

Trade Secrets, Covenants, and Employee Movement: An Advanced Course

Jerome P. Coleman
Putney, Twombly, Hall & Hirson LLP*

Prepared for Cornell University seminar

Cornell University
School of Industrial and Labor Relations
June 19, 2009

I. Non-Compete Agreements

1. Reasonableness

- A. Time
- B. Place
- C. Space
- D. Sale of business

Restrictive covenants in this context are negotiated at arm's length and thus are subject to less exacting scrutiny. See *FTI Consulting, Inc. v. Graves*, 2007 U.S. Dist. LEXIS 55325 at *14-15 (S.D.N.Y. 2007) (“There is routine enforcement of restrictive covenants in the context of a sale of business because it is assumed that the buyer has in part bargained for the good will of the seller’s customers.”).

2. Equitable considerations/inherent policy tensions

- A. Fundamental fairness
- B. Overreaching and blue pencil

“New York law permits courts, under certain circumstances, to rewrite unreasonable contracts into reasonable ones.” *Reimer v. Cipolla*, 929 F. Supp. 154, 160 (S.D.N.Y. 1996); see also *Estee Lauder Cos. v. Batra*, 430

* The Firm acknowledges the contribution of Robert M. Tucker, a student at the Fordham University School of Law, in the preparation of this outline.

F. Supp. 2d 158 (S.D.N.Y. 2006) (where court rewrote a 1-year noncompetition agreement into a 5-month agreement).

But courts may decline to blue pencil where the employer has overreached, as where the agreement lacks reasonable geographic or temporal limits. *Scott, Stackrow & Co., C.P.A.'s, P.C. v. Skavina*, 780 N.Y.S.2d 675, 676 (3d Dep't 2004); *see also AM Medica Communications Group v. Kilgallen*, 261 F. Supp. 2d 258 (S.D.N.Y. 2003); *Heartland Securities Corp. v. Jared Gerstenblatt, et al.*, 2000 U.S. Dist. LEXIS 3496 (S.D.N.Y. 2000).

Several states still prohibit blue pencil changes, *e.g.*, Georgia, Wisconsin and Nebraska.

C. Hardship and public policy

Covenants are restraints of trade and contrary to basic notions of free markets and free trade. *Reed, Roberts Assocs. v. Strauman*, 40 N.Y.2d 303, 307 (1976) (“Our economy is premised on the competition engendered by the uninhibited flow of services, talent and ideas.”). They are disfavored in the law, and must meet a rule of reason to be enforceable.

Individual employees should not be put out of work in their chosen profession. *Columbia Ribbon & Carbon Mfg. Co. v. A-I-A Corp.*, 42 N.Y.2d 496 (1977) (“Restrictive covenants which tend to prevent an employee from pursuing a similar vocation after termination of employment are disfavored by the law.”).

D. Goodwill

“The employer has a legitimate interest in preventing former employees from exploiting or appropriating the goodwill of a client or customer, which had been created and maintained at the employer's expense, to the employer's competitive detriment.” *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 392 (1999).

E. Garden leave

Mitigates concern over “loss of livelihood.”

Estee Lauder Cos. v. Batra, 430 F. Supp. 2d 158 (S.D.N.Y. 2006)

Natsource LLC. Paribello, 151 F. Supp. 2d 465, 472 (S.D.N.Y. 2001)

3. Common Law Applications

A. Faithless Servant Doctrine / Breach of Fiduciary Duty

1. Grounded in agency law and well established

Murray v. Beard, 102 N.Y. 505 (N.Y. 1886).

Indep. Asset Mgmt. LLC v. Zanger, 538 F. Supp. 2d 704, 709 (S.D.N.Y. 2008).

Carco Group Inc. v. Maconachy, CV 05-6038 (E.D.N.Y. April 21, 2009)

2. Severe damages available from “the first disloyal act.”

Phansalker v. Anderson Weinroth & Co., L.P., 344 F.3d 184 (2d Cir. 2003); see also *Webb v. Robert Lewis Rosen Association*, 2004 U.S. Dist. LEXIS 12024 (S.D.N.Y. 2004).

