

China Trade Secret Developments Bring Certainty For US Cos.

By **Chiang Ling Li, Haifeng Huang and Jiahui Sheng** (June 8, 2021)

Recent international trade secret cases in which U.S. or European companies alleged theft of trade secrets outside of China have led to the parties eventually fighting cases both in and outside of China.

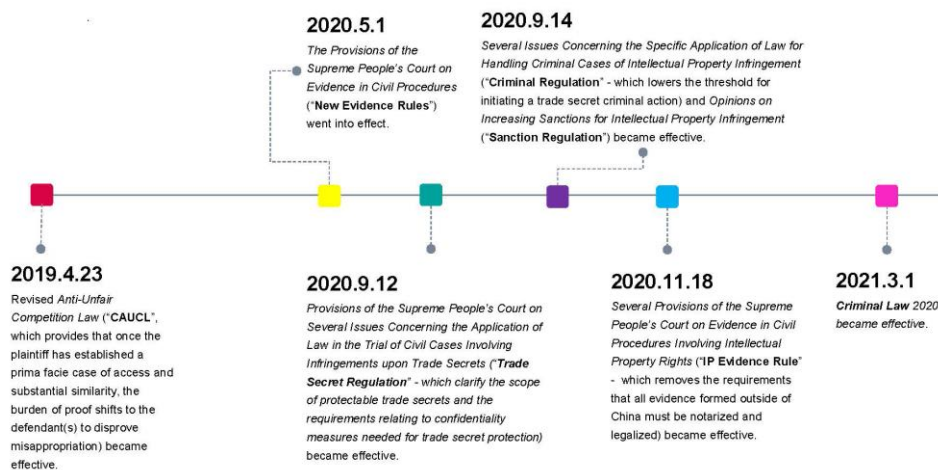
Major reasons for also having trade secret suits in China include Chinese parties' desire to have a Chinese court issue judgment ahead of courts outside of China, the difficulty of enforcing court judgments from the U.S. and many countries in Europe, and Chinese parties' lack of assets outside of China.

However, there are tremendous challenges with trade secret suits in China due to various factors, including the lack of a common law discovery system, the restriction against private investigation, the need to have all evidence sourced from outside of China notarized and legalized, and the burden of proof on the party making the claim.

The Beijing High People's Court in December 2020 published a report on trade secret cases, revealing that they are relatively rare in China. Only 338 judgments on trade secret cases were issued from 2013 to 2017, compared to the approximately 100,000 judgments in all intellectual property cases issued each year.

U.S. and European companies should therefore welcome the recent reforms to Chinese trade secret laws that have leveled the playing field for opposing parties and provided more legal certainty. This article highlights key legislative developments and two leading cases that provide guidance in this evolving area.

Legislative Developments



First, the new trade secret regulation clarifies what may be protected as trade secrets, specifically identifying certain technical information and business information, and bringing



Chiang Ling Li



Haifeng Huang



Jiahui Sheng

light to an area that has long frustrated trade secret enforcement efforts in China.

According to the report, more than 66.7% of the trade secret cases were lost because the court ruled that the technical or business information claimed as trade secrets was not protectable trade secrets. The new trade secret regulation targets this issue.

Articles 1 and 2 of the regulation specify that business information includes all information "on creativity, management, sale, finance, plans, samples, bidding materials, clients' information and data, relating to business activities."

The regulation focuses on customer information, a common area of dispute, defining the term "clients' information" to include "client's name, address, contact information, and trading practices, business plans, commercial details, and other information."

However, a party may not claim a specific client as trade secret solely because the party "maintains a long-term stable trading relationships with the client." And an accused infringer who is an ex-employee of the plaintiff and conducts business with the plaintiff's client after leaving the plaintiff will not be liable for trade secret misappropriation if the client voluntarily chooses to conduct business with the ex-employee based on the client's personal trust of that ex-employee.

Second, the new trade secret regulation sets out examples of confidentiality measures required for trade secret protection:

- Entering into confidentiality agreements;
- Adopting confidentiality requirements in the form of company rules, training, regulations or written notifications to employees, former employees, suppliers, clients, visitors and others who are able to access or obtain trade secrets;
- Restricting access to the factory, workshop and other production or distribution premises involving the trade secret;
- Adopting special treatment for or segregating trade secrets and their embodiments, such as (1) identifying them as trade secrets, (2) using encryption to protect the trade secrets, (3) locking up the trade secret, or (4) limiting individuals who are able to access or obtain the trade secrets or their embodiments;
- Prohibiting or restricting the use of, access to, or reproduction from computer equipment, electronic equipment, network equipment, storage equipment or software that can access or obtain trade secrets; and

- Requiring exiting employees to register and either return or destroy the trade secrets they accessed during their employment and to affirm that they will continue to honor confidentiality obligations.

The lack of clarity on this issue has also long frustrated trade secret enforcement efforts in China, and companies should promptly assess their practices to incorporate this welcome guidance.

