



# CHINA LEGAL REPORT\*

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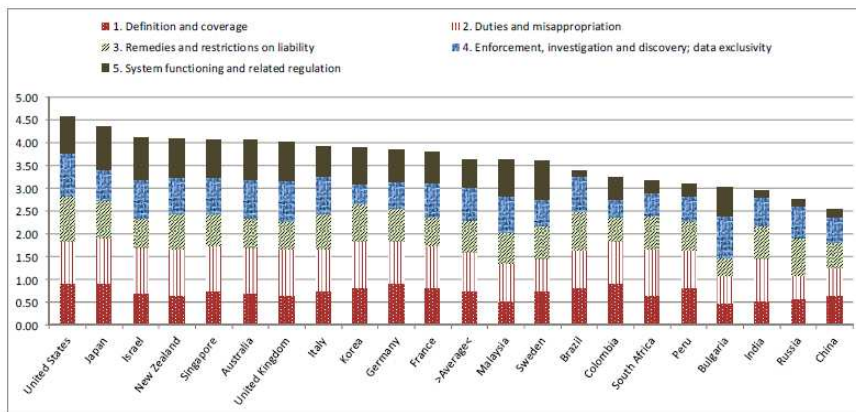
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# Trade Secret Protection in China

## I. Introduction

As the development of the economy progresses further in China, trade secret misappropriation has become a severe issue, especially in the manufacturing and technology sector.

The Organization for Economic Cooperation and Development (“OECD”) recently issued a report related to the level of protection of trade secrets in numerous countries. Each country was rated on 5 different aspects, namely: definition and coverage; duties and misappropriation; remedies and restrictions on liability; enforcement, investigation, discovery and data exclusivity; and system functioning and related regulation. These are recognized as the main factors of an effective protection of trade secrets. The table below compares the level of trade secret protection in different countries in 2010. China ranks at the very bottom of the whole list.



Source: OECD Trade Policy Paper No. 162: Approaches to Protection of Undisclosed Information (Trade Secrets) – Background Paper of 22 January 2014

Are your trade secrets safe in China? What should be paid attention to with regard to your trade secrets? What are serious threats to your trade secrets? The following chapters will provide an insight into important rules regarding trade secrets as well as strategies to increase their protection in practice.

## II. What is a trade secret?

A trade secret in China, according to the definition in Article 10 of the Anti-Unfair Competition Law, stands for information about technologies and business operations, which is non-public, has actual or potential commercial value and is protected by confidentiality measures. A trade secret can cover technology-related information, such as designs, procedures, formula of products, manufacturing techniques and methods, as well as information related to business operations, such as management secrets, customer lists, resources information, production and sale strategies, bottom prices of a bid, contents of a bidding document, etc.

Thus, a trade secret has the following three defining elements:

## **1. Unknown to the Public**

The information is not directly accessible through public means, i.e. the information is unknown and difficult to be acquired by market-players in the relevant field. In particular, the information cannot be qualified as “unknown to the public” in the following cases:

- the information is common knowledge or the industry practice for the people in the relevant technical or economic field;
- the information only refers to the simple combination of dimensions, structures, materials and components, and can be directly obtained through observation of products by the public after the products enter into the market;
- the information has been disclosed in a publication or other public media;
- the information has been publicized through open conferences or exhibitions;
- the information can be obtained through other public channels;
- the information can be easily obtained without any substantial efforts and costs.

## **2. Economic Benefits and Practical Utility**

Information with a definite practical use which can bring actual or potential commercial value or a competitive advantage to the owner shall be regarded as having “economic benefits and practical utility”.

## **3. Confidentiality Protection Measures**

Confidentiality is the essential feature of a trade secret. Owners of trade secrets must have taken specific measures to keep them confidential; however, not all measures are reasonable and effective. According to the Interpretation of the Supreme People's Court on Some Issues Concerning the Application of Law in the Trial of Civil Cases Involving Unfair Competition, it is very clear that the Court should confirm whether the trade secret owner has taken confidentiality protection measures according to features of information carrier, the will of the owner, the identifiability of confidentiality measures, the difficulty of acquiring the information and other factors in consideration of determining whether the owner has adopted reasonable confidentiality measures. Thus, the owner of classified information must make efforts to maintain their secrecy in order to benefit from the legal framework applicable to trade secrets.

