

Legal Updates & News

Legal Updates

Update on Trade Secret Law

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I. Introduction

Despite the widespread adoption of the Uniform Trade Secrets Act, trade secret principles continue to develop primarily through the common law. It is this reliance on a few broadly stated rules, whether from the Uniform Act or from the Restatement (of Torts or, since 1995, of Unfair Competition), that distinguishes trade secret law from the other three main forms of intellectual property, each of which is based on a federal statute. That reliance also reflects the policy tension, present in most trade secret cases, between the need to support investment in useful data and the need to respect an individual's right to pursue his or her career. As the information age continues to unfold, we can expect the stream of case law to continue.

What follows is a sampler of developments during the last year, with cases reported through February 2008. The cases chosen are those which seem to provide useful clarification of issues likely to come up repeatedly in the intellectual property lawyer's caseload.

II. Uniform Act Preemption (or "Displacement") of Alternative Claims

One of the most interesting and meaningful issues considered by courts is the extent to which the Uniform Trade Secrets Act preempts – or "displaces" in the statutory terminology – other theories of state law that might apply to misappropriation of information. This is based on section 7 of the UTSA which, with some variation among the states, provides that the statute "displaces conflicting tort law, restitutionary law and any other law . . . providing a civil remedy for misappropriation of a trade secret." Most courts dealing with the question have applied section 7 rigorously to achieve the Uniform Act objective of providing a single cause of action to replace an unnecessary variety of claims.

We can expect continuing developments in this critically important, but controversial, aspect of the Uniform Act. A recent split decision by the Wisconsin Supreme Court, in *Burbank Grease Services, LLC v. Sokolowski*, 717 N.W.2d 781 (Wis. 2006), gave preemption a narrow reading, allowing plaintiffs the option of pursuing alternative claims where trade secrets cannot be proved. The early response has been to brand this approach as a "minority view" and wrong. *Chatterbox, LLC v. Pulsar Ecoproducts, LLC*, 2007 WL 1388183 at *3 (D. Idaho 2007) (reviewing case law). See also *Patriot Homes, Inc. v. Forest River Housing, Inc.*, 489 F.Supp.2d 865 (N.D. Ind. 2007) (plaintiff has no "election" to pursue alternative claims where Uniform Act applies).

III. Proving Trade Secrets

One essential element of a plaintiff's burden to prove trade secret misappropriation is that the information provides competitive value. This is true whether the controlling law is the Uniform Trade Secrets Act or the common law as expressed in the 1939 Restatement of Torts or the 1995

Restatement of Unfair Competition. In practice, however, plaintiffs sometimes overlook the need to provide specific evidence on this issue, with severe consequences. See, for example, *Yield Dynamics, Inc. v. TEA Systems Corp.*, 154 Cal.App.4th 547, 66 Cal.Rptr.3d 1 (Cal.App. 2007) (affirming judgment for defendant; in software dispute, plaintiff failed to address the specific routines allegedly misappropriated by demonstrating that their “net value” to defendant – after accounting for the inefficiency of the appropriation – was more than trivial). See also *Global Water Group, Inc. v. Atchley*, 244 S.W.3d 584 (Tex.App. 2008) (JMOL properly granted to set aside plaintiff jury verdict when plaintiff offered insufficient evidence to show that its claimed secret formula provided competitive value).

Value also matters in cases involving compilations of information, such as customer databases. One case has emphasized the difference between a simple list of customers and addresses, which may not qualify as a trade secret, and compilations of other customer-related data such as correspondence, historical costs, and the like. *San Jose Construction, Inc. v. S.B.C.C., Inc.*, 155 Cal.App.4th, 67 Cal.Rptr.3d 54 (Cal.App. 2007) (where the latter sort of information is concerned, the existence of a protectable trade secret is more likely to be a triable question of fact, precluding summary judgment). See also *Lydall, Inc. v. Ruschmeyer*, 282 Conn. 209, 919 A.2d 421 (Conn. 2007) (injunction against use or disclosure of entire combination secret is overbroad as to individual components which cannot qualify as trade secrets).

IV. Litigation Strategy

One important aspect of pre-litigation strategy is whether and when to send a letter to someone who might be misusing your technology. Among other things, you may risk triggering the running of a limitations period. Recent signals from the courts on this issue are mixed. Compare *Epstein v. C.R. Bard, Inc.*, 460 F.3d 183 (1st Cir. 2006) (complaint dismissed where in an early letter a licensor “wondered out loud” about the legitimacy of the licensee’s continued sales after expiration of the license) with the more forgiving attitude of the court in *Porex Corp. v. Haldopoulos*, 284 Ga.App. 510, 644 S.E.2d 349 (Ga.App. 2007). There the plaintiff had sent two letters, the first saying it had “strong reason to believe” a misappropriation had occurred, the other claiming it was “inconceivable” that the defendant had been able honestly to establish a competing business so quickly. The court denied summary judgment, noting that the plaintiff had only discovered the “objective” facts indicating a misappropriation more than five years later, when it toured the defendant’s facilities while considering a potential acquisition.

