SQUIRE SANDERS

CHINA UPDATE

September–October

The First Preliminary Injunction Issued by China Court in Trade Secret Cases.......... 1
Draft Regulations on Personal Information Protection are Finalized 2
China to Test Free Trade Area in Shanghai 3
New Rules on Foreign Exchange Administration Under Service Trade 4
Emerging Judicial Practice of Vertical Monopolistic Agreements in China 6

The First Preliminary Injunction Issued by China Court in Trade Secret Cases

Key Points

- The first preliminary injunction issued for a trade secret case in Shanghai is based on the amended Civil Procedure Law.
- This injunction could be an important reference in practice in future to protect trade secrets.

Background

It is reported that Shanghai Municipal First Middle People's Court has recently issued the first preliminary injunction in China according to the application of Eli Lilly and Company and Lilly (China) R&D Co., Ltd. ("Lilly") in a trade secret case against one of former employees of Lilly (the "Employee"). Both Eli Lilly and Company and Lilly are the plaintiffs in this case, who have asserted that the Employee (i.e. the defendant) violated the company rules and breached the confidential agreement, whereby incurred the infringement to the trade secret of the plaintiffs.

According to the China Court report [www.chinacourt.org] dated 3 August 2013, Lilly and the Employee entered into a labor contract and a confidential agreement on 3 May 2011. Such agreements provide that the Employee has the confidential obligation on the confidential and proprietary information of the plaintiffs which the Employee obtains during the employment term. The Employee, however, downloaded confidential documents from the server of Lilly without the consent of the plaintiffs on 19 January 2013. Lilly terminated the employment contract with the Employee on 27 January 2013 after failure to request the Employee to delete the confidential documents. Accordingly, the plaintiffs instituted the legal action in the court against the Employee on 2 July 2013, requesting the Employee to compensate the loss and damage of the plaintiff (including attorney fees) the sum of RMB20 million. Meanwhile, the plaintiffs applied with the court to issue the injunction to prevent the Employee from copying, disclosing, using or licensing any third party to use the 21 documents which included trade secrets of the plaintiffs, and provided the security in the amount of RMB100,000 to the court for the application of the injunction. After reviewing the application materials, the court issued the injunction according to Article 100 of the Civil Procedure Law of the People's Republic of China (the "Civil Procedure Law").

Analysis

The legal basis for the preliminary injunction, Article 100 of the Civil Procedure Law, is newly added into the Civil Procedure Law, amended on 31 August 2012 and effective as of 1 January 2013. Article 100 of the Civil Procedure Law provides that if the judgment enforcement may become difficult or any other damage may be caused to a party because of the other party's actions or for other reasons, the court may, upon application of the party,

(i) issue an order on preservation of the other party's property

(ii) order conduct of certain action of the other party, or

(iii) prohibit the other party from certain action.

Whether preliminary injunction relief would be applicable in a trade secret case had been a widely discussed question for years before the injunction was issued by Shanghai Municipal First Middle People's Court. The patent, trademark and copyright laws of the PRC all have specific provisions on the application of the preliminary injunction. There is no express legislation specifically providing that the preliminary injunction is applicable for trade secret cases. Although the amended Civil Procedure Law includes the concept of injunctive relief for general civil lawsuits, there was some uncertainty whether such injunctive relief is applicable for trade secret cases from the practice perspective until the injunction for the above case was officially issued by the court in Shanghai.

Conclusion

Although China is not a case law country, commentaries believe that the above case may be an important reference for similar cases in the future. The application preliminary injunctive relief in trade secret cases will play a significant role for protecting trade secret and improving the enforceability of judgments and arbitration awards in China.

Contacts

Olivia Zhan
olivia.zhan@squiresanders.com

Draft Regulations on Personal Information Protection are Finalized

Key Points

- No material change to the finalized regulations after soliciting of public opinion.
- Effectiveness of regulations on the personal information protection might be limited.

Background

After the process of soliciting public opinions this April, the Ministry of Industry and Information Technology of China ("MIIT") issued the finalized Rules on the Personal Information Protection of Internet and Telecommunication Users (the "Protection Rules") and Rules on the True Identity Registration of Telephone Users (the "Registration Rules") on 16 July 2013, which will be effective as of 1 September 2013.