If any of the following measures are taken by trade secret owner to protect the confidential information, it shall be affirmed that the owner has adopted reasonable measures to protect confidentiality.

- Limiting the distribution of the confidential information to those individuals who need to know about it;
- Locking up the carrier of the classified information or similar preventive measures;
- Applying a confidentiality mark on the carrier of classified information;
- Applying passwords or codes to the classified information;
- Conclusion of confidentiality agreements;
- Restriction of visitors' access to classified machinery, factories, workshops etc., or subjecting them to a confidentiality declaration/agreement;
- Adoption of any other appropriate measures to protect the confidentiality of information.

## **III. What is stipulated in Chinese Law?**

There is a whole range of laws and regulations in China covering the use and protection of the trade secrets, including the Anti-Unfair Competition Law, Company Law, Contract Law, Labor Law, Labor Contract Law, Tort Law, Criminal Law and Administrative Law. In addition, some judicial interpretations provide supplementary rules and guidelines.

## **1. Trade secret misappropriation**

The primary law regarding the misappropriation of trade secrets is the Anti-Unfair Competition Law, which was promulgated on 2 September 1993. It defines trade secret misappropriation as any of the following actions:

- Acquiring a trade secret by theft, inducement, duress or other unfair means;
- Disclosing, using, or allowing others to use a trade secret of another acquired by the above illegal means;
- Disclosing, using, or allowing others to use a trade secret in breach of an agreement or a confidentiality obligation imposed by the legal owner.

In addition, the third party who knows or should know about the above illegal activities, and who acquires, uses or publishes the trade secret shall be considered as trade secret infringer. However, the obtainment of a trade secret through independent research and development or reverse engineering shall not be treated as an infringement. Reverse engineering refers to the obtainment of a products' technical information through dismantling, mapping or analyzing of a product acquired through other public channels.

## **2. Other rules**

In general, the people who are involved in the infringement of trade secrets are either employees, such as the directors, managers or workers, or external parties, such as clients, customers or competitors. Different types of people are subjected to different laws.

With regard to employees, the Company Law prescribes that directors or managers of a company shall not illegally disclose the company's trade secrets. If they violate trade secrets during the course of their employment, leading to harmful results for the company, they are responsible for the damage. Additionally, according to the Labor Law and Labor Contract Law, both parties to an employment contract can reach a confidentiality agreement and/or a non-competition agreement covering the disclosure of trade secrets.

As for external parties, according to the Contract Law, neither party may disclose or inappropriately use a trade secret obtained in negotiating a contract, whether or not the contract is executed. The transferee under a technology transfer contract shall, in conformity with the scope and the time period as agreed upon in the contract, abide by its confidentiality obligations in respect of trade secrets provided by the transferor. Thus, the law provides statutory protection even at an early stage in negotiations where no contractual agreements regarding the use of confidential information have been signed yet.

## **IV. How are trade secret rights enforced?**

In case of a misappropriation, the owner of the trade secret has three avenues to enforce his/her rights.

## 1. Administrative enforcement

The primary authority dealing with the infringement of trade secrets is the Administration of Industry and Commerce (“AIC”) and its branches at or above the county level. In case infringements occur, the AIC can order the infringer to cease the violation and impose a fine of no less than RMB 10,000 and no more than RMB 200,000.

According to the Several Provisions on Prohibiting Infringements upon Trade Secrets, the AIC also has the power to force the infringer to return the technical drawings, software and other relevant data containing the misappropriated information. Unless the owner of the trade secret agrees to purchase or sell the products, the AIC supervises the destruction of the products manufactured using the owner’s trade secret. If the infringer refuses to execute the decision and continues with the infringement, the AIC will deem it as a new violation and thus accord a heavier punishment.