Of course, no matter how long you wait around while secret information is being misused, you may not have a fatal limitations problem if your state recognizes trade secret misappropriation as a “continuing tort,” allowing the plaintiff to recover damages at least for the limitations period. See *Harry Miller Corp. v. Mancuso Chemicals Ltd.*, 469 F.Supp.2d 303, 318 (E.D. Pa. 2007).

Once you have sued, you would do well to continually assess the merits of your case, and be prepared to dismiss if the emerging facts belie your original, reasonable assumptions. The consequence of forging ahead may be an attorneys’ fee award based on continued prosecution of a claim that was properly filed at first. See *CRST Van Expedited, Inc. v. Werner Enterprises, Inc.*, 479 F.3d 1099, 1112 (9th Cir. 2007) (trial court can infer bad faith when defendant warned plaintiff its claims were specious, plaintiff first tried to get a release, and plaintiff ultimately withdrew its claims only after defendant was forced to file a motion to dismiss).

For those plaintiffs who would rather have their trade secret cases heard in federal court (often a dubious choice, given the generally greater availability of summary judgment), or who just want to maximize the number of claims arrayed against a defendant, an emerging tactic is to use the Computer Fraud and Abuse Act, 18 U.S.C. §1030, which applies to “unauthorized” access and use of an employer’s computers. However, the courts seem to be interpreting the notion of authorization literally, and have refused to apply the statute where the employee hasn’t yet resigned but is sending emails with confidential information to his prospective employer. See, e.g., *Shamrock Foods Co. v. Gast*, 535 F.Supp.2d 962 (D.Ariz. 2008).

That doesn’t mean that a departing employee’s use of computers at work is without risk. In *Banks v. Mario Industries of Virginia, Inc.*, 650 S.E.2d 687 (Va. 2007), the court rejected an attorney/client privilege objection and admitted an employee’s communication to his attorney about his plans to resign. He had written the memorandum on his work computer and then erased it, but the employer’s forensic computer specialist had recovered the document. By using the employer’s facility to compose the document, the court held, the employee had waived the privilege.

V. Discovery

The widespread use of protective orders in all sorts of litigation (see next section) has led many lawyers to believe that all information is subject to discovery, and that the only dispute will be about the terms of the protective order. That's not so. In fact, in most states, there is a privilege not to disclose secret information (and in federal court Rule 26(c) provides an enforcement mechanism through protective orders). In practice, the privilege is usually easily overcome, particularly as to the parties in the litigation. But not always. In *Bridgestone Americas Holding, Inc. v. Mayberry*, 878 N.E.2d 189 (Ind. 2007), a products liability case, the defendant tire manufacturer resisted producing a rubber formula. The court applied a widely adopted three-factor test: is the information a trade secret; is it necessary to the requesting party's case; and does the "balance of interests" favor production. Importantly, the first factor is satisfied by only a prima facie ("minimal") showing, while the second factor requires the requesting party to show that "suitable substitutes" for the information are "completely lacking". Since the defendant easily carried its burden on the first factor and the plaintiff could not demonstrate the second, the court held that the third factor was irrelevant. Thus, production was denied, even though the formula in question was no longer in use.^[1]

Pincheira v. Allstate Ins. Co., 142 N.M. 283, 164 P.3d 982, 993 (N.M.App. 2007) also applied the multi-step test, noting that as applied the test is less stringent in state courts, where good cause is presumed from establishing secrecy, than in federal courts, where the party resisting discovery under Rule 26 usually must show specific, serious harm.

VI. Protective Orders

Protective orders are critical to management of cases that involve the exchange of confidential data, which is to say most civil litigation. So-called "two-tier" orders allow the most sensitive information to be produced in the first instance only to counsel. They are typically entered in cases where the parties are direct competitors and the risk of misuse of discovery is most acute. See, e.g., *A Major Difference, Inc. v. Wellspring Products, LLC*, 243 F.R.D. 415 (D.Colo. 2006). But where this is not true, and the field of technology is narrow, so that a party must rely on its employed scientists for advice, a single tier of confidentiality may be more appropriate. *MGP Ingredients, Inc. v. Mars, Inc.*, 245 F.R.D. 497 (D.Kan. 2007).