“[F]ormer employees...may create a competing business prior to leaving [a former employer] without breaching any fiduciary duty unless they made improper use of their employers’ time, facilities, or proprietary secrets. In comparison, post-employment activities in furtherance of a scheme to solicit and steal employers’ business, which actually began while the individuals were still employed, constitute breach of fiduciary duty.”

Roessel Cine Photo Tech, Inc. v. Kapsalis, Index No. 109251/96, 1997 N.Y. Misc. LEXIS 299, at *15 (Sup. Ct. N.Y.Co. 1997); *Phansalker v. Anderson Weinroth & Co.*, 344 F.3d 184, 211 (2nd Cir. 2003); *Doublick v. Henderson*, No. 116914/97, 1997 WL 731413, at *4 (N.Y. Sup. Ct. N.Y., 1997)

3. Damages are pecuniary loss, but punitive damages are available

American Federal Group, Ltd v. Rothenberg, 136 F.3d 897 (2d Cir. 1998).

Benson v. RMJ Sec. Corp., 683 F. Supp. 359 (S.D.N.Y. 1988); see also *Duane Jones Co. v. Burke*, 117 N.E.2d 237 (N.Y. 1954).

Whitney v. Citibank, N.A., 782 F.2d 1106 (2d Cir. 1986).

4. Must distinguish between breach of contract vs. tort and fiduciary duty; fiduciary breach must be independent of duties under control to stand. *Carvel Corp v. Noonan*, 350 F.3d 6, 16 (2d Cir. 2003).

New York Univ. v. Cont'l Ins. Co., 87 N.Y.2d 308, 316 (N.Y. 1995).

B. Tortious interference

1. Intentional/tortious interference with business relations:

“In order to establish such a claim, a plaintiff must prove: (1) the existence of a valid contract between the plaintiff and a third party; (2) the defendant’s knowledge of the contract; (3) the defendant’s intentional procurement of a breach of contract by the third party; and (4) damages caused by the breach.” *Innovative Networks, Inc. v. Satellite Airlines Ticketing Centers, Inc.*, 871 F.Supp. 727 (S.D.N.Y. 1995); *Lockheed Martin Corp. v. Atlas Commerce Inc.*, 283 A.D.2d 801, 803 (3d Dep’t 2001).

Yet, defendant may raise a defense of economic justification where he is not motivated by an “improper motive” or by malice, but rather simply advancing his own economic interests. *Foster v. Churchill et al.*, 87 N.Y.2d 744, 750, 751 (1996).

2. Intentional/tortious interference with prospective business relations:

“To prevail on such a claim, the plaintiff must show that the contract would have been entered into but for the actions of the defendant” and “the defendant’s sole purpose was to damage the plaintiff or that the means employed to induce termination of the of the relationship [was by wrongful means].” *PPX Enters., Inc. v. Audiofidelity Enters., Inc.*, 818 F.2d 266, 269 (2d Cir. 1987); see *Shred-It USA, Inc. v. Mobile Data Shred, Inc.*, 202 F.Supp.2d 228 (S.D.N.Y. 2002); *Pacheco v. United Medical Associates, P.C.*, 305 A.D.2d 711 (3d Dep’t 2003).

C. Unfair competition

“ The essence of an unfair competition claim under New York law is that the defendant misappropriated the fruit of plaintiff’s labor and expenditures by obtaining access to plaintiff’s business idea either through fraud or deception, or an abuse of a fiduciary or confidential relationship.”

Katz, Dochtermann & Epstein, Inc. v. HBO, No. 97 Civ. 7763 (TPG), 1999 U.S. Dist. LEXIS 3971, at *9 (S.D.N.Y. 1999)

A cause of action sounding in unfair competition will be sustained “even where the information would not otherwise qualify as a trade secret, the unauthorized physical taking and exploitation of internal company documents for use in a competitor’s business constitutes unfair competition.”