Comparison Between the Draft and Finalized Rules

Compared with the drafts rules issued in April, there is no material change the finalized version.

1. According to the Draft Protection Rules, "personal information" refers to the identity information of a user which is collected by the telecommunication business operators and internet service providers ("ISPs") during the process of providing that service. The data collected includes identity information such as the name of the user, date of birth, ID card number and address as well as information related to the use of the service, such as service account number, time and location of using the service. The finalized Protection Rules specified that telephone number, account number and password are also included in the personal information.
2. Regarding the information collection, the finalized Protection Rules added a section in Article 9: "after users stop using telecommunication or Internet services, telecommunication service operators and Internet information service providers (ISPs) shall stop collecting and using personal information of users, and deactivate phone numbers or accounts of users."
3. Regarding the safety measure, both of the finalized Protections Rules and Registration Rules added an article to provide that telecommunication administrative authorities shall evaluate the impact of reported and discovered behaviors which may violate the Rules; if the impact is severe, the telecommunication administrative authority at the provincial level shall report the issue to the Ministry of Industry and Information Technology of China ("MIIT"). Before the telecommunication administrative authority making any decision according to the Protection Rules, the telecommunication administrative authority may request the relevant business operator to suspend its business.
4. In the legal liability part of both finalized rules, "behaviors of violators will be announced to the public" is added as another penalty to violators.

Conclusion

In our previous discussion on the draft Rules, we mentioned that there are two main issues for the implementation of the Rules. These issues still remain: (a) the safety measures are not very detailed and (b) the penalty is too light for violators. It seems the legislators were also provided with similar comments, but the revisions on these two points nevertheless remain limited in the finalized Rules.

Contact

Olivia Zhan
olivia.zhan@squiresanders.com

China to Test Free Trade Area in Shanghai

Key Points

- Trial plan to test the openness of the Chinese market in Shanghai as part of a move towards reform of the economy.
- FTPZ will cover an area of 28 square kilometers along the east coast line of Pudong District.
- Plans to introduce national treatment for foreign banks, allow freely convertible RMB, create a genuine free trade zone, lower taxes for corporates and individuals, and improve market entry to foreign investment.

Background

On 3 July 2013, the Overall Plan for China (Shanghai) Free Trade Pilot Zone was approved in principle at the State Council Executive Meeting. The China (Shanghai) Free Trade Pilot Zone (the "Shanghai FTPZ") is designed to be an experimental area to test the "full-range" openness of the Chinese market as part of a reform and update of the Chinese economy including free flow of capital, trading and RMB convertibility. The Shanghai FTPZ may become a breakthrough for Chinese economic reform in the future and could create great opportunities for foreign investors.

Highlight of the Regulations

The current planning shows that Shanghai FTPZ will cover an area of 28 square kilometers along the east coast line of Pudong District including the current Waigaoqiao Bonded Zone, Yangshan Bonded Port and Pudong Airport Bonded Zone. Although the implemented regulations and detailed rules of Shanghai FTPZ are being drafted and are expected to be published soon, the proposed plan suggests, alongside additional information from commentators and analysts, that the key developments are expected to include the following aspects.

- National treatment to foreign financial institutions

  Foreign banks may be able to enjoy national treatment in Shanghai FTPZ including being allowed to form wholly-owned subsidiaries (currently foreign banks can only have branches in China) and being allowed to engage in the full range of financial businesses (currently foreign banks' permitted business is limited) and innovative financial products.

- RMB "free convertibility"

  Foreign exchange is strictly regulated in China, particularly for capital in nature funds. The ultimate goal for the Shanghai FTPZ is to allow RMB to be freely convertible. However, due to the concern of national economic security, analysts expect that will be achieved through a step-by-step approach – in the early stages, the authority will likely loosen personal overseas investment and offshore banking business.

- Real Free Trading

  Unlike the existing free trade zones or bonded zones in China, where goods in the zones are under customs supervision at all times, Shanghai FTPZ intends to be a real free trade zone, i.e., goods coming from and leaving for overseas will require no customs supervision. It is expected to largely facilitate international trading, making Shanghai an international transition and processing center, allowing the international commodity futures traders to set up their futures delivery warehouses in Shanghai.

