

Post-Contractual Secrecy Obligations in Japan:

Osaka High Court, 26 December 1994,
Osaka District Court, 10 September 1998

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I. INTRODUCTION

Trade secrets are valuable property to a company, yet handling them is often more difficult than handling intellectual property rights. Once made public, trade secrets are no longer protectable. Thus, it is vital for a company to make sure that its trade secrets are not leaked, particularly not through employees. Secrecy obligations during and after actual employment would seem an obvious step to ensure the proper maintenance of trade secrets. The two decisions introduced here deal with two different aspects of post-employment secrecy obligations: the first (Osaka High Court, 26 December 1994, 1553 Hanrei Jihô 133 [1996] – “Foaming Method”) with the question of whether a post-contractual secrecy obligation has been expressly agreed upon between the parties, or can also be *implied*. The second (Osaka District Court, 10 September 1998, 1656 Hanrei Jihô 137 [1999] – “Water Purifying Device”) concerns the question of whether an (expressly agreed) post-contractual secrecy obligation can be interpreted as a *restrictive covenant*, in other words, a post-employment obligation not to compete.

II. OSAKA HIGH COURT, 26 DECEMBER 1994

a) The trade secret in question concerned a foaming method of polyolefin which had been developed by a Japanese company, whose 100% subsidiary was the plaintiff in the present proceedings. The defendant began employment with the mother company and was transferred to the plaintiff once he had reached the position of second in charge in the research and development department, where the original foaming method was invented. While working for the plaintiff, the defendant was made executive director and head of the research and development department, which was responsible for improving the above foaming method. Indeed, a number of improvements were made not by him, but by his department under his supervision. Specifically, an improved two-tier process called “PE” was invented. These improvements were not made public or applied for as patents, but rather were kept secret.

Upon retirement, the defendant set up his own company and sold the above foaming technology to a Chinese company. The plaintiff apparently got wind of this and now claimed damages in the form of lost profits.

b) In dispute were basically three issues:

- (1) Was the technology used by the plaintiff new when measured against the state of the art;
- (2) Was the defendant entitled to use such knowledge, namely since he had been in charge of supervising the development of the secret technology;
- (3) Was there any post-contractual duty not to use the trade secret by selling it to third parties despite the lack of an explicit provision providing so.

The Osaka District Court in the first instance (decision of 16 December 1991) had rejected the plaintiff's claim, while the Osaka High Court reversed and awarded damages in the amount of Japanese Yen 52,800,000.

c) In its ruling, the court held as follows:

- (1) The plaintiff was the only one in Japan to possess knowledge of the foaming process and had duly kept such information secret. Therefore, the plaintiff's know-how qualified for protection.
- (2) Although the defendant had helped to develop the secret technology, his participation was not sufficient to entitle him to use it for his own disposal.
- (3) Even in the absence of express contractual provisions, the defendant as an executive director owed the company the duty of good management and loyalty. This implied not leaking any company secrets to outside sources without good reason even after the termination of his contract. This followed from the defendant's duty not to injure his former employer.

III. OSAKA DISTRICT COURT, 10 SEPTEMBER 1998

a) In this case, the trade secret in question concerned a water purifying device developed by the plaintiff and a list of the plaintiff's customers. The plaintiff had developed both in the course of the company's business since it was set up in 1980. Defendants were three former employees of the plaintiff and the company these three had set up one month after leaving the plaintiff's employment in 1995. The defendants also deal in water purifying devices.

In dispute were the following issues:

- (1) Did the customer lists and/or the technology to manufacture the plaintiff's water purifying device qualify as a "trade secret";
- (2) If so, had the defendant company formed by the three other defendants acquired such trade secret by "improper means";
- (3) Were the three defendants in setting up a competing company and using the plaintiff's information in breach of a secrecy obligation; and
- (4) Could such secrecy obligation be interpreted as a restrictive covenant.

b) In dismissing the action, the court held as follows:

(1) The misappropriation of a customer list was not sufficiently specified and pursued by the plaintiff to succeed: “The act of unfair competition mentioned in Sec. 2(1)(iv) Unfair Competition Act refers to a ‘trade secret’. This can be defined as a method of production, sale, or any other technical or commercial information valuable in commerce that is not generally known to the public. As to the contents of the ‘trade secret’, the plaintiff refers to technical and commercial information, namely ‘the design and technology for the construction of the device, and the list of customers as business information’. Yet without further specification of such ‘business know-how and customer list’, it is hardly possible to decide if this information would indeed qualify as a ‘trade secret’. Accordingly, the plaintiff’s claim must be dismissed for want of evidence in this respect.”

