The Corporate Counselor

- Insights into Japanese Corporate Law -

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ENFORCEABILITY OF NON-COMPETE PROVISIONS IN JAPAN

Non-compete clauses are used for a variety of purposes, such as to deter employees from undertaking competitive acts that are contrary to the business interests of their employer during and after the term of employment, to discourage commercial parties from competing after a contractual relationship has ended, and to prevent the seller of a company from competing with the business it recently sold to a third party. Japanese law does not prohibit outright non-competes, but there are no bright-line tests or safe-harbor rules under Japanese law that provide assurances as to the minimum non-compete terms that are acceptable. Instead, the enforceability of a non-compete is often viewed in terms of its compatibility with vague notions of Japanese public policy and social moral norms, which creates uncertainty as to the permissible scope of these provisions. However, as a general rule, a lower level of circumspection is often applied to a non-compete clause entered into as part of an M&A transaction (in comparison to those arising in the employment and commercial agreement context), and a separate non-solicit covenant that restricts a person from contacting third parties and a confidentiality undertaking can serve as meaningful alternatives to a non-compete clause and should pass muster with less regulatory and judicial scrutiny.

This edition of the *Corporate Counselor* discusses the various factors that a beneficiary of a non-compete clause should consider when negotiating and seeking to enforce such a provision in light of the context in which it is used. This newsletter culminates with an analysis of the remedies available upon the breach of a non-compete clause, and addresses how to frame an effective remedy.

Non-Compete Provisions

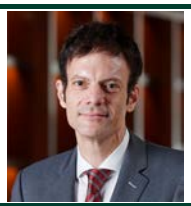
The enforceability of a non-compete clause in Japan depends on whether it is agreed in the context of an employment agreement, a commercial agreement, or in an M&A transaction.

Each scenario is discussed below:

Employment agreements. An employer in Japan is legally entitled to insist that its employees devote all of their working time for the company's benefit and not undertake competitive activities after-hours during the course of their employment. Post-employment restrictions are less clear cut. While there is no express statutory provision that prohibits an employer from imposing a non-competition clause after an employee leaves the company, Article 22 of the Constitution of Japan states that "every person shall have the freedom to choose and change … his occupation to the extent that it does not interfere with the public welfare." Consequently, there is less certainty as to the enforceability of non-compete clauses in Japan that restrain an employee after the expiration or termination of employment as there will be a delicate public policy balancing act between protecting a person's Constitutional right to enjoy any occupation while at the same time preserving public welfare.

Japanese courts have considered various factors when determining the enforceability of post-employment non-compete clauses, including: (i) whether there is a legitimate interest of the company that requires protection (e.g., know-how, trade secrets, and customer relationships), (ii) the position held by the employee (i.e., whether the employee had access to high-level information in the company regardless of title), (iii) the geographical scope of the non-compete, (iv) the duration of the non-compete and how long the person was employed, (v) the scope of prohibited activities (e.g., any employment with a competitor could be viewed as unduly onerous, while employment with a competitor with similar job responsibilities could be viewed as more reasonable), and (vi) the amount of compensation paid in exchange for the non-compete.

While the weight of each of the above factors will vary depending on the facts and circumstances, generally speaking, Japanese courts tend to place greater emphasis on whether the employee was sufficiently compensated for compliance with the non-compete covenant and the duration of the non-compete. If a company can successfully argue that the employee held a well-compensated senior position and his or her salary included a meaningful payment for the post-



Stephen D. Bohrer
Nishimura & Asahi
Partner
+81-3-6250-6348
s.bohrer@nishimura.com

Jiro Abe
Nishimura & Asahi
Partner
+81-3-6250-6452
j.abe@nishimura.com

employment non-compete clause, then a post-employment non-compete lasting up to 12 to 18 months often will be viewed by a Japanese court as justifiable on public policy grounds. Post-employment non-compete clauses exceeding two years under most circumstances are often struck down by Japanese courts; however, if a reasonable payment is made that equates to meaningful additional compensation for the longer restrictive covenant period (either in a lump sum or through periodic payments), then the duration of a post-employment non-compete clause could be extended. The term of a post-employment non-compete applicable to mid-level employees with above-average compensation is a matter of negotiation (but typically less than one year, so long as a sufficient payment is provided for compliance with the non-compete clause), and post-employment non-compete clauses are typically not enforceable against junior-level employees.