- Taxes

  Lower tax rates for corporate as well as individuals are expected to attract businesses such as regional headquarters, offshore trading, shipping and logistics businesses, and financial leasing businesses.

- Market Entry to Foreign Investment

  Nationwide, market entry to foreign investment is regulated through the Foreign Investment Industries Catalog. In Shanghai FTPZ, the principle is to allow foreign investment in all sectors unless prohibited or restricted in the "negative list" which is supposed to be much shorter than the list in the Foreign Investment Industries Catalog. For example, apart from the banking industry, clinics and creditability research and evaluation sectors may be opened to foreign investment. In addition, approvals and registrations for foreign investment are expected to be significantly simplified and relaxed in Shanghai FTPZ. Ultimately, the goal is to grant national treatment to foreign investment, i.e., applying the same incorporation and maintenance procedures to foreign invested enterprises as those applicable to local companies.

Conclusion

Through this pilot test in Shanghai, China hopes that suspending laws governing foreign investment in this proposed free trade zone may help the country increase its foreign competition and, as a result, further increase its economic success. Ultimately aimed at improving direct foreign investment in China, it will be interesting to observe any future developments relating to this experimental zone.

Contacts

Lindsay Zhu
Senior Associate
lindsay.zhu@squiresanders.com

New Rules on Foreign Exchange Administration Under Service Trade

Key Points

- No approval for foreign exchange purchase and payment under service trade, which can be handed directly into financial institutions.
- No requirement for trade documents verification for transactions under service trade with a value of US$50,000 or less.
- Simplified requirement for trade documents verification for transactions under service trade with a value of more than US$50,000.
- Cleaning up and integration of rules and regulations, abolishing more than 50 relevant rules and regulations replaced by the Guide and the Rules.
- Relaxing Conditions for domestic enterprises to deposit overseas foreign exchange receipts under service trade and allowing enterprise groups to do so in a centralized manner.

Background

On 18 July 2013, the State Administration of Foreign Exchange ("**SAFE**") issued the Notice to Print and Distribute the Regulations on Foreign Exchange Administration for Service Trade (Hui Fa [2013] No.30)(the "Notice") to bring into force the Guide on Foreign Exchange Administration for Service Trade (the "**Guide**") and the Detailed Rules for Implementing the Guide on Foreign Exchange Administration for Service Trade (the "**Rules**) from 1 September 2013.

The issuance of the Guide and the Rules signifies a reform of foreign exchange administration rules for the service industry by SAFE, with the purpose to promote and facilitate foreign exchange administration. The Notice abolishes around 50 rules and regulations currently applied to foreign exchange administration for service trade and purports to provide the financial institutions, domestic enterprises and individuals involved in the international service trade with a more systematic, clear and transparent legal basis.

In connection with the issuance of the Guide and the Rules, SAFE and the State Administration of Taxation jointly published the Proclamation on Tax Record-Filing of External Payment under Service Trade and Other Items (the "**Proclamation**") on 9 July 2013, which will take effect from 1 September 2013. Under the Proclamation, domestic enterprises and individuals engaging in the international service industry need to provide the relevant financial institution with a Tax Record-Filing Form, instead of a Tax Certificate, when making a foreign exchange payment.

Highlights of the Rules

General Principal of Foreign Exchange Purchase and Payment Under Service Trade

SAFE does not impose a limitation on foreign exchange payments under service trade. Domestic enterprises and individuals may make foreign exchange payment using the foreign exchange they own or foreign exchange purchased with RMB. Domestic enterprises may wire their foreign exchange receipts to China or deposit overseas under certain conditions and within a specific time limit. Foreign exchange receipts can be retained or settled with RMB.

Trade Documents Verification

Financial institutions are responsible for verifying trade documents for service transactions with a value of more than US$50,000 to ensure authenticity of the trade documents and consistency between the trade documents and the foreign exchange payment and receipt being made. The Rules lists the trade documents required for each type of transaction under service trade, including contracts, payment notices and any other documents that can prove the legality and authenticity of the transaction. Compared with the current requirements for different types of service trade transactions, the requirements provided by the Rules are much more simple and easy to handle (abolishing more than 50 current rules and regulations from 1 September 2013), particularly where some authority approvals have been removed. For example, for foreign exchange payment under a technology import and export contract, the registration form issued by the local commercial bureau will no longer need to be verified by the financial institutions when making a foreign exchange payment under the technology import and export contract.