(2) The design of the device had been publicly circulated by the plaintiff and could not qualify as “secret” any more: “Also in the enquiry material sent to the Japanese Association of Waste Water Business, the structure of the above device was specified, and the corresponding marketing information was distributed to all self-governing associations and design firms in the country. Thus, the research documents were distributed to the self-governing bodies of the country, to university libraries, and to research institutions. In other words, the plaintiff’s information related to the structure and function of the above water purifying device were made public by the above-mentioned marketing information and the research information that was distributed and therefore became publicly known.”

(3) Even though the plaintiff had made the defendants sign secrecy agreements when taking up employment in the plaintiff’s company with a pledge not to take any relevant material with them when leaving the plaintiff’s company, the mere use and sale of a device similar to the plaintiff’s did not necessarily indicate misappropriation, as the information had been publicly available.

(4) “Certainly, the defendants pledged in the agreement to maintain trade secrets and not disclose or leak trade secrets to third parties, or enable third parties to use such trade secrets after the termination of the current employment. This, however, did not relate to knowledge acquired in the course of working for the plaintiff, but was limited to the trade secrets disclosed to the defendant in the course of employment. Because it could not be proven that the defendants did indeed make use of any properly maintained trade secrets after they ceased to work for the defendant’s company, they are not in breach of their contractual obligations. ... The plaintiff argues that the defendants’ obligations should be construed as a restrictive covenant. Yet, the defendants’ obligations towards the plaintiff related to properly maintained secrets and the use of information. There is no evidence that the defendants were indeed burdened with a genuine restriction of competition after their contract ended.”

IV. TRADE SECRET PROTECTION IN JAPAN

Trade secrets in Japan are protectable either by contract, under tort law or under the Unfair Competition Prevention Act. Only the latter gives a definition of trade secrets. Under Sec. 2(4) Unfair Competition Prevention Act, “the term trade secret refers to a manufacturing or sales method, or any other technical or commercial information of commercial value that is kept secret and that has not become known to the general public.”

a) Contractual secrecy obligations most frequently occur in the context of employment, work for hire or licensing. When in breach of such a secrecy obligation, the right owner would be entitled to injunctive relief and damages. Yet a suit against the contractual partner would only be of interest in cases where the latter used the trade secret for himself rather than when employed by another company. In cases of an employment contract, the courts have held that post-contractual secrecy obligations need not be expressly provided for, as such obligations would already follow from the employee’s duty of loyalty even towards a former employer (see the above Osaka High Court decision; this is also good law in other countries: e.g., English High Court, *Coco v. Clark*, [1969] R.P.C. 41, German Supreme Court, GRUR 1963, 367 – “Industrieböden”). A duty of loyalty also makes it unlawful for a former employee to actively recruit (poach) employees of his former employer (Tokyo District Court, 30 March 1988, 1272 Hanrei Jihô 23 – “Nihon Setsubi”). In know-how licensing agreements, post-contractual secrecy obligations are permissible and can be enforced as long as the information has been kept secret by its owner. Under the Guidelines for Patent and Know-How Licensing Agreements of the Japanese Fair Trade Commission of 1999, an obligation to protect secrecy is not considered an unfair trade practice (Guidelines Part 4(3)(vii)(b)).