Applying the above factors, in 2016 the Osaka District Court held that a non-compete clause in an employment agreement was unenforceable on public policy grounds because it was too restrictive and unfair from a social and moral standpoint to the employee. The Osaka District Court voided the three-year non-compete clause because (i) the employee did not hold a managerial position and had worked at the company for only one year before his departure, (ii) the non-compete clause did not have a geographical limitation, and (iii) the company paid the employee an aggregate amount of only JPY 30,000 (a special allowance of JPY 2,200 per month during the employment term) as additional compensation for compliance with the non-compete clause.

A non-compete clause does not always need to appear in an employment agreement. An employee whose employment agreement does not contain a non-compete clause still could be subject to a non-compete obligation if the company's work rules include such a restrictive covenant. In Japan, a company's work rules are equivalent to an employee handbook, and are binding on all employees as a condition to accepting employment and do not require an employee's explicit consent (because the work rules are typically cross-referenced in an employment agreement and the employee normally agrees under the executed employment agreement to comply with the company's work rules). While a work rule that applies a non-compete obligation for the duration of the employment term should be enforceable, a generic post-employment non-compete obligation that does not adequately take into account the factors listed above, which Japanese courts often consider when evaluating the enforceability of a post-employment non-compete clause, is susceptible to being adjudicated invalid due to lack of precision (since generic criteria applied against a subject employee may not be sufficiently granular to pass Japanese court review). It would behoove a company, therefore, to execute an employment agreement with its key employees that includes a tailored non-compete covenant instead of relying on a generic post-employment non-compete covenant contained in its work rules. Also, since directors (and possibly top management) of a company are not considered employees, the company's work rules would not apply to these individuals, so an executed agreement containing a tailored non-compete clause is required for such a covenant to be binding on these persons.

Commercial agreements. A non-compete clause may appear in a number of commercial agreements, including a distribution agreement, a supply agreement, a franchise agreement, and a joint venture/shareholders agreement. The common thread in such arrangements is that a party seeks to protect its brand value and know-how during and after the contractual relationship. The validity of a non-compete in a commercial agreement is normally evaluated based on Japanese public policy grounds and Japanese competition laws.

If the terms of the non-compete are viewed as too stringent in comparison to the rights being protected, then all or part of the clause could be invalidated based on Japanese public policy grounds. In this context, Japanese courts tend to focus their analysis on (i) the scope of the restriction (a prohibition on dealing with or conducting the same or similar business should be enforceable), (ii) the geographic reach (the absence of any regional limitation would pose a high risk of the non-compete being deemed excessive, unless sales are made online and are globally widespread), and (iii) the length of the restriction (a term of up to two years should be enforceable). A Japanese court also may consider the circumstances that result from the application of the non-compete. For example, if a commercial agreement is terminated due to a material breach, then a court may be persuaded to apply a more restrictive non-compete clause against the breaching party.

A non-compete in a commercial agreement also can be invalidated based on Japanese competition laws. For example, Japan's Fair Trade Commission included in its "Guidelines Concerning the Franchise System" factors to consider when evaluating the validity of a non-compete clause in the franchising context. The

Guidelines state that when the restrictions in a non-compete exceed the time period, stringency or geographical scope necessary to preserve a franchisor's commercial rights in a specified geographical area or to protect the know-how that the franchisor provided to the franchisee, then the non-compete clause can be deemed an abuse of dominant bargaining position, which is prohibited as an unfair trade practice under Japanese competition laws. While these factors resemble the analysis for the invalidation of a non-compete clause in a commercial agreement based on Japanese public policy grounds, the thrust of the analysis is different because under Japanese competition laws, the Japan Fair Trade Commission (in a regulatory action) and Japanese courts (in a civil suit) normally also examine the relevant parties' market share, market position, and whether the non-compete obligation would foreclose the market as important elements in determining whether the factors included in the Guidelines are satisfied.

M&A transactions. The Japan Constitutional arguments that cast doubt on the enforceability of non-compete clauses in the employment area do not apply in the M&A context. In fact, the opposite view is taken, namely that a buyer has a legitimate expectation that it will acquire a business without post-closing interference from the seller. Under Article 21 of Japan's Companies Act, if a business is sold either through an asset purchase transaction or a de-merger/corporate split (as opposed to a stock purchase transaction or a corporate merger), then the seller will be subject to a statutory 20-year obligation not to compete with the same activities of the transferred business within the same cities where the business is located and the immediate surrounding areas, unless the parties expressly agree otherwise.