Third, the new trade secret regulation reiterates the right of the trade secret owners to obtain preliminary injunctive relief. Although the law has long provided for preliminary injunctions, such relief was rarely granted in trade secret misappropriation cases. The rightsholder may file such a petition before or at the time as filing suit.

Further, under urgent circumstances, the court should make a decision within 48 hours. Whether the new regulation will encourage the court to grant preliminary injunctions remains to be seen.

Fourth, the new intellectual property evidence rule removes the requirement that all evidence formed outside of China must be notarized and legalized. Given the time-sensitive nature of claims for theft of trade secrets, the delays associated with the formerly onerous process had significant consequences.

Under the new rule, only a narrow subset of evidence, such as evidence concerning identity, e.g., powers of attorney, or official documents issued by government agencies or courts outside of China, needs to be notarized and legalized. The rule further provides that evidence formed outside of China may be admissible if the party submitting the evidence declares the authenticity of the evidence and offers to accept punishment if he or she commits perjury.

Fifth, the new regulations reasonably distribute the burden of proof between plaintiffs and defendants. In general, in China, each party in litigation bears the burden of proof for all its claims, and neither party can obtain discovery from its adversary, though courts may assist a party in obtaining evidence under exceptional circumstances.

Without the benefit of a common law discovery system, and in light of strict rules on evidence collection by private parties, the previous burden of proof created a nearly insurmountable challenge to bringing trade secret cases to in China.

The new laws change the burden of proof and availability of discovery in trade secret cases. First, under the revised Chinese Anti-Unfair Competition Law, once the plaintiff has established a prima facie case of access and substantial similarity, the burden of proof shifts to the defendant to disprove misappropriation.

Second, the IP evidence rule provides that the party with the burden of proof may petition the court to order the party in possession of the evidence to produce the evidence. If the court considers the grounds of the petition reasonable, it is required to issue such an order.

In addition, if a party refuses to submit such evidence without justifiable reason, submits false evidence, destroys evidence, or conducts any other act that renders the evidence unusable, the court is required to find against the party on the issue.

Finally, the new criminal regulation lowers the threshold for initiating trade secret criminal actions. Previously, trade secret owners were required to prove that the illegal income from the misappropriation exceeded \$70,000, which was difficult to establish given the lack of discovery.

Under the new regulations, trade secret owners may initiate a criminal action by proving either of the following: (1) the illegal income from the misappropriation exceeded \$42,000; or (2) the trade secret owners face bankruptcy or liquidation due to major operational difficulties directly caused by the trade secret misappropriation. As discussed below, criminal actions are very powerful tools in China for fighting trade secret cases.

Leading Cases

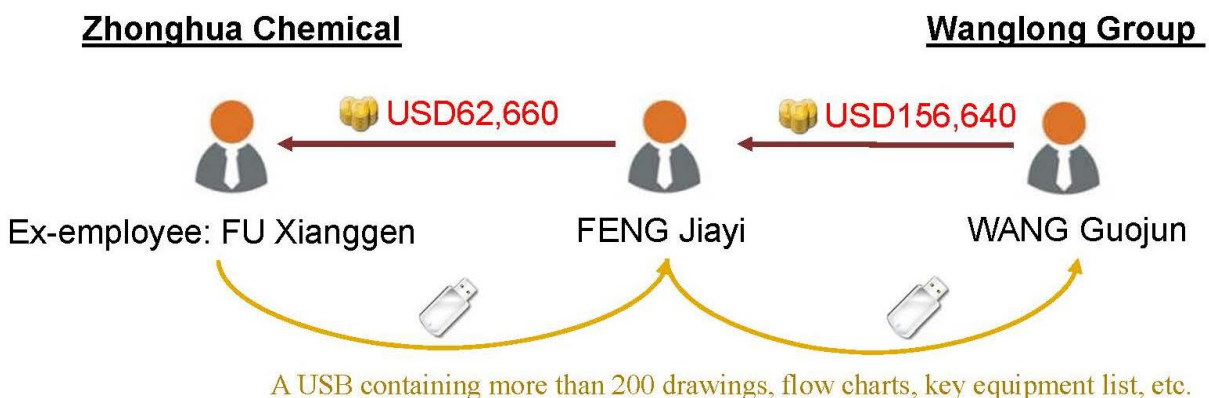
In general, the Chinese legal system is not based on case law. However, China is starting to employ more and more features of such a system. In April 2020, February 2021 and April 2021, the Intellectual Property Tribunal of the Chinese Supreme People's Court and some local courts issued guiding trade secret cases. Two such cases are highlighted below.

Zhonghua Chemical v. Wanglong Group

On Feb. 26, the IP Tribunal ruled on a trade secret misappropriation case, Jiaxing Zhonghua Chemical Co. Ltd. and Shanghai Xinchun New Technology Co. v. Wanglong Group Co. Ltd., and awarded the plaintiffs \$24.9 million in damages. It is the largest damage award ever awarded by a Chinese court in trade secret misappropriation cases.

