By Jeffrey W. Kramer

# How Misuse of the UTSA Can Be Countered

**The Uniform Trade Secrets Act should not be used for anticompetitive purposes**

The laudable objective of the Uniform Trade Secrets Act[1] is to codify the common law protection of confidential business information that has competitive value. Information that is not protected or protectible by patent, copyright, or trademark may be denied to others if the broadly worded requirements of the UTSA are met. Under the UTSA, protectible information—whether it is a formula, pattern, compilation, program, device, method, technique, or process[2]—must have some economic value from not being generally known to the public or to those to whom it would be economically useful.[3] Additionally, the information must be the subject of reasonable efforts to maintain its secrecy.[4] If business information meets these rather simple criteria, anyone who has possession or makes use of the information without consent may be enjoined from further use and may be liable for compensatory damages, unjust enrichment, a reasonable royalty, exemplary damages, and attorney's fees.[5]

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The UTSA is a powerful tool for businesses that seek to protect their investment in valuable competitive information. Unfortunately, it has also become a weapon used by aggressive businesses bent on stifling legitimate competition. The problem is inherent in the act's definition of a trade secret, which when taken at face value applies to practically every kind of information that a business possesses. If information that is not published in a trade publication or otherwise demonstrably known to most competitors is used in a business, the information presumably has economic value to that business. And if the business employs at least some security measures—computer password access, confidentiality agreements, or even locks on office doors—a possible trade secret is born.

The ease of stating at least a prima facie case for a trade secret and the development of sympathetic California case law has made the UTSA a route to anticompetitive conduct that would otherwise contravene California public policy. California law strongly favors vigorous competition in the marketplace[6]—so much so that, in contrast to the laws of many states,[7] California generally prohibits employers from enforcing covenants not to compete with employees who leave.[8] The UTSA has in many ways undermined this procompetitive policy. An astute defense and judicial awareness of the dangers can help to ensure that the UTSA is not misused. How these dangers might arise, and some strategies for avoiding them, are important areas of concern for litigators.

## Ways of Misapplication

The anticompetitive danger of the UTSA often begins with employment contracts and confidentiality agreements that have an overbroad definition of trade secrets. Employers often hope to avoid California's prohibition on covenants not to compete by defining every piece of information that an employee receives in the course of employment as a trade secret. A typical provision states: "[F]inancial, personnel, sales, scientific, technical and other information regarding formulas, patterns, compilations, programs, devices, methods, techniques, operations, plans and process…[constitute] the Employer's 'trade secrets.'"[9]

When an employee quits to join or form a competing business, a foundation has been laid for the charge that the employee is using the former employer's trade secrets in the new employment. Trade secret law has been employed in many jurisdictions to enjoin former employees from working for a competitor in cases in which the "new employment will inevitably lead [the employee] to rely on the [former employer's] trade secrets."[10] As one commentator has observed, "[U]sing principles of commercial morality, most…courts [other than California's] have been inclined to protect trade secrets over an employee's freedom to work for a direct competitor."[11]

In 1999, a court of appeal in California adopted this doctrine, finding that the "inevitable disclosure rule is rooted in common sense,"[12] but the California Supreme Court ordered the opinion depublished. Recently, in *Schlage Lock Company* v. *Whyte,*[13] a California appellate court rejected the "inevitable disclosure" doctrine, finding that it is contrary to California law and policy because it creates an after-the-fact covenant not to compete, restricting employee mobility.[14]

Strong public policy, expressed in a legislative prohibition of contracts in restraint of a trade or profession,[15] is an important reason that the inevitable disclosure doctrine historically has not gained favor in California. The *Schlage* decision, however, notes that California public policy also protects trade secrets. In rejecting the inevitable disclosure doctrine, *Schlage* does not regard as dispositive California's public policy favoring employee mobility and instead relies on principles of contract law. Namely, *Schlage* holds that employees should not be held to a restrictive employment covenant imposed "after the employment contract is made and [that] therefore alters the employment relationship without the employee's consent."[16]

However, the extent to which this rationale favoring employee mobility will yield to trade secret protections incorporated into carefully drawn employment agreements remains unclear—even after *Schlage*. There was no employment agreement with a covenant not to compete in *Schlage*. Yet the court noted that "under the circumstances presented in this case, an employer might prevent disclosure of trade secrets through, for example, an agreed-upon and reasonable nonsolicitation clause that is narrowly drafted for the purpose of protecting trade secrets."[17] As a result, the UTSA may have renewed potency in California to limit competition.

