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Calculating Monetary Damages In Theft of Trade Secrets Cases

Co-authors: Ernest E. Badway & Daniel A. Schnapp

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The value of trade secrets to domestic and international companies is beyond dispute. The Brookings Institution estimates that "at least 50%, and possibly as much as 85%" of the value of American companies is attributable to intangible assets.¹ Similarly, trade secret losses are an international problem as well. Kroll's 2010-2011 Global Fraud Report states that intellectual property theft is the second most common fraud in China, and is seen in many industries, among others, the healthcare, pharmaceutical and biotechnology sectors.² Notwithstanding the broader economic effect, in the first instance, such trade secret or confidential information losses have enormous economic impact on the individual holders of these property rights. Often a company will need to resort to "bet the company" litigation to assert their rights to their property.

However, establishing liability is only half the battle. Once liability for the loss of a trade secret has been established, monetary damages for misappropriation must account for loss of the asset, in addition to the recovery of equitable relief, usually provided in the form of an injunction. The existence and recovery of monetary damages is paramount, particularly where the trade secret has already been publicly disclosed through the defendant's misappropriation. Although there are several ways a plaintiff may obtain a remedy through litigation, this article focuses upon the methods of proving and obtaining monetary damages, as interpreted by the New York federal and state courts. We also examine a methodology in a recent case involving the loss of complex technology, including the court's review of proffered expert testimony.

General Damage Theories

The plaintiff's basic objective in claiming damages is to recover an amount sufficient to compensate it for the economic loss caused by the defendant's misappropriation. Given the circumstances, a plaintiff may also be able to recover punitive damages, prejudgment interest and attorney's fees. New York courts, cognizant of the difficulties inherent in measuring the value of trade secrets, typically permit plaintiffs to claim damages for their misappropriation in a variety of forms. Although calculation of the amount of damages is a factual determination, the formula used in making that calculation is a question of law.³

There are, generally, four legal theories for damages.: (1) plaintiff's losses; (2) defendant's profits; (3) reasonable royalties; and (4) an obligation to pay for what has been wrongfully obtained through some other method.⁴

Initially, a plaintiff may recover its losses, including, among other things, the cost for developing such items as a customer list.⁵ Plaintiff's losses may also include the revenue plaintiff would have made but for the defendant's wrongful conduct.⁶ "Unjust enrichment is measured by the profits the defendant obtained from using the trade secret." *Id.* "[A] victim of misappropriation may recover for both his actual loss and the wrongdoer's unjust enrichment but only to the extent that the latter is not taken into account in computing the former."⁷ Recovering such losses, effectively, makes the plaintiff whole without further compensation. However, this approach does not necessarily apply to all situations.

For example, defendants are not allowed to retain profits. Damages in these intellectual property theft cases may be measured by profits unjustly received by a defendant.⁸ In this situation, it would require a defendant to disgorge his or her unjust gains.

Additionally, courts will also consider a reasonable royalty as a measure of damages. When a plaintiff is not adequately compensated, such as where the defendant's gain or the plaintiff's loss is difficult to calculate, a damages award may be calculated based upon a reasonable royalty provided that no other method would ensure reasonable compensation.⁹

In *Vermont Microsystems Inc. v. Autodesk Inc.*, the Second Circuit Court of Appeals, citing the Restatement of the Law on Unfair Competition, stated that, "if the trade secret accounts for only a portion of the profits earned on the defendant's sales, such as when the trade secret relates to a single component of a product marketable without the secret, an award to the plaintiff of defendant's entire profit may be unjust. The royalty that the plaintiff and defendant would have agreed to for the use of the trade secret made by the defendant may be one measure of the approximate portion of the defendant's profits attributable to the use."¹⁰ The Second Circuit went on to note that "[a] reasonable royalty award attempts to measure a hypothetically agreed value

of what the defendant wrongfully obtained from the plaintiff...the court calculates what the parties would have agreed to as a fair licensing price at the time that the misappropriation occurred."¹¹

For example, in *Vermont Microsystems Inc.*, the court found that, to approximate the parties' agreement concerning a licensing amount, had they bargained in good faith at the time of the misappropriation, the trier of fact should consider such factors as the resulting and foreseeable changes in the parties' competitive posture. Further, the Second Circuit stated that the trier of fact should also consider the prices past purchasers or licensees may have paid; the total value of the client list to the plaintiff, including the plaintiff's development costs and the importance of the client list to the plaintiff's business; the nature and extent of the use the defendant intended for the client list; and if there were any other unique factors in the particular case that might have affected the parties' agreement, such as the ready availability of alternative processes. Additionally, the Second Circuit determined that:

[i]n fashioning a reasonable royalty, "most courts adjust the measure of damages to accord with the commercial setting of the injury, the likely future consequences of the misappropriation, and the nature and extent of the use the defendant put the trade secret to after misappropriation."¹²

This would permit the plaintiff to recover for any potential "going forward" violations.

Lastly, courts have created a "catch-all" provision where the measure of damages is simply not apparent. "The lack of actual profits does not insulate the defendants from being obligated to pay for what they have wrongfully obtained."¹³ Such a result was indicated in *In re Cross Media Marketing Corp.*, where defendants, who stole plaintiff's customer list, unsuccessfully attempted to auction plaintiff's list.¹⁴ The court calculated the damages by determining how much each lead on the customer list cost plaintiff to develop, and then multiplying that cost by the amount of leads on the customer list.¹⁵ Thus, the court arrived at a result that most closely approximated plaintiff's losses although such losses had not precisely fit into any other damage theory category.