Zhonghua Chemical developed a highly lauded new process to manufacture vanillin. Zhonghua Chemical protected the related technologies, including equipment and the manufacturing process, as trade secrets.

In 2010, Wanglong Group paid Zhonghua Chemical's former employee, Fu Xianggen, who was also sued as an individual, to disclose Zhonghua Chemical's vanillin manufacturing process.



Fu was subsequently employed by an affiliate of Wanglong Group, working at the vanillin workshop. In June 2011, Wanglong Group began to manufacture vanillin. In a very short period of time, by selling vanillin at a comparably low price, Wanglong Group became the third-largest vanillin manufacturer in the world, and Zhonghua Chemical's global vanillin

market share dropped from 60% to 50%.

One key feature of this case — and critical to Zhonghua Chemical's success — is that most evidence was obtained from a corresponding criminal case. Without access to this information, Zhonghua Chemical would have faced potentially prohibitive challenges with obtaining evidence for the case.

The criminal trade secret misappropriation case was commenced by the Jiaxing Public Security Bureau, and its powerful investigation furnished essential evidence for the civil trade secret misappropriation case.

Another interesting point of this case relates to damages. China did not provide punitive damages for trade secret misappropriation cases before April 2019, when the revised Anti-Unfair Competition Law became effective.

In this case, the damages awarded only covered misappropriation through 2018. The IP Tribunal pointed out that the trade secret owners may seek separate remedies against the misappropriation that occurred after 2018. It is thus possible for the plaintiffs to rely on the revised Anti-Unfair Competition Law to claim punitive damages for misappropriation that occurred after April 2019.

Sike v. Languang

In February, the IP Tribunal issued its decision in the trade secret misappropriation case Jinan Sike Testing Technology Co. Ltd. v. Jinan Languang Electromechanical Technology Co. Ltd. This case adopted a very high standard on the confidentiality measures needed to obtain trade secret protection.

Sike sued Languang for trade secret misappropriation, asserting trade secrets embedded in Sike's photometer product. One of the issues was whether Sike took necessary confidentiality measures to protect the alleged trade secrets.

Sike submitted evidence of: (1) internal trade secret protection policies, including nondisclosure agreements with employees and the trade secret protection system of Sike's manufacturing workshop; (2) confidentiality clauses in Sike's sales agreements with customers, which stated that Sike retained ownership of the trade secret information within the photometer and that the customers were not allowed to disclose the trade secret information to third parties; and (3) stickers on the photometers with the words "no warranty if removed," and "Danger! No quality guaranty if disassembled."

The IP Tribunal held that none of the evidence submitted established sufficient confidentiality measures. It ruled that the evidence of the internal trade secret protection policies did not amount to sufficient confidentiality measures.

The IP Tribunal also held that none of the confidentiality clauses in the sale agreements constituted sufficient confidentiality measures. The sale agreements imposed confidentiality obligation on only Sike's customers but not on third parties who might acquire the photometers from someone other than Sike, the initial seller.

The sale agreements did not prohibit the customers from reselling, transferring or otherwise disposing of the photometers to third parties. Third parties could therefore purchase the photometers without signing confidentiality agreements with Sike. As a result, Sike's confidentiality measures did not prohibit third parties from obtaining the trade secrets by

reverse engineering.

The IP Tribunal opined that sufficient confidentiality measures must at least include (1) measures to prohibit third parties from obtaining the trade secrets through reverse engineering, based on the nature of the trade secret; or (2) physical protection measures sufficient to preempt reverse engineering.

With respect to the third group of evidence, the IP Tribunal held that the stickers were just safety reminders and product guaranty reminders, which did not constitute sufficient confidentiality measures or physical protection mechanisms sufficient to prevent reverse engineering.

The IP Tribunal concluded that third parties who acquired the photometers did not owe contractual obligations to Sike not to reverse engineer the photometers and thus wholly dismissed Sike's trade secret misappropriation claims.

This case adopted an extremely high standard for confidentiality measures. To prove trade secrets embedded in products that are for public sale, Chinese courts may look for supporting evidence beyond confidentiality clauses in agreements with customers, such as whether the trade secret owner had the right of first refusal in case of resale by the customer, whether customers were required to place the products away from public view, whether photographing or videotaping of the products was prohibited or whether physical measures were adopted to prevent examination or reverse engineering.

Key Takeaways

Companies still face other obstacles in enforcing trade secret rights in China, including the lack of a common law discovery system and strict rules on evidence collection by private parties. But the current legal reform has put opposing parties on a more level playing field and has provided more legal certainty for all. Companies should carefully prepare their cases and structure their trade secret protection systems based on these new laws.

Chiang Ling Li and Haifeng Huang are partners, and Jiahui Sheng is an associate, at Jones Day.

Jones Day associates Luke Song and Albert Wang contributed to this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.