Often, plaintiffs use the allegation that trade secrets have been misappropriated as a springboard to other causes of action. For example, California law defines "unfair competition" as "any unlawful, unfair or fraudulent business act or practice."[18] Plaintiffs alleging misappropriation of trade secrets invariably allege unfair competition as well, citing the misappropriation of trade secrets as the "unlawful" conduct engaged in by the defendant competitor.

Often, plaintiffs invoke the business tort of interference with prospective economic advantage, which requires pleading and proof that "the defendant not only knowingly interfered with plaintiffs' expectancy, but engaged in conduct that was wrongful by some legal measure other than the fact of interference itself."[19] The UTSA frequently supplies this legal measure of wrongful conduct, with plaintiffs alleging that defendants used their knowledge of misappropriated trade secrets to obtain business from plaintiffs' customers. Frequently these other causes of action cannot be pled without allegations of trade secret misappropriation.

The trade secret lawsuit can be a devastating competitive weapon, particularly against start-up or marginally financed smaller businesses. The charge is made that the departing employee or employees have taken their former employer's trade secrets and are using them to compete in their new business. The trade secrets may be described as customer information, supplier information, manufacturing processes, financial information, or any of these in combination. If the employees have in their possession or take with them any papers or electronic information relating to their former employment, as many employees do, a preliminary injunction against the use of these materials and information derived from them is a serious risk. If a preliminary injunction—even of limited scope—issues, it places the defendant business at a serious competitive disadvantage. Even though the scope of the injunction may be relatively benign, the existence of such a court order may discourage customers, lenders, and investors from doing business with the defendant.

Crushing and intrusive discovery may be the next order of business for the aggressive trade secrets plaintiff. The discovery may be designed to learn the customers, product lines, processes, and finances of the defendant business—all of which is valuable competitive information.[20] The cost of gathering and producing this information may be great, in terms of attorney's fees, employee time, and employee morale. Key employees of the defendant business may spend their workdays preparing and sitting for depositions. The trade secret claim, regardless of its ultimate merit, can force the defendant business to yield sensitive business information to an aggressive and hated competitor and hobble the defendant business by distracting its employees and straining its financial resources.

Third-party discovery may be even more destructive. Existing and potential investors, lenders, and suppliers to the defendant business may all be targeted. The message that this discovery conveys to the investors, subtly or directly, is that they may soon be defendants. Lenders will fear that their loans may involve substantial risk. Suppliers will fear that selling to the defendant may not be worth the loss of goodwill to a larger client or the expense of becoming involved in a lawsuit.

Trade secret litigation in California poses a unique threat to investors in start-up businesses. In *PMC* v. *Kadisha,*[21] the California Court of Appeal articulated a new theory of officer and director liability when a new business is the beneficiary of trade secret misappropriation or other unlawful conduct. Corporate officers or directors "may be liable *for an intentional tort* if: (1) the officer or director purchased or invested in the corporation the principal assets of which were the result of unlawful conduct; (2) the officer or director took control of the corporation and appointed personnel to run the corporation; and (3) the officer or director did so with knowledge or, with respect to trade secret misappropriation…had reason to know, of the unlawful conduct."[22]

In *PMC,* the plaintiffs—PMC and its subsidiary WFI—sued WFI's former president and other senior managers, who left WFI to form a competing plastics manufacturing business that the plaintiffs alleged was an "exact replica of WFI."[23] The plaintiffs alleged that the defendants formed this competing business, which they also sued, by engaging in tortious conduct that included the misappropriation of trade secrets consisting of WFI's customer lists, customer product specifications, and manufacturing specifications and processes.[24] After the lawsuit was filed, defendant Neil Kadisha and others invested in the defendant start-up business; became majority shareholders, officers, and directors; appointed personnel to run the business; and effectively took control of the new corporation.[25] The plaintiffs demanded that the investor defendants cause the new business to "cease and desist from the ongoing use of WFI's confidential and proprietary information," and then added the investor defendants to the lawsuit when they refused to comply.[26]