As more cases involve law firms that both litigate and prosecute patent applications, participation by patent lawyers in litigation becomes increasingly challenging. Similarly, patent counsel (but not outside corporate counsel) was barred from receiving attorneys-only information in *Infosint S.A. v. H. Lundbeck A.S.*, 2007 WL 1467784 at *5 (S.D.N.Y. 2007) ("While Infosint's desire to have its trusted counsel involved in the litigation is understandable, Lundbeck's desire to keep its proprietary information protected is a superior interest."). But see *Avocent Redmond Corp. v. Rose Electronics, Inc.*, 242 F.R.D. 574 (W.D. Wash. 2007) (rejecting contrary case law and allowing access by patent prosecution counsel) and *Intervet, Inc. v. Merial Ltd.*, 241 F.R.D. 55, 58 (D.C.D.C. 2007) (company's inside IP counsel and its regular outside patent litigation counsel were not "competitive decision-makers" and therefore could have access).

Whatever protective order you get, be careful about compliance with its procedural requirements, or it may become the means by which you lose your client's trade secret rights. In *In re Guidant Corp. Implantable Defibrillators Products Liability Litigation*, 245 F.R.D. 632 (D.Minn. 2007), despite the existence of a protective order, at a hearing on motions for summary judgment no attorney asked to seal the courtroom, and certain confidential documents and information were referred to. Because members of the press were present, that information lost protection. And in *Pettrey v. Enterprise Title Agency, Inc.*, 470 F.Supp.2d 790, 795 (N.D. Ohio 2007), the court denied a motion to designate documents because it was not filed within the required time period.

High profile litigation often attracts the press or other third parties who would like to gain access to information sealed under protective orders. In *Ford Motor Co. v. Manners*, 239 S.W.3d 583 (Mo. 2007), the order classified some information as "non-sharing," meaning that the plaintiff could not distribute the discovery to lawyers representing other potential plaintiffs. Following settlement, plaintiff successfully moved to modify the order because its rationale (facilitation of discovery) was no longer applicable. The appellate court reversed, holding that defendant's reliance on the non-sharing provision was controlling. Similarly, the court in *Massachusetts v. Mylan Labs., Inc.*, 246 F.R.D. 87 (D.Mass. 2007) refused modification to allow the plaintiff to distribute discovery materials to authorities in all 49 other states and the federal government. Absent some specific threat to public health, the court held, each potentially interested entity would be required to seek intervention pursuant to Rule 24.

A number of states have established procedural rules to govern requests for sealing information in court. One of these states, California, recently confronted the interpretation of a provision that applies the rules to documents used as the basis of a court's "adjudication of a substantive matter." In *Mercury Interactive Corp. v. Klein*, 158 Cal.App.4th 60, 70 Cal.Rptr.3d 88 (Cal.App. 2007), the court held that this threshold did not apply to documents attached as exhibits to a complaint, which could therefore remain sealed.

VII. Misappropriation

The "taking" that is necessary to demonstrate misappropriation need not be physical, but can be accomplished through memorization. In *AI Minor & Assoc., Inc. v. Martin*, 117 Ohio St.3d 58, 881 N.E.2d 850 (Ohio 2008), the Ohio Supreme Court overruled a pre-UTSA decision by an intermediate appellate court joining the majority of states that consider memorization of secret data (here, customer information) as a means of misappropriation.

But in the end, it is often the use (or lack thereof) by the defendant that drives the result. In *Cintas Corp. v. Perry*, 517 F.3d 459 (7th Cir. 2008), the former employee had brought confidential reports to his new job, but only used them to establish a format for reporting to his new employer. In upholding summary judgment for defendant, the court reasoned that the format could not be claimed as a secret, and there was no evidence that he used the contents.

VIII. Injunctions

In pursuing injunctive relief against misappropriation of a "combination" secret, where some aspects of the secret may consist of publicly known information, one needs to focus on exactly what behavior is restrained. It is error for a court to enjoin use of well-known concepts merely because they happen to form part of an overall process or plan. *Lydall, Inc. v. Ruschmeyer*, 282 Conn. 209, 241, 919 A.2d 421 (Conn. 2007). And because of the overriding concern that injunctions be sufficiently specific to inform the defendant what behavior is prohibited, it is error to phrase the order in general terms such as "plaintiff's trade secrets." See *Patriot Homes, Inc. v. Forest River Housing, Inc.*, 512 F.3d 412 (7th Cir. 2008).

Preliminary injunctive relief requires that the plaintiff demonstrate a substantial risk of irreparable harm. Where disclosure of a trade secret is threatened, this is virtually presumed. However, in a customer list case, where damages will be limited to lost revenue, it is very difficult to make the required showing unless the defendant's behavior threatens to destroy the plaintiff's business. See, e.g., *Ajilon Professional Staffing, PLC v. Kubicki*, 503 F.Supp.2d 358 (D.D.C. 2007).