b) Outside contractual relationships, trade secrets can be protected against unlawful acts under the general tort laws of Sec. 709 Japanese Civil Code. However, as trade secrets merely qualify as a commercial interest rather than property, Sec. 709, in case of infringement, only allows the court to award damages rather than grant injunctive relief (This, at least, is the position of Tokyo High Court, 5 September 1966, 17(9/10) Kakyû Minshû 769 – “Waukesha”). Damages, however, are extremely difficult to prove in these cases. While Tokyo District Court, 10 March 1987, 650 Hanrei Times 203 – “ICS”, awarded 17 million Yen, Tokyo District Court, 19 February 1973, 713 Hanrei Jihô 83 – “Atena”, only awarded token damages for immaterial loss, and Nagoya District Court, 29 September 1986, 1224 Hanrei Jihô 66, awarded no damages at all, as the plaintiff was unable to prove that the infringer’s turnover would otherwise have been made by the trade secret’s owner. Some courts awarded damages in the amount of what an ordinary licensing fee would have been: Urawa District Court, 24 June 1983, 509 Hanrei Times 177 – “River Counter”; Osaka High Court, 3 March 1983, 1084 Hanrei Jihô 122 – “Colm”. It stands to reason that a limitation of legal remedies to

damage awards only is hardly satisfactory, given that these often do not even cover the legal fees incurred.

c) Since a 1990 amendment of the Unfair Competition Prevention Act, misappropriation and unauthorised use of trade secrets outside contractual relationships also have become actionable. Here, the plaintiff can request injunctive relief, and can statutorily claim either the infringer's profits, an adequate licensing fee, or his own loss as damages (Secs. 3-5 Unfair Competition Prevention Act).

V. OWNERSHIP AND RIGHT OF DISPOSITION

a) As the Osaka High Court in the above 1994 decision correctly observed, breach of a secrecy obligation can only be claimed against a person not entitled to use the secret. Entitlement to use, in turn, would depend upon the ownership of the trade secret. Someone who, out of his own wit or endeavour, develops valuable commercial or technical information, does not "acquire" it, as would be necessary for an action under the Unfair Competition Prevention Act. Both developers and co-developers would thus be entitled to use the trade secret, as they had not obtained it by a third source (Y. TAMURA, *Fusei kyôshô hô gaisetsu*, Tokyo 1994, 247).

b) Employee's inventions that are applied for as patents follow the rules of Sec. 35 Patent Act. Hereunder, an invention made in the course of employment belongs to the employee, while the employer obtains a non-exclusive licence without further consideration. This is different if the employee has created a copyrightable work: Sec. 15 Japanese Copyright Act applies the work for hire doctrine in such case and grants ownership to the employer if the employee was hired to develop a certain work. What applies to know-how is not quite clear. While one decision obliged the employer to compensate the employee when using a trade secret developed by the latter (Tokyo District Court, 23 December 1983, 15-3 Mutaishû 844), another decision apparently applied the work for hire doctrine (Tokyo District Court, 10 March 1987, 1265 Hanrei Jihô 103 – "ICS"):

VI. CIVIL PROCEDURE AND ENFORCEMENT

Art. 82 Japanese Constitution requires proceedings in civil lawsuits to be open to the public. An exception for proceedings involving trade secrets is not provided for. This has made the enforcement of trade secrets almost impossible (very instructive Tokyo District Court, 24 September 1991, 1429 Hanrei Jihô 80 [1992] – "Gould", where the plaintiff lost his case because he refused to disclose the trade secret in open court. See also Y. TAMURA, *Fusei kyôshô hô gaisetsu*, Tokyo 1994, 267-271). Effective 1 January 1998, the revised Code of Civil Procedure now permits the court to seal those parts of the court records of proceedings which deal with the trade secret (Sec. 92 Code of Civil

Procedure). This procedure was followed in the above-mentioned 1998 decision of the Osaka District Court and those parts of the decision that describe the trade secret were made illegible. And while the oral proceedings still have to be public, in practice, proceedings are conducted in the privacy of the judge's rooms in order to encourage an amicable solution to the conflict ("*benronken wakai*").