Innovative Networks, Inc. v. Satellite Airlines Ticketing Centers, Inc., 871 F. Supp. 709, 729 (S.D.N.Y. 1995)

“An employee’s right to compete with his former employer is indeed protected, but this protection does not extend so far that an employee can, with impunity, unlawfully seize his employer’s property.”

Advanced Magnification Instruments of Oneonta v. Minuteman Optical Corp., 135 A.D.2d 889, 891 (3d Dep’t 1987)

D. The emerging inevitable disclosure doctrine

Inevitable disclosure is used as a basis for establishing irreparable harm in the absence of evidence of actual misappropriation.

Factors that guide the courts: (1) the extent to which the new employer is a direct competitor of the former employer; (2) whether the employee’s new position is nearly identical to his old one, such that he could not reasonably be expected to fulfill his new job responsibilities without utilizing the trade secrets of his former employer; (3) the extent to which the trade secrets at issue would be valuable to the new employer; and (4) the nature of the industry and its trade secrets.” *IBM v. Papermaster*, 2008 WL 4974508, at *7 (S.D.N.Y. 2008); *Payment Alliance Int’l. Inc. v. Ferreira*, 530 F.Supp.2d 477, 482 (S.D.N.Y. 2007); *EarthWeb, Inc. v. Schlack*, 71 F.Supp.2d 299, 310 (S.D.N.Y. 1999).

No evidence of intent / motive / malice needed. *Lumex Inc. v. Highsmith*, 919 F.Supp. 624, 631 (E.D.N.Y. 1996).

The doctrine has been heavily criticized. *See e.g., International Paper Co. v. Suwyn*, 966 F.Supp. 246, 258-59 (S.D.N.Y. 1997); *EarthWeb, Inc. v. Schlack*, 71 F.Supp.2d 299, 310 (S.D.N.Y. 1999) (“absent evidence of actual misappropriation, the doctrine should be applied only in the rarest of cases”); *Tactica International v. Atlantic Int’l. Inc.*, 154 F.Supp.2d 586 (S.D.N.Y. 2001).

Courts more likely to use the doctrine as a basis to support enforcement of an express restrictive covenant rather than when inevitable disclosure is used as “a surrogate for an express restrictive covenant not to compete.” *Payment Alliance Int’l. Inc. v. Ferreira*, 530 F.Supp.2d 477, 481 (S.D.N.Y. 2007); see *IBM v. Papermaster*, 2008 WL 4974508, at *9 (S.D.N.Y. 2008) (Court relied, in part, on explicit provision in non-compete agreement acknowledging that employer would suffer irreparable harm); *Estee Lauder Cos. v. Batra*, 430 F. Supp. 2d 158 (S.D.N.Y. 2006).

Although the Court of Appeals and the Appellate Division courts have yet to adopt inevitable disclosure [*Marietta Corp. v. Fairhurst*, 301 A.D.2d 734 (3d Dep’t 2003)], at least one trial court has recognized and considered the doctrine. See *Spinal Dimensions, Inc. v. Chepenuk*, 2007 WL 2296503, *6-7 (N.Y. Sup. Ct. Albany Cty. 2007).

The doctrine has been cited favorably by Federal courts in New York. *IBM v. Papermaster*, 2008 WL 4974508 (S.D.N.Y. 2008); *Payment Alliance Int’l. Inc. v. Ferreira*, 530 F.Supp.2d 477 (S.D.N.Y. 2007); *Estee Lauder Cos. v. Batra*, 430 F. Supp. 2d 158 (S.D.N.Y. 2006); *Lumex, Inc. v. Highsmith*, 919 F.Supp. 624 (E.D.N.Y. 1996).

II. Trade Secrets

1. Uniform Trade Secret Act

Adopted in 46 states and the District of Columbia. New York has not adopted the Act.