## 2. Civil litigation

A further method to enforce trade secret rights, particularly where the owner has sustained losses as a result of a misappropriation, is to file a civil litigation. Civil liability of the infringer falls into two categories under PRC law: liability for breach of contract and tort liability. However, the trade secret owner can base his claim only on either contract or tort liability, not both together. The preservation of evidence is a key point in the litigation. Chinese courts also take protective measures during the course of the litigation.

### (1) Liability for breach of contract

Anyone who discloses a trade secret in violation of a contractual agreement has to pay liquidated damages to the trade secret owner. The parties can make stipulations about liquidated damages in their contract, either by providing for a specific method to calculate the amount of damages or by determining a fixed compensation due in case of a breach. In practice, if the agreed amount of compensation is lower than the actual damages, the trade secret owner has the right to request that the Court increases the amount. If the agreed amount of compensation is significantly higher than the actual loss, the infringer can submit a request for reducing the amount. If the agreed compensation exceeds the loss incurred by 30%, it shall generally be deemed as “significantly higher than the losses incurred”. Finally, the court will make a ruling on the basis of the parties’ requests, taking into account the actual loss, loss of expected profits, the status of the contract performance, seriousness of the fault, and other factors.

### (2) Tort liability and Unfair Competition

Since trade secrets are also protected by intellectual property rights, the trade secret owners have an exclusive right to use them. In other words, the breach of a trade secret will infringe on the rights of owner regardless of the existence of a contract. Both Article 118 of the General Principles of Civil Law and Article 2 of the Tort Law stipulate that a person abusing trade secrets will be subject to tort liability. The possible legal consequences of tort liability generally include cessation of infringement, removal of obstruction, elimination of danger, return of property, compensation for losses, restoration to the original status, apology and elimination of consequences and restoration of reputation. In trade secret cases, the infringer is typically ordered to both cease further infringements and pay a compensation for losses.

Furthermore, the breach of a trade secret can lead to a liability under Article 20 of the Anti-Unfair Competition Law. If the amount of loss is hard to calculate, the owner can take the revenue earned by the infringer as a result of the infringement as a calculation basis. In addition, the infringer can also be held to pay reasonable fees to compensate the trade secret owner for investigating the illegal activities of the infringer.

### (3) Injunctions

According to the Civil Procedure Law, there are two ways for trade secret owners to claim the cessation of infringement: one is the interim injunction, the other is preliminary injunction. The main purpose of applying for an interim injunction is to prevent more profits earned by the infringer and to avoid the extension of damage during the litigation. Therefore, in the event that an infringer's action disturbs the execution of judgment or causes other damages to the trade secret owner, the court may, upon application of the owner, issue a ruling to ban certain actions of the infringer before or during the litigation. It is worth noticing that in some urgent cases, the court has to issue a ruling within 48 hours. However various requirements shall be satisfied in order to perform an interim injunction, for example, the trade secret owner shall provide evidence to prove that there are clear infringing actions and undertaking the interim injunction will not cause any damage to the infringer. Furthermore, if the trade secret owner finally wins the case, the court will have to make a judgment concerning preliminary injunction. Generally, the preliminary injunction will not expire until the trade secret is known to the general public.

### (4) Preservation of evidence

Obtaining proof for trade secret violations is challenging. Trade secrets are naturally unascertainable and can be easily hidden. An additional difficulty is that courts in China prefer original, documentary evidence to prove a case. Therefore, gathering evidence in a trade secret case is crucial. According to the *Civil Procedure Law*, a trade secret owner can apply to the court for preservation of evidence. Generally, the evidence whose preservation can be applied for mainly falls into two categories.

One type of evidence relates to the profits gained by the infringer, e.g. financial statements, bank statements etc. In this regard, the court usually suggests the trade secret owner to go to the AIC, the Municipal Bureau of Taxation and other related bureaus to retrieve evidence about the state of the infringer's business without influencing the infringer's normal operation.

