquidated damages when they leave the company.

The workers' fault is mainly reflected in the malicious departure, especially the workers who have the employer's commercial secrets. Suppose they enter the same industry and engage in the same position after leaving the company subjectively. In that case, there is intentional malice and behavioral losses to the original company, and it promotes the "digging" trend[10]. First of all, the implementation of non-compete behavior is an important basis for measuring the subjective fault; if the agreement is in force at the beginning of the violation of the obligation, the subjective malice can be identified as larger; secondly, the reason for leaving the job is also key, which can be divided into the worker's reasons, the termination of the labor contract and the employer's reasons for the three cases, subjective malice is diminished, and then also need to take into account the limitations of the industry of the laborer and the right to survive.

5. Conclusions

A separate non-compete system is an important way to protect trade secrets in labor law. However, in reality, some units blindly set high non-compete liquidated damages provisions to protect trade secrets, limiting workers' legitimate rights and interests and exacerbating the imbalance between the status of labor and management. Given this, it is necessary to adjust the high amount of liquidated damages to protect laborers' legitimate rights and interests when disputes over non-competition liquidated damages occur. Considering the significant difference between non-competition liquidated damages and civil law liquidated damages, and the difference in the way of realizing, characteristics, and specific case handling, it is necessary to reconstruct and establish the special rules of discretionary reduction of non-competition liquidated damages to protect the employer's commercial secrets while safeguarding the lawful rights and interests of the workers[11], and to give full play to the core functions of the non-competition system in balancing the interests and protecting the competition.

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