Defines trade secret as “information, including a formula, pattern, compilation, program device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from no being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”

2. Trade Secret—Restatement of Torts § 757 (NY)

“Any formula, pattern device, or compilation of information which is used in one’s business, and gives him an opportunity to obtain an advantage over competitors who do not know or use it.” *Integrated Cash Mgt. Svces. Inc. v. Digital Transactions*, 920 F.2d 171, 173 (2d Cir. 1990); *B.U.S.A. Corp. v. Ecogloves, Inc.*, 2006 WL 3302841 (S.D.N.Y. 2006); *Ashland Mgmt. v. Janien*, 82 N.Y.2d 395 (1993).

Though customer lists are generally not trade secrets [*H. Meer Dental Supply Co. v. Commiso*, 269 A.D.2d 662, 664 (3d Dep't 2000)], such may be a trade secret where the information is not readily ascertainable, must be cultivated with great effort and is secured through great expenditure of time and money.

“Whether something is a trade secret depends, in part, upon the ease or difficulty with which the information could be acquired or duplicated by others” and “[i]nformation is not considered a trade secret where...it is readily available through other sources outside the business.” *Ivy Mar Co., Inc. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 556-57 (E.D.N.Y. 1995).

The more detailed and sophisticated the information, the more likely it will be protected, *e.g.*, purchasing preferences, volume of business, pricing discounts, pricing structures, key contacts at client, etc. *Royal Carbo Corp. v. Flameguard, Inc.*, 645 N.Y.S.2d 18, 19 (2d Dep't 1996); *see also Softel, Inc. v. Dragon Med and Scientific Communications*, 118 F.3d 955 (2d Cir. 1997); *Lumex, Inc. v. Highsmith*, 919 F.Supp. 624 (E.D.N.Y. 1996). *But see Silipos, Inc. v. Bickel*, 2006 WL 2265055 (S.D.N.Y. 2006); *Marietta Corp. v. Fairhurst*, 301 A.D.2d 734 (3d Dep't 2003).

Even “casual memory” of an individual may be enjoined in the proper case if the list is held to be a trade secret. *North Atlantic Instruments, Inc., v. Haber*, 188 F.3d 38 (2d Cir. 1999); *but see International Paper Co. v. Suwyn*, 966 F.Supp. 246, 256 (S.D.N.Y. 1997).

3. Misappropriation

Must show: (1) that a company/individual possessed an actual “trade secret” and (2) the defendant used that trade secret in breach of an agreement, a confidential relationship, or duty, or as a result of discovering by improper means. *Thin Film Lab, Inc. v. Carmelo Cometo*, 218 F. Supp.2d 513 (S.D.N.Y. 2002).

Trade Secrets must be established by the six factor test: (1) the extent to which the information is known outside of plaintiff's business, (2) the extent to which it is known by employees and others involved in the business, (3) the extent of measures taken by the owner to guard the secrecy of the information, (4) the value of the information to the owner and their competitor, (5) the amount of effort or money expended in developing the information, and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. *Amacorp, Inc. v. Shell Knob Services, Inc.*, 29 F.3d 621 (2d Cir. 1994); *Hudson Hotels Corp. v. Choice Hotels, Ltd.*, 995 F.2d 1173, 1176 (2d Cir. 1993).

All of the factors need not be present. *Freedom Calls Found. v. Bukstel*, 2006 WL 845509 (E.D.N.Y. 2006).

Whether it is a trade secret is a question of fact. *AFA Tours v. Whiteburch*, 937 F.2d 82, 89 (2d Cir. 1991); *Ashland Mgmt. v. Janien*, 82 N.Y.2d 395 (1993).

III. Statutory Considerations

1. Computer Fraud and Abuse Act, 18 U.S.C. § 1030, *et seq.*

A criminal statute with civil amendments. Confers federal jurisdiction.

Only applies when