For service trade transactions with a value of US$50,000 or less, the financial institutions normally will not have to verify certain trade documents. However, if the financial institution cannot determine nature of the payment or receipt being made, it may ask the enterprise or individual to provide relevant documents for verification.

All trade documents that have been verified by the financial institution shall be kept for five years by the domestic enterprises, individuals and the financial institutions. Trade documents submitted to a financial institution under service trade can either be in the form of hard copy or electronic.

Overseas Deposit of Foreign Exchange Receipts by Domestic Institutions

Domestic enterprises may deposit foreign exchange receipts overseas under certain terms and conditions as specified by the Rules, for example, where there is a continuous need to make foreign exchange payment overseas or there is no violation of foreign exchange regulations by that domestic enterprise for the past two years, etc. Domestic enterprise groups may also be allowed to deposit their foreign exchange receipts overseas in a centralized manner under the Rules by meeting specific conditions.

Domestic enterprises may open a bank account overseas ("**Foreign Bank Account**") to deposit their foreign exchange receipts. To open a Foreign Bank Account, domestic enterprises shall submit documents as required to the local counterpart of SAFE at the place of the enterprise for approval. Once the Foreign Bank Account is opened, the domestic enterprise shall report the basic information, any change of it and closing of the Foreign Bank Account to the local counterpart of SAFE within ten days. Once the Foreign Bank Account is closed, the domestic enterprise shall remit back to China the balance of the Foreign Bank Account.

The balance in the Foreign Bank Account must not exceed 50% of the total amount of the enterprise's foreign exchange receipts for the last year. Relevant trade documents for transactions of which foreign exchange receipts deposited in the Foreign Bank account shall also be kept for five years by the domestic enterprise.

The Proclamation

Under the Proclamation, foreign exchange payment under service trade with value of more than US$50,000, domestic enterprises and individuals shall file with the local state tax bureau in charge and obtain a Tax Record-Filing Form approved by the state tax bureau. This must be submitted to the relevant financial institutions together with other trade documents for verification. The Proclamation lists the circumstances under which such Tax Record-Filing Form shall be obtained, but the list is not exhaustive. According to SAT's explanation, unless the foreign exchange payment falls within the circumstances stipulated in Article 3 of the Proclamation, such Tax Record-Filing Form shall be obtained.

Before taking effect of the Proclamation, domestic enterprises and individuals need to provide the financial institution with a Tax Certificate issued by the tax bureau, certifying that the withholding tax on the foreign exchange payment being made has been paid.

However, under the Proclamation, the tax bureau will not check if the withholding obligations has been performed or not, and will approve the Tax Record-Filing Form so long as the form has been properly filled out and the required documents (including the contract) have been submitted. No information about withholding tax is mentioned in the Tax Record-Filing Form. The tax bureau will inspect if relevant withholding tax has been paid afterwards.

Conclusion

Issuance of the Rules makes it more simple and convenient for domestic enterprises and individuals to do business under service trade, by cancelling trade documents verification for transactions with value of US$50,000 or less and simplifying the documents required where verification is still needed.

Contact

Olivia Wang
olivia.wang@squiresanders.com

Emerging Judicial Practice of Vertical Monopolistic Agreements in China

Background

On 1 August 2013, Shanghai High People's Court (the "Court") made a final judgment on the reportedly first civil action of a vertical monopolistic agreement whereby Johnson & Johnson Medical (Shanghai) Ltd. and Johnson & Johnson Medical (China) Ltd. (collectively "J&J") entered into and implemented a vertical monopolistic agreement by imposing a minimum resale price on Beijing Ruibang Yonghe Technology and Trading Co., Ltd. ("Rainbow"), a distributor of J&J, in violation of the Anti-monopoly Law ("AML") of the People's Republic of China. Consequently, J&J was ordered to indemnify the loss of profit incurred by Rainbow arising from such monopolistic agreement in the total amount of RMB530,000. As far as judicial practice is concerned, this judgment shed some light on a few key issues in the recognition of a vertical monopolistic agreement, especially the establishment of minimum resale price, as summarized below.