The other type of evidence relates to the act of violating the trade secret, e.g. contracts between the infringer and his clients, technical data of the infringer, etc. In this case, the courts usually ask the trade secret owner to provide the prima facie evidence of a violation. Based on this evidence, the court will decide whether to approve the application for preservation of evidence.

### (5) Protection of the trade secret during the litigation

To avoid the risk of a public disclosure of secret information during court proceedings, the Civil Procedure Law provides that a trade secret case may be tried in camera upon an application of the parties. During the litigation, evidence which involves trade secrets shall not be presented in open court. After the litigation, the court decisions concerning trade secrets are not disclosed for public consultation.

### **3. Criminal enforcement**

According to Article 219 of the PRC Criminal Law, whoever engages in one of aforementioned trade secret misappropriations and thus causes “serious” or “exceptionally serious” loss to the trade secret owner shall bear criminal liabilities. Article 7 of the Interpretation on Certain Issues Concerning the Application of Law in Handling Criminal Cases Involving Infringement of Intellectual Property Rights, provides that losses above RMB 500,000 are considered “serious” and losses above RMB 2,500,000 are considered “exceptionally serious”.

If a trade secret owner suffers from serious losses, the individual infringer will be sentenced to no less than three years of fixed-term imprisonment or criminal detention and may in addition or exclusively be sentenced to a fine. Where the trade secret owner has suffered exceptionally serious losses, the infringer will be sentenced to no less than three years and no more than seven years of fixed-term imprisonment and a fine.

## **V. Precautions to avoid disclosure of trade secrets**

Although China has quite a detailed legal framework to protect trade secrets, evidence collection in case of a misappropriation is difficult, legal proceedings are expensive and they present an additional risk of exposing the trade secret to third parties. Therefore, undertaking precautions to avoid an involuntary disclosure is still the best way to protect a trade secret.

### **1. Internal control system**

Building a sophisticated internal control system is key to an effective trade secret protection. This requires that a company first goes through a self-evaluation process and decides which information shall be deemed as a trade secret. The next step is to sort out confidential files and mark them as “confidential”, “classified”, “restricted”, “do not disclose”, “do not copy” or similar indications. The third step is to clarify all the circumstances as well as the consequences of an improper use of confidential information by establishing internal rules (e.g. a personnel handbook). The internal rules should give details about procedures of transferring confidential information, the duties of authorized employees, restriction of access to company information. All computers should be equipped with security software, protected by passwords and access to certain information should be restricted for different categories of employees. Each transfer of paper files containing trade secrets should be documented, including the purpose, time and duration of the transfer, and signatures of the authorized person and the receiver. Archives and paper files should be kept in a separate, protected storage room.

### **2. Confidentiality and non-competition agreements**

As outlined above, anyone who illegally uses or discloses a trade secret is subject to tort liability, regardless if there is a contract. However, it is not enough to rely on statutory protection alone. First of all, confidentiality agreements are often necessary in order to show that sufficient protective measures have been taken. Furthermore, the scope of the confidential information, the specific rights and obligations of the user, the duration of the protection, and liability in case of a breach can best be regulated in a contractual agreement. Unless specified otherwise in the agreement, the confidentiality obligation lasts until such moment when the trade secret becomes known to the public.

With regard to an employee who has a confidentiality obligation, according to Article 23 and 24 of the Labor Contract Law, the employer and the employee could enter into a non-competition agreement. With such agreement, the employee shall not work for a market player that produces the same products or is engaged in the same business as his original employer, or to establish his own business to produce the same products or engage in the same type of business, after the labor contract is revoked or terminated. In order to compensate the employee, a financial compensation should be paid on a monthly basis during the term of the non-competition agreement. In other words, if the employer makes clear that he will not pay any compensation to the employee, such agreement is invalid. In the event that the employee breaches the non-competition agreement, he shall pay penalty to the employer as agreed upon. The maximum duration of such non-competition agreement is 2 years.

