

**Labor & Employment Law Newsletter****Non-Compete Obligation and Garden Leave****Michihiro Mori****1. Introduction**

Companies must be able to secure their trade secrets and other confidential information, as a matter of high importance. In order to protect the company's confidential information, and its relations with its customers, many companies incorporate non-competition clauses into employees' employment contracts or termination agreements. Moreover, some companies, especially in the case of international/foreign companies, follow the practice of garden leave at the time of termination of employment.

This newsletter outlines the rules and regulations with respect to such non-competition clauses under Japanese employment law.

**2. General rules on non-competition clauses under Japanese employment law**

As each individual has a constitutional right to select his/her own job freely, under Japanese constitutional law,<sup>1</sup> the courts construe restrictions on such constitutional rights very strictly. An explicit agreement must exist with respect to non-competition between an employer and an employee, as a prerequisite to imposition of a non-compete obligation.

**A. During the term of employment**

Basically, an employer can demand that an employee work only during the work hours, and cannot bind the activities of the employee during off-work hours. However, as a sideline business, or dual employment, may cause harm to the

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<sup>1</sup> Article 22 of the Constitution of Japan

employer's business, the employer can demand that the employee refrain from other work without its permission, by a clause of the labor contract or work rules, in order to prevent the employee from engaging in such harmful sideline work. In a case where the employee engages in a competitive business, such employee's activity usually can cause harm to the employer's business. Therefore, the employer can prohibit the employee, by the labor contract or work rules, from engaging in competitive business. In the case of a substantial breach of such non-compete obligation, the employer can seek an injunction or compensation for damages.

## B. Post-employment

After the employment contract ends, the former employee has a right to choose his/her own job freely. There must be a legitimate reason for any limits to such freedom of choice. Therefore, an agreement cannot legally impose a non-compete obligation for post-employment, unless there is a necessity to do so in order to protect the employer's legitimate interest, and such obligation is reasonably limited to that purpose.

The court precedents take the following factors into consideration to decide the validity of a non-competition clause: 1) the interest of the company to be protected, 2) the position of the employee (whether the employee is in a position where it is deemed necessary to impose an obligation to avoid competition), 3) the regional scope of the limitation, 4) the duration of the obligation to refrain from competition, 5) the scope of the prohibited activities, and 6) the compensation for the restriction.<sup>2</sup>

### 1) Interest of the company to be protected

While the term, "trade secrets," as defined in the Unfair Competition Prevention Act, is very narrow, the scope of the interest of the employer to be protected by the non-competition is more comprehensive. Not only such "trade secret," but also other types of information, such as technical information, information on customers or suppliers, know-how on business methods which are peculiar to the employer, and business strategies or plans, are included as such interests to be protected. Moreover, some court cases have held that relations with customers, or common business know-how, can also stand as interests to be protected, vis-à-vis an employee's freedom of choice in his/her work after the employment contract is terminated.

### 2) Position of the employee

Courts also take into consideration the position of the employee. The emphasis here is not necessarily merely on the title, but rather on the substantial access to high-level information in the company. Some court precedents have refused to recognize a non-compete obligation of an executive officer, on the grounds that he did not deal with the substantial confidential information to be protected.

### 3) Regional scope of limitation

Very few court judgments refer to the regional scope of limitation to decide the effectiveness of a non-competition clause. Even if the regional scope of non-competition is unlimited, courts will generally find a non-competition clause to be valid, through comprehensive consideration of the nature of the business (especially the business development area), and the degree of the constraint on freedom of occupation (especially with respect to the scope of prohibited acts). If the agreement reasonably limits the regional scope, courts will consider such factors in favor of supporting the validity of a non-compete obligation.

### 4) The duration of the obligation to avoid competition

Courts will not find a non-competition obligation to be valid merely on the grounds that the term of non-competition is

<sup>2</sup> <http://www.meti.go.jp/policy/economy/chizai/chiteki/pdf/sankoushiryou6.pdf>

short. However, the duration of the non-competition period stands as one important factor in deciding its validity. Courts will probably hold a two-year non-competition period to be too long. On the other hand, if the non-competition period is less than one year, courts have often found such period to be reasonable.

5) The scope of prohibited activities

Regarding the scope of the prohibited competitive acts, consistency with the employer's protected interests is key. If the non-competition clause is abstract, and, for example, merely provides that employment by a competitor is prohibited, regardless of the nature of the employment, courts will find such clause to be invalid. On the other hand, if the non-competition clause provides the details of the activities it prohibits (for example, sales activities with respect to customers who were dealt with during the previous employment), courts are more likely to hold such provision to be valid. Likewise, courts will likely uphold a non-solicitation obligation against customers with whom the employee dealt.

6) The compensation/compensatory measures for the restriction

In deciding whether a non-compete provision is valid, courts place the greatest emphasis on whether the agreement provides any compensation/compensatory measures for the restrictions on the employee's freedom of choice in his/her occupation. Although a court will take into account the other factors stated above in a comprehensive manner, if there is no compensation, a court will tend to deny the validity of the restriction. This compensation does not need to come in the form of salary for the period of non-competition. Rather, in theory, the court should consider the difference in the salaries, between the one which the ex-employee could earn if he/she engaged in competitive business, and the one which he/she can earn otherwise. Although some cases have counted a high wage as such compensation, other court precedents have refused to deem a high wage to be such compensation.

### **3. Enforcement of non-competition**

If the non-competition clause is valid and enforceable, the employer may avail itself of remedies, such as a provisional injunction, and compensation for damages. However, oftentimes an employer will experience difficulty in proving that the ex-employee is in charge of competitive business in a competitor, and/or that the employer has actually suffered damage from that business. To avoid such burden, it is sometimes useful to incorporate a clause on the calculation of damages in the case of breach. Moreover, to deter such breaches, employers often find it useful to incorporate a clause regarding the installment payment of a retirement allowance, and on deductions from retirement allowances.

Even in a case where a non-competition clause is not enforceable, the existence of the clause itself sometimes has the effect of deterring an ex-employee's competitive acts.

### **4. Garden leave**

Some companies, especially foreign/international companies, incorporate a "garden-leave" system into the employment contract and/or termination agreement. Garden leave, or gardening leave, describes the practice where an employee leaving a job – having resigned or otherwise had their employment terminated – is instructed to stay away from work during the notice period, while still remaining on the payroll.

Basically, during the garden leave period, the employee is still under employment, and therefore, the treatment of the non-competition obligation is the same as that described under 2.A above for the employee “during the term of employment.”

Therefore, the employer can prohibit the employee, by contract or work rules, from engaging in competitive business. In the case of a substantial breach of such non-compete obligation, the employer can seek an injunction, or compensation for damages.

## **5. Conclusion**

In order to provide a non-compete obligation, an employment contract or the company’s work rules must explicitly provide such obligation, as a prerequisite to its enforceability. In the case where an employer enters into a termination agreement, it is also recommended to provide such a non-compete obligation, and specify the competitive activities to be prohibited.

If the employer would like to enforce a restriction against competitive activities by the former employees, it is necessary to limit the scope of the prohibited activities, according to each employee’s position and assignment, as well as the duration of the obligation to avoid competition. Moreover, to enforce such a non-compete obligation, it is essential to provide some kind of compensation, for the restriction on the employee’s freedom of choice.

On the other hand, if the non-competition clause is overly broad in terms of the prohibited activities, and/or the duration of prohibition, such clause may be found to be invalid if it goes to court. However, even such an overly broad clause may serve as a useful psychological deterrent to involvement in competitive activities by the former employees, as the employees, also, may be unsure of the validity of such a clause.



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