The investor defendants moved for summary judgment on the grounds that they could not be personally liable for misappropriation of trade secrets and the other alleged wrongful conduct because they had not authorized or participated in any of the wrongful conduct, and had not done anything more than serve as directors and officers of the defendant business.[27] The trial court granted the investor defendants summary judgment, but the court of appeal reversed, rejecting the investor defendants' argument that they could not be held vicariously liable for the tortious conduct of the corporation. Noting that the "defendants purchased a corporation whose sole assets were purportedly corruptly acquired resources," the court of appeal opined, "Liability imposed on a corporate shareholder, officer, or director who knows or has reason to know about tortious misappropriation under these circumstances and allows it to occur is *not* vicarious."[28]

This new business tort, born of allegations of trade secret misappropriation, poses clear risks for new business formation. Investors willing to risk a capital investment in a new business may be loathe to risk personal liability if the new business is later adjudged to have misappropriated trade secrets. Established companies, facing incipient competition from former employees, now have a powerful new strategy to stifle competition if they can make a colorable claim of misappropriation of trade secrets. By putting new investors and the officers and directors they appoint on notice of the trade secret claim, plaintiffs can make investors face a difficult choice. They can withdraw from the corporation and risk the loss of their investment or be defendants in a lawsuit, facing potential personal liability for compensatory and punitive damages. Used aggressively in this way, a claim of misappropriation of trade secrets can bring even greater pressure than before on a fragile start-up business.

## The Lessons of *PMC*

*PMC* demonstrates the aggressive use of the UTSA. The court of appeal reversed a summary judgment in favor of the defendant, Kadisha, who was a director of the defendant start-up business, based in part on the fact that the plaintiffs had put Kadisha on notice of their assertion that the new business was started with the plaintiffs' trade secrets. Yet at trial the plaintiffs' trade secret claims were defeated and adjudged by the court to have been brought in bad faith. Just as the court of

appeal decision reversing the investor defendants' summary judgment became final, the case went to trial against the other defendants. After more than two months of a jury trial, the court granted the defendants a directed verdict on the plaintiffs' trade secret claims on the grounds that the plaintiffs had not proved the alleged misappropriation involved any trade secrets. Thereafter, the jury returned verdicts against the plaintiffs on their other tort claims.[29] The investor defendants then obtained a second summary judgment in their favor, on the grounds that the lack of any wrongful conduct on their behalf was conclusively established by the verdicts in favor of the other defendants. In *PMC,* the investors in the start-up company had the financial resources and the willingness to weather the litigation, which could otherwise have put the new company out of business. Other investors may not have this fortitude, and other start-up companies may not be so fortunate.

Defendants charged with misappropriating trade secrets have a variety of tools available to minimize the damage of trade secrets claims that are marginal or made in bad faith.

An aggressive judicial response in cases in which the suppression of legitimate competition may be the intended or even unintended result of the litigation should flow from healthy judicial skepticism of trade secret allegations. The first order of business in trade secrets cases is usually the plaintiffs' application for a temporary restraining order and preliminary injunction. Aggressive plaintiffs' counsel typically seek a broadly worded order to prohibit a range of competitive activity that may not be tightly connected to the allegedly misappropriated trade secrets, or the trade secrets themselves may be broadly and vaguely described. There may be evidence that a defendant left the plaintiff's employ and took hard copy or electronic information belonging to the plaintiff. If injunctive relief is to issue, it should be carefully limited to the protection of well-defined trade secrets and not used merely as a punishment against former employees for taking property belonging to their former employer. Because the issuance of injunctive relief, no matter how narrowly constrained, may have serious competitive ramifications, courts should carefully balance the equities and enjoin the use of information only when the information clearly qualifies as a trade secret.