While it is common practice for transaction parties to opt out of the statutory 20-year non-compete obligation under Article 21, the mere existence of this protection provides ample support in the Japanese market that a seller should be bound by a non-compete covenant, absent special circumstances (e.g., a private equity seller may argue from a commercial perspective that the application of a non-compete is inappropriate in light of its business model). While the length of a non-compete in an M&A transaction is subject to negotiation, the general duration regardless of transaction form (i.e., including stock purchase transactions and a corporate merger) is approximately five years from the closing date, with ten years serving as the maximum period to protect the legitimate business interests of the buyer.

A non-compete in an acquisition agreement can be broader than a non-compete in an employment agreement. For example, the type of restricted activities and geographic scope can be wider in an acquisition agreement, so an individual selling his or her business who also will work for the target business post-closing under an employment agreement can be subject to vastly different non-compete obligations. Furthermore, a non-compete in an acquisition agreement can be enforceable even if the acquisition agreement does not stipulate that a portion of the purchase price is intended to compensate for the non-compete obligation, since the total consideration will be viewed as sufficient to cover the seller's post-closing covenants. However, if the total consideration that a seller will receive is *de minimis*, then a buyer may need to consider whether additional measures are needed to bolster the enforceability of a seller's non-compete (as discussed immediately below).

Other Restrictive Covenants

To buttress the enforceability of a non-compete clause in an employment agreement, commercial agreement and M&A contract, it is customary to include other restrictive covenants that prohibit the counter-party from (i) soliciting employees, customers and other key contacts, and (ii) using confidential information. These restrictive covenants are traditionally not interpreted as impinging on an individual's Constitutional right to freely pursue an occupation of his or her choice or violate Japanese public policy or competition laws, so they are normally considered legal and valid under Japanese law (unless the obligations thereunder are so broad that they equate to an unlawful *de facto* non-compete).

To reduce the likelihood of being invalidated on Japanese public policy grounds, these restrictive covenants should have embedded time limitations. For example, assuming an employee non-solicit includes standard exceptions (e.g., allowing general solicitations of employment, retaining persons who make voluntary contact, recruiting through specialized search firms, and employing persons who are unemployed at the time of the solicitation), then the typical duration is three to five years. A customer non-solicit is typically up to two years, and a confidentiality obligation can range from three to five years depending on when the confidential information is reasonably likely to become stale. The time limit for a confidentiality obligation should expressly exclude trade secrets, as such information should remain

confidential so long as it is protected under Japan's Unfair Competition Prevention Act.

Available Remedies

Breach of contract damages and injunctive relief are the common default remedies available for the violation of a non-compete or other restrictive covenant. However, such awards may not be satisfactory to an aggrieved party because it may be difficult to fully quantify monetary losses arising from the breach of a non-compete or other restrictive covenant. Furthermore, it is conceivable that injunctive relief may be awarded only after irreparable damage has been incurred (especially since a Japanese court may be reluctant to order injunctive relief pending a trial and the exhaustion of available appeals). As a consequence, the beneficiary of a non-compete or other restrictive covenant may have a legal right without a meaningful remedy.

To provide more robust and immediate relief, a party seeking to enforce a non-compete or other restrictive covenant should request the payment of a fixed amount if the covenant is breached (though reaching agreement on the quantum of the fixed amount could lead to a negotiation impasse). Unlike injunctive relief, Japanese courts are more prone to render a provisional execution order for a payment. However, if the fixed amount is considered excessively high, a Japanese court may partially or wholly invalidate the monetary award. Accordingly and contrary to many other jurisdictions, it is preferable under Japanese law to stipulate in a commercial agreement or M&A contract that a fixed payment amount is a penalty and not liquidated damages. Sample language capturing this concept is "the parties agree that any amounts payable hereunder shall not constitute liquidated damages (*songaibaishou gaku no yotei*) as provided in Article 420 of the Civil Code of Japan." On the other hand, Article 16 of the Labor Standards Act of Japan prohibits the establishment of fixed damages between an employer and an employee, so a court most likely would view as void and unenforceable a liquidated damages or penalty clause in an employment agreement for the breach of a non-compete or other restrictive covenant.

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If a non-compete or other restrictive covenant clause is contested in court, then it will depend on the approach of the particular judge whether the covenant should be invalidated in its entirety or reduced in scope to a range considered reasonable by the judge. Japanese public policy grounds can be used to either defeat or uphold a non-compete or other restrictive covenant, which makes predicting enforceability difficult, especially since court decisions are often fact-specific. Given that the enforceability of a non-compete or other restrictive covenant is highly predicated on the facts and evolving Japanese court precedents and Japanese ministerial announcements, parties evaluating the enforceability of a non-compete should consult with legal counsel.