Highlights of the Judgment

Establishment of Minimum Resale Price Not a Per Se Violation

There are technical arguments on whether the resale price maintenance, including fixing of resale price and establishment of minimum resale price, is a "*per se*" violation of the AML, i.e., the resale price maintenance, by itself, constitutes a vertical monopolistic agreement regardless of its effect on competition, or needs to be assessed under the rule of reason, i.e., the legitimacy of resale price maintenance depends on whether such arrangement has anti-competitive effect.

The Court concluded in the judgment that a particular resale price maintenance would be recognized as a vertical monopolistic agreement only if such arrangement has the effect of eliminating or restricting competition, which implied that the Court did not consider the establishment of minimum resale price to be a *per se* violation of the AML. In the opinion of the Court, a judicial interpretation of the AML made by the Supreme People's Court in 2012 indicates that the anti-competitive effect arising out of a given agreement is a precondition of the recognition of a horizontal monopolistic agreement. As a vertical restraint generally causes less anti-competitive effect than a horizontal restraint does, the same effect must be present in the recognition of a vertical monopolistic agreement.

On the other hand, as the government agency responsible for striking pricing-related monopoly, the National Development and Reform Commission ("NDRC") has yet to reveal its stance toward the presence of anti-competitive effect in the recognition of a vertical monopolistic agreement. Particularly, in light of the recent penalties the NDRC imposed on certain milk powder suppliers for resale price maintenance, NDRC did not disclose details of its recognition of such vertical monopolistic agreements. Nevertheless, even if NDRC holds the same opinion as the Court with respect to the required presence of anti-competitive effect in a monopolistic agreement, it is widely believed that NDRC may likely not subject itself to the "burden of proof" as heavy as a plaintiff would bear in a civil action.

Four Elements for Consideration in Exploring Anti-competitive Effect

With the effect of eliminating or restricting competition seemingly a precondition of a monopolistic agreement, the Court then identified four elements to be considered when exploring the existence of such anti-competitive effect, as discussed below:

1. Competition Status in Relevant Market

The Court noted that the lack of sufficient competition in the relevant market is the primary condition for the establishment of a minimum resale price to constitute a vertical monopolistic agreement because consumers in a sufficiently competitive market would be able to switch to alternatives if the price of a given product is artificially inflated.

To begin with, the Court identified the relevant product market and geographical market based on an analysis of demand substitution, and concluded that an analysis of supply substitution was not necessary in this case. The Court also noted that market concentration, market entry thresholds, and bargaining powers of downstream market need to be accounted for in exploring the existence of sufficient competition.

In the case of J&J, the Court concluded that there is no sufficient competition in the relevant market based on the observations that (i) motives of bargaining are absent from the downstream market as the costs of relevant product are shifted to end users, (ii) downstream player's loyalty to J&J brand decreases demand flexibility, (iii) thresholds for entering into the relevant market are high due to the marketing authorization required for the relevant products and the relationship-based sales model, and (iv) the prices of J&J products remained level consistently for 15 years.

2. Strong Market Powers

According to the Court, the anti-competitive effect in the context of resale price maintenance is also conditioned upon the defendant's possession of "strong market powers", which is notably different from the term "dominant market powers" as used in another dimension of the AML, i.e., abuse of dominant market powers. The Court, however, did not specify any market share criteria for the determination of "strong market powers"; rather, as stated in the Court's judgment, "strong market powers" are reflected by the capabilities to control pricing.

Apart from the observation that the prices of J&J's products remained level consistently for 15 years, the Court also noted J&J's strong control over its distributors in its affirmation of J&J's possession of "strong market powers", including that the distributor is subject to (i) the non-compete obligations, prohibiting it from selling competing brands, (ii) segregation of downstream market, prohibiting it from selling to hospitals other than those designated by J&J, and (iii) a distribution contract with a short term of one year only, though renewable. In addition, the Court concluded that J&J acquired leading market share on the ground that "J&J, as a globally well-known multinational corporation, should be able to provide its exact market share [but failed to do so], and given its position in this litigation, its actual market share should be higher than J&J's estimate of 20.4%", and that J&J never identified any competitor that holds higher market share than J&J does.