VII. SECRECY OBLIGATIONS AND RESTRICTIVE COVENANTS

a) Because of the above difficulties in proving damages in cases of misappropriation of trade secrets, employers might find it easier to impose restrictive covenants upon their employees: "Since it is extremely difficult positively to establish proof that trade secrets have been misappropriated, actions for non-compliance with provisions in the contract concerning maintenance of trade secrets in practice mostly fail. On the other hand, contravention against non-competition contracts can be easily established, though this undeniably imposes a considerable burden on the employee. For this reason, a substantial degree of control of such contracts is necessary." (S. CHAEN, *Taishokusha kimitsu hotoku gimu no han'i to fusei kyôshô* (Scope of post-contractual secrecy obligations and unfair competition), in: *Fusei kyôgyô hô*, Tokyo 1992, 661. Restrictive covenants are not particularly common in Japan. This is so because the current employment system acts as a disincentive towards changing jobs by tying income levels to seniority. Changing companies would thus mean having to start from the bottom of the ladder again. This system was developed at the beginning of the 20th century when a scarcity of skilled labour forced companies to provide incentives for employees to stay. It is thus no coincidence that the cases concerning post-contractual secrecy obligations and restrictive covenants overwhelmingly concern employees that became independent and founded their own company after leaving their former company.

b) Dealing with restrictive covenants seems to be difficult for the courts because different principles clash with each other. When dealing with employment contracts, the courts grant the employer significant leeway in dictating working conditions and would only intervene if certain employees' obligations would contravene public policy or good morals. Further, courts tend to stress the duty of loyalty an employee owes to the employer. This would suggest striking down restrictive covenants only in cases of clear abuse. On the other hand, the courts have always construed the scope of intellectual property rights (and trade secrets, for that matter) narrowly as an exception to the general freedom of commercial activities. Finally, Art. 22(1) Japanese Constitution, which stipulates the freedom of labour, would require the courts to scrutinise restrictive covenants more closely than just for cases of clear abuse.

c) Restrictive covenants have to be explicitly agreed upon. They cannot be implied from a duty of loyalty or from a secrecy obligation (so held in Osaka District Court, 5 December 1989, 1363 Hanrei Jihô 104, apart from the above-mentioned 1998 Osaka

District Court decision). This would be consistent with court decisions in other countries which have construed a secrecy obligation as a restrictive covenant only in cases where the new employment would inevitably require the employee to make use of trade secrets of the former employer (*PepsiCo v. Redmond*, US Court of Appeals, 7th Cir., 54 F3d 1262 (1995)).

d) Restrictive covenants are not invalid per se, as would be the case, e.g., in California (Sec. 1600 Business and Professions Code). Neither do they necessarily require compensation, as would be the case in Germany (Sec. 74 German Commercial Code). There is no legislative provision in Japan which governs restrictive covenants, the control of which is thus a matter of the judiciary. In what is considered as the leading case in this respect, the Nara District Court (23 October 1970, 21-10 Kakyû Minshû 1369 – “Foseco”) weighed the interests of the employee (freedom of choosing employment) with those of the employer (protection of trade secrets) and the general public (narrow interpretation of what would amount to a monopolistic right). Still, the court upheld a non-compete clause for two years. Two more recent cases even found a covenant of three years without a geographical limit not excessive (Tokyo District Court, 17 April 1990, 1369 Hanrei Jihô 112 – “Tokkyo Gakushû Kyôryokukai”: Osaka District Court, 15 October 1991, 596 Rôdô Hanrei 21 – “Shin Osaka Bôeki”; further details by F. OBATA, *Taishoku shita rôdôsha no kyôgyô kisei* (Post-employment limitations of competition), 1066 Jurisuto 119). This goes far beyond what would be considered reasonable in countries such as England, which also leave the control of restrictive covenants to the judiciary. The leading English case in that matter decided in the 18th century, *Mitchell v. Reynolds*, High Court of Chancery, 24 English Reports 347 (1711) already held that “to obtain the sole exercise of any known trade throughout England, is a complete monopoly, and against the policy of the law.” The last two years in particular have shown that the Japanese labour market needs more flexibility and that even employees of large conglomerates can no longer expect a secure life-long employment. This in turn should also make the courts more suspicious of any attempts by employers to prevent employees from taking their fate into their own hands. If the example of the United States is anything to go by, Japan desperately needs innovative start-up companies. Their creation should be facilitated rather than obstructed by unnecessarily broad, and perhaps generally unnecessary restrictive covenants.