In opposing injunctive relief, defendants sometimes neglect to present specific evidence of the harm that would result from an improper restraint; also courts sometimes refuse to take that evidence into account, instead reflexively setting a "nominal" amount for an injunction bond. This approach led to reversal in *Atwood Agency v. Black*, 374 S.C. 68, 646 S.E.2d 882 (S.C. 2007) (the order "erroneously assumes the injunction is proper instead of providing an amount sufficient to protect appellants in the event the injunction is ultimately deemed improper").

IX. Contracts

Although trade secret misappropriation is a tort, contracts are often relevant. Nondisclosure contracts define the nature of the confidential relationship and the kind of information that will be protected, and noncompete covenants frequently require careful attention and interpretation.

Because they are in restraint of trade, post-employment noncompete covenants entered into after employment begins must be supported by "fresh" consideration. Continued employment of an at-will employee is insufficient. *Access Organics, Inc. v. Hernandez*, 341 Mont. 73 175 P.3d 899 (Mont. 2008). And noncompete covenants will not be enforced where they are not supported by a legitimate business interest such as shared goodwill or trade secret information. Merely providing business-enabling assistance is not enough to support a covenant between two corporations. See *Guardian Fiberglass, Inc. v. Whit Davis Lumber Co.*, 509 F.3d 512 (8th Cir. 2007). On the other hand, a covenant not to compete for 18 months after termination of a patent and know-how license will be judged under a rule of reason, and may be enforceable. See *County Materials Corp. v. Allan Block Corp.*, 502 F.3d 730 (7th Cir. 2007).

Sometimes an overbroad agreement can be saved when courts apply a variation on the "blue pencil

rule” (allowing offensive provisions to be stricken) and essentially rewrite the agreement, for example to set a shorter time period or narrower geographic coverage. However, by asking for such discretionary modification, the beneficiary may be held to admit that the contract as drafted was not reasonable, justifying the court’s refusal to modify or enforce it. *Cintas Corp. v. Perry*, 517 F.3d 459 (7th Cir. 2008).

A broad “no-hire” clause in an engagement agreement between a consulting company and its client was held unenforceable in *VL Systems, Inc. v. Unisen, Inc.*, 152 Cal.App.4th 708, 61 Cal.Rptr.3d 818 (Cal.App. 2007). Reversing a trial court award of liquidated damages against the former client that hired away the consultant’s employee, the court emphasized that the provision was not narrowly drawn to protect legitimate interests, but could be applied (as the consultant had tried to do here) to employees who had never worked on the former client’s project. The opinion relied to a great extent on California’s strong public policy favoring employee mobility and disfavoring agreements in restraint of competition. The same policy was at work in *Alliance Payment Systems, Inc. v. Walczel*, 152 Cal.App.4th 620, 61 Cal.Rptr.3d 789 (Cal.App. 2007), where the court held that a settlement agreement resolving litigation between partners was partially unenforceable because it required each to forfeit to the other any revenue received from the other’s assigned customers, regardless of whether there was solicitation. Finally, we can expect a decision soon from the California Supreme Court in the case of *Edwards v. Arthur Andersen LLP*, which will address the Ninth Circuit’s so-called “narrow restraint exception” to California’s statutory prohibition on noncompete agreements.

X. Damages and Attorneys’ Fees

Although a secret plan by trusted managers to raid their union employer in favor of another union was not accomplished by misappropriation of trade secrets, it was held to be a breach of fiduciary duty, justifying a damage award consisting of the salary and benefits that had been paid to the employees during the time they hatched and executed their plan. *Service Employees Int’l Union v. Colcord*, 160 Cal.App.4th 362, 72 Cal.Rptr.3d 763 (Cal.App. 2008).

Under the Uniform Trade Secrets Act, attorneys’ fees are recoverable by the plaintiff in the event of a willful and malicious misappropriation, or by the defendant in the case of a claim that turns out to have been prosecuted without justification. Where a defendant employee has been indemnified by his new employer who paid for his successful defense, he may still recover fees under the statute because they were “incurred.” *Cintas Corp. v. Perry*, 517 F.3d 459 (7th Cir. 2008).

Footnotes

[1] The result might be different in states that have not yet adopted the Uniform Trade Secrets Act. See, e.g., *Portfolioscope, Inc. v. I-Flex Solutions Limited*, 473 F.Supp.2d 252 (D.Mass. 2007), where the court dismissed with prejudice a trade secret misappropriation claim because there was no allegation that the plaintiff was currently using the software, a requirement for trade secrecy under the 1939 Restatement of Torts. The court acknowledged the different rule of the modern (1995) Restatement of Unfair Competition, but concluded that Massachusetts law had not changed.