The failure to provide for a financial compensation in the non-competition agreement can have different consequences under various local regulations. For example, in Beijing, the agreement will still be deemed valid. However, in order to remedy such agreement, the parties must agree on a compensation through consultation and, failing that, the court will determine the amount of the compensation. In Jiangsu Province, if the payment of economic compensation is not included in the non-competition agreement, such agreement is invalid. Furthermore, due to different levels of economic development, the amount of the compensation is fixed on different standards. For instance, in Tianjin, the compensation should be no less than 50% of the monthly salary and should meet the city minimum living standard. In Foshan, the amount of economic compensation should be more than 30% of the monthly salary.

If the agreed amount of economic compensation is unfair to the employee or lower than a local minimum standard, the court will increase the amount.

### 3. Enhance the protective environment

Most disputes about trade secret misappropriation are related to trade secrets disclosed by employees. Therefore, it is in any company's best interest to provide trainings on confidentiality policies for the employees, especially managers, senior technicians and file keepers, with the aim of creating an understanding of trade secrets as intangible assets that bring great value to a company. Furthermore, it can prove useful for companies to hire a person to supervise, update and enforce confidentiality policies.

## VI. Recent Case

### Is website user information a trade secret?

**Wanlian Co.v. Zhou Huimin et al.:** In this case, Wanlian Network Technology Co., Ltd.(Wanlian) sued Zhou Huimin, Feng Huai, Chen Yunsheng, Chen Yufeng and Chen Yongping for trade secret misappropriation at the Shanghai High People's Court. The defendants were former employees of Wanlian. Zhou Huimin was one of the key engineers in charge of website development. In 2004, the defendants resigned from Wanlian and founded their own company, which had a similar business scope. Zhou Huimin copied Wanlian's website user information including password information.

One key issue in this case was whether the user information constituted a trade secret. The Court held that the user information at issue was a trade secret, because it met every element of what constitutes a trade secret. Firstly, it could be considered unknown to the public. Although a single user's information is easy to obtain by a market-player in the relevant field, it is difficult to obtain user information on all



500,000 users of Walian. Secondly, the information had commercial benefits and a practical utility not only for Wanlian by also for the defendants' company. Thirdly, Wanlian took adequate measures to protect the information by entering into a confidentiality agreement with Zhou Huimin and by setting a password for the database which was only known by the legal representative of Wanlian and Zhou Huimin.

As a result, the Court held that Zhou Huimin was liable for trade secret misappropriation by theft to obtain a trade secret. The other four defendants were treated as co-perpetrators liable for trade secret misappropriation by using a trade secret of another acquired by theft. All defendants were held jointly liable for RMB 1, 000,000. The Shanghai High Court later dismissed an appeal by Zhou Huimin and confirmed the original judgment.

## **VII. Conclusion**

As seen above, China offers a comprehensive legal framework for the protection of trade secrets. As a signatory of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS"), which contains basic common standards for the protection of trade secrets, China has made efforts to build a legal framework that is in line with international standards.

Despite this progress, significant efforts must still be made in practical terms in order to achieve an equitable and fully effective protection system. In the field of intellectual property rights, a fair and efficient enforcement mechanism, and in particular the existence of independent and professional courts are of particular importance. These requirements have not yet been fully met in China.

Some particular issues that companies still face in China are the following:

- 1) Because Chinese officials and courts on average only see a small number of trade secrets infringement cases each year, they often have limited experience in dealing with such cases. This can have an effect on the quality of decisions or it can lead to burdensome procedures, in particular with regard to the initial determination whether certain information qualifies as a trade secret.
- 2) Since trade secret cases are often difficult to solve, officials in administrations of industry and commerce, public security bureaus, and courts are often reluctant to take cases unless they are seen as straightforward or high-value.
- 3) When presenting evidence, companies face a high burden in trade secrets cases, especially in administrative and civil cases where they essentially have to assemble a complete case using their own resources.

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