The foregoing reasoning suggested a heavier burden of proof with respect to market share on a large multinational corporation as a defendant, which, though understandable, is inconsistent with the Court's allocation of burden of proof as further discussed below.

3. Motives of Establishment of Minimum Resale Price

The Court also considered the motives of the establishment of minimum resale price as an element in exploring anti-competitive effect, and concluded that J&J's motive was to avoid price competition, as evidenced by J&J's imposing of contractual obligations on the distributors to maintain the pricing level of J&J's products. In addition, the Court also noted an action plan of J&J requiring distributors to "establish good relationship with physicians in order to mitigate the impact of unfavorable pricing".

Given the inherent difficulties in proving any motive, it is arguable whether the motive should be included as an element to be considered in exploring anti-competitive effect.

4. Anti-competitive and Pro-competitive Effect of Minimum Resale Price

With the recognition that the establishment of minimum resale price may have both anti-competitive effect and pro-competitive effect, the Court concluded that minimum resale price would constitute a vertical monopolistic agreement only where the anti-competitive effect cannot be fixed or offset by the pro-competitive effect.

In the case of J&J, the Court concluded that the anti-competitive effect included the elimination of intra-brand competition (i.e. no price competition among distributors of J&J's products) and the avoidance of inter-brand competition (i.e. discouragement of price competition from other brands) whereas no obvious pro-competitive effect was proved. In particular, the Court did not believe there is a need for J&J to (i) improve the quality of products or services, (ii) eliminate insufficient distributors, and (iii) promote market entry of new brand or new product, through the establishment of minimum resale price.

Burden of Proof on Plaintiff

Whereas a defendant alleged to implement a horizontal monopolistic agreement has the burden of proof to demonstrate that the agreement does not have anti-competitive effect according to the judicial interpretation of the Supreme People's Court, the Court concluded that such reverse of burden of proof does not apply to a vertical restraint. Consequently, a plaintiff must prove the existence of anti-competitive effect in accordance with the four elements noted above, which could be quite difficult to accomplish, especially where a consumer sues for implementing monopolistic agreements.

In the case of J&J, most of the evidences accepted by the Court appear to be circumstantial and, arguably, insufficient to prove the anti-competitive effect arising out of the minimum resale price. Despite the foregoing, the Court appeared to have given full play to its interpretation of, and inference from, the common observations in the relevant market, and eventually ruled in favor of the plaintiff.

Exemptions under AML

According to the AML, even if resale price maintenance constitutes a vertical monopolistic agreement, such arrangement would be allowed if it qualifies any exemption provided under Article 15 of the AML, e.g. improvement of technology and development of new products, increase of small-medium enterprises' competitiveness, etc.. Such exemptions were not addressed in the J&J case. Nevertheless, the Court's analysis of the absence of pro-competitive effect shed some light on their stance toward such exemptions. Specifically, as stated in the judgment, the establishment of minimum resale price for the purpose of procuring distributors to improve after-sales services in the event of a new product's market entry may be reasonable.

Calculation of Loss

In the case of J&J, the Court concluded that the loss of profit incurred by the plaintiff should not be calculated according to the rules under contract law because the calculation according to contract law would result in excessive profit derived from a monopolistic activity. Such opinion implies that a contractual arrangement, i.e., limitation of liability, will likely be unenforceable in the case of monopolistic agreements.

Conclusion

The Court's judgment on the J&J case may have established a framework of civil action of vertical monopolistic agreement quite favorable to a defendant because a plaintiff would bear the burden of proof to demonstrate not only the existence of a vertical restraint but also the anti-competitive effect arising therefrom. Nevertheless, in view of a court's potential interpretation of, and inherence from, common observations in support of its judgment and the unclear stance of NDRC, a company should remain very cautious about implementing any resale price maintenance. In any case, a comprehensive analysis of competition risks is advisable if any resale price maintenance is contemplated.

Contact

Ryan Chen
ryan.chen@squiresanders.com

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

© Squire Sanders.

All Rights Reserved 2013