The legislature has enacted some discovery protection in the form of Code of Civil Procedure Section 2019(d), which requires a party alleging trade secret misappropriation to "identify the trade secret with reasonable particularity" before commencing discovery relating to the trade secret. Before forcing defendants to comply with the intrusive and burdensome discovery that legitimate trade secret claims may justify, courts should require plaintiffs to state the specific information that constitutes the trade secret. Such broadly stated trade secrets as customer identities, customer purchasing requirements, the process for manufacturing certain products, or cost and profit information should not suffice. These may or may not be protectible trade secrets. Without specific information, it is impossible to tell.[30]

All too often, employees take information belonging to their former employer with them. They may have been given the information to do their job, they may have accumulated the information themselves during their employment, or they may have taken the information when leaving. The information may be useful to the employee in taking a new position with a competitor, the information may be proprietary to the former employer in the sense that it is physical property that belongs to the former employer or was compiled by the former employer, and it may be to some extent confidential because the information or the compilation is not published or disseminated by the former employer.

But is the information a trade secret? To make this determination, courts should require objective evidence that the information has independent economic value.[31] Although there is little case law on the meaning of this UTSA requirement, courts most frequently look to the "work effort" and cost of developing or compiling the confidential information.[32] Courts may also look to whether the information itself is marketable[33] or whether the information provides a competitive advantage in the industry, one example being an "innovator's premium."[34]

Beyond demonstrating that time and effort were required to compile the confidential information, a party suing on a true trade secret should be able to produce evidence that the same or similar information is sold or licensed in the industry. The absence of such evidence would seem to belie an argument that the information has independent economic value. The information must also be "the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[35] Here the required proof should demonstrate steps taken specifically to maintain the secrecy of the alleged trade secret, rather than more generalized business security measures.

The UTSA authorizes the court to award reasonable attorney's fees to the prevailing party if "a claim of misappropriation is made in bad faith."[36] The legislature intended this attorney's fees provision "as a deterrent to specious claims of misappropriation."[37] Recently, the California Court of Appeal has interpreted this bad faith standard to require a showing of the "objective speciousness of [the plaintiff's] claim, as opposed to frivolousness, and its subjective bad faith in bringing or maintaining the claim."[38] Moreover, "[b]ad faith may be inferred where the specific shortcomings of the case are identified by opposing counsel, and the decision is made to go forward despite the inability to respond to the arguments raised."[39] Awarding attorney's fees liberally when confronted with specious trade secret claims should prove to be an effective deterrent to such claims.

The final outcome of *PMC* demonstrates effective judicial use of the attorney's fee provision of the UTSA. Following the entry of judgment in their favor, the defendants moved for an award of attorney's fees under the authority of the UTSA. The court granted the defendants' motions for attorney's fees, finding that the plaintiffs' trade secret claims were brought in bad faith and rejecting the plaintiffs' argument that attorney's fees should be strictly limited to the trade secret cause of action. Because the trade secrets claims were linked with the plaintiffs' other claims, the court awarded the defendants most of the attorney's fees they incurred over more than two years of intense litigation defending the trade secrets claims and the related causes of action.[40]

The UTSA provides important protections for valuable business information but if misused has the potential for serious anticompetitive harm. Trade secret claims based on broadly defined, arguably confidential business information may be used to discourage employees from accepting employment with competing businesses; to discourage investment in start-up businesses; to support other causes of action with anticompetitive potential; and to sustain prolonged, intensive, and expensive litigation that itself may discourage or even eliminate competition. An aggressive defense of marginal trade secret claims and judicial awareness of the dangers trade secret litigation may pose are the keys to containing the dark side of the UTSA. ■

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[1] The Uniform Trade Secrets Act, CIV. CODE §§3426 *et seq.*

[2] *See* CIV. CODE §3426.1(d).

[3] CIV. CODE §3426.1(d)(1).

[4] CIV. CODE §3426.1(d)(2).

[5] *See* CIV. CODE §§3426.2, 3426.3, 3426.4.

[6] *See, e.g.,* The Unfair Competition Act, BUS. & PROF. CODE §§17200 *et seq.*; The Unfair Practices Act, BUS. & PROF. CODE §§17000 *et seq.*; The Cartwright Act, BUS. & PROF. CODE §§16700 *et seq.*; and the prohibition on restraints of profession, trade, or business, BUS. & PROF. CODE §16600.