Complex Technology Cases

Complex technology cases are particularly difficult to pin down for a damage calculation analysis. Nonetheless, Senior U.S. District Court Judge Thomas J. McAvoy was recently confronted with this issue, when he was asked to determine the most appropriate method of damages arising out of the alleged loss of a computer code that was conveyed to the defendant as part of a proposed joint venture.¹⁶ *In Member Services Inc., et al. v. Security Mut. Life Ins. Co. of New York et al.*, the court wrestled with whether one party had a competitive advantage over another, where both were engaged in the business of selling insurance contracts, and plaintiffs had alleged that the defendants wrongfully obtained plaintiffs' proprietary computer code during proposed joint venture

negotiations. The defendants sought to preclude the plaintiffs from obtaining damages based upon a royalty rate, because the computer code was allegedly not related to the sale of the insurance contracts, the parties' principal business. The defendants argued that the plaintiffs should be limited to the fair market value of what was misappropriated. Conversely, in making its claim for damages, the plaintiffs argued that their damages should be calculated as a royalty award that the defendants would have agreed upon in a hypothetical royalty negotiation.

The court agreed with the plaintiffs, finding that neither the "plaintiff's losses" nor the "unjust enrichment" methodologies were the appropriate measure of damages, since it was difficult to ascertain direct losses to the plaintiffs or direct gains to the defendants as a result of the use of the misappropriated software. Thus, the court determined that the reasonable royalty method should be used. The court went on to note that it did not mean to rule that damages should be based on a percentage of the defendants' sales, but that the trier of fact should calculate, as close as possible, what the parties would have agreed to as a fair licensing price at the time that the misappropriation occurred. The court, in fashioning a flexible remedy, determined that plaintiffs' damages may be based, after trial, on a flat rate, a percentage of sales, or an hourly basis related to the amount of time spent developing the software.¹⁷

Not only did the court seek to place the parties in a position to account for the transfer of the software, but went further and provided some conceptual basis for how such a royalty might have been negotiated in a real-life situation. In sum, this case demonstrates that New York courts are willing to look for creative business approaches to intellectual property theft disputes.

Expert Witness Testimony

Legal theories may be fine, but proving damages through the admission of appropriate evidence is always the ultimate question. To prove damages arising from the loss of a trade secret or similar confidential information, there must be a strong factual basis to justify the claimed damages. "Pie in the sky" beliefs or dreams will not do. Facts must be realistic and demonstrable, even at the pleading stage. The courts do not take kindly to mere speculation.

For example, one court dismissed, at the pleading stage, two causes of action alleging the existence of "trade secrets" or "confidential information." The court described these purported trade secrets as general methods in the computer industry for trying to reconcile various computer software data programs with various types of computer hardware. The court agreed with defendants' assertion that plaintiff's allegations were "bald legal conclusions," without any foundation, and were not entitled to any legal significance. The court, ultimately, dismissed the claims.¹⁸

Similarly, expert testimony must be sufficiently grounded in both the technology as well as the potential economic benefits. As discussed above, although the *Member Services Inc.* court determined that the plaintiff's damages theory could be sustained through the use of a hypothetical royalty rate, the court precluded plaintiff's proposed expert from testifying. In doing so, the court found that the proffered royalty rate was insufficiently reliable and based on an inadequate foundation because, among other things:

(i) it was only "the opening gambit" in negotiations, and not a proper amount for a royalty; (ii) the proposed expert did not rely on similar licensing agreements (that is, licenses with a relationship to the software or of a similar subject matter); (iii) the analysis did not take into consideration the actual functionality of the subject software or how it contributed to the defendant's operations or whether it helped improve sales; (iv) the proposed expert's conclusion was also based, in part, on the assumption that the defendant has exclusive use of the software; and (v) the proposed expert's testimony was based, in part, on "[a] number of confidential conversations with knowledgeable people in and out of the insurance industry..."

Further, the proposed expert did not provide information about the identity or reliability of these confidential informants to assist the court in ensuring that his opinions were based on a reliable foundation.¹⁹

This decision underscores the need for reliable and well-grounded expert testimony. It is, therefore, critical that the expert's analysis in a trade secrets theft case is grounded not only upon a thorough understanding of the industry at hand, but the competitive landscape as well as comprehensive empirical research.

Additionally, the plaintiff must be aware that the defendant, faced with liability for misappropriation, will likely seek to minimize the amount of claimed damages. The defendant has several tools at its disposal to accomplish this task, including, among other things, proffering competing expert testimony that the amount claimed is far lower than the plaintiff purported it to be as well as seeking to preclude the plaintiff's proposed expert testimony. The defendant could also seek to demonstrate that the claimed damages are unrelated to the trade secret, as the defendant did in *Member Services Inc.*, and seek to have the trier of fact offset expenses incurred in connection with its alleged use of the trade secret. The defendant could also try to reduce the accounting period for the damages, particularly in the absence of a valid non-compete agreement.

Conclusion

Company executives are well advised to inventory and protect trade secrets and confidential information. Trade secrets not only provide the very foundation of a company's history and profitability (for example, the secret formula of Coca-Cola, the sine qua non of a trade secret), but also clear the strategic path forward (proprietary sales forecasting software). When the worst happens, and the company has lost confidential information, it is imperative that the value of the information is properly determined with competent evidence and testimony so the victim obtains the appropriate monetary relief.

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