[7] *See generally* B. MALSBERGER, COVENANTS NOT TO COMPETE: A STATE-BY-STATE SURVEY (2d ed. 1996).

[8] The exceptions include a person who sells the good-

will of a business or all of his or her shares in a corporation (BUS. & PROF. CODE §1660) and a partner who sells his or her interest in a partnership (BUS. & PROF. CODE §16602).

9 28 CALIFORNIA LEGAL FORMS, TRANSACTION GUIDE §85.200[2], at 85-121 (2002).

10 Pepsi Co. Inc. v. Redmond, 54 F. 3d 1262, 1269 (7th Cir. 1995).

11 Keith A. Roberson, *Annual Survey of South Carolina Law: Employment Law*, 52 S.C. L. REV. 895 (Summer 2001).

12 Electro Optical Indus. v. White, 76 Cal. App. 4th 653, 90 Cal. Rptr. 2d 680 (1999) (depublished Apr. 12, 2000).

13 Schlage Lock Co. v. Whyte, 2002 *Daily Journal* D.A.R. 10594, 2002 WL 31040309 (Sept. 12, 2002).

14 *Id.*

15 BUS. & PROF. CODE §16600.

16 Schlage, 2002 *Daily Journal* D.A.R. at 10599.

17 *Id.* at 10600.

18 BUS. & PROF. CODE §17200.

19 Della Penna v. Toyota Motor Sales, 11 Cal. 4th 376, 393, 45 Cal. Rptr. 2d 436, 447 (1995).

20 The defendant may seek a protective order limiting disclosure of sensitive information to the attorneys or to a limited group of the plaintiff's representatives, but as a practical matter this order may not afford real protection.

21 PMC v. Kadisha, 78 Cal. App. 4th 1368, 93 Cal. Rptr. 2d 663 (2000).

22 *Id.,* 78 Cal. App. 4th at 1372.

23 *Id.* at 1375.

24 *Id.* at 1374-75.

25 *Id.* at 1375.

26 *Id.* at 1374.

27 *Id.* at 1378-79.

28 *Id.* at 1389 (emphasis in original).

29 Los Angeles Superior Court Case No. BC 193482, Judgment on the Verdicts for Defendants (Feb. 22, 2001).

30 *See* CODE CIV. PROC. §2019(d), which recognizes that the identification of such sensitive information may require protective orders, in camera hearings, sealing the records of the action, or other court orders, as authorized by the UTSA in CIV. CODE §3426.6, to preserve the secrecy of the alleged trade secret.

31 CIV. CODE §3426.1(d)(1).

32 *See* Courtesy Temporary Serv., Inc. v. Camacho, 222 Cal. App. 3d 1278, 1287, 272 Cal. Rptr. 352, 357 (1990); Morlife, Inc. v. Perry, 56 Cal. App. 4th 1514, 1522, 66 Cal. Rptr. 2d 731, 736 (1997).

33 *See* Fred Stores of Miss., Inc. v. M & H Drugs, Inc., 725 So. 2d 902, 910 (1998) ("The information on the list had independent economic value as evidenced by the fact that marketing companies are willing to pay money to obtain it."); Hoffmann-La Roche Inc. v. Yoder, 950 F. Supp. 1348, 1358 (S.D. Ohio 1997) ("[C]ourts have held, however, that the fact a party is willing to pay a large price to acquire information is evidence of the value of such information.").

34 Avery Dennison Corp. v. Finkle, 2002 Conn. Super. LEXIS 329 (2002).

35 CIV. CODE §3426.1(d)(2).

36 CIV. CODE §3426.4.

37 Gemini Aluminum Corp. v. California Custom Shapes, 95 Cal. App. 4th 1249, 1261, 116 Cal. Rptr. 2d 358, 367 (2002).

38 *Id.*, 95 Cal. App. 4th at 1262.

39 *Id.* at 1264.

40 The attorney's fees awarded totaled approximately $6 million. *See* PMC v. Paul Winkler, Los Angeles Superior Court Case No. BC 193482. *See also* Gemini Aluminum Corp., 2002 *Daily Journal* D.A.R. 1443 (2002) (affirming an award of $160,200 in attorney's fees under §3426.4 for a bad faith prosecution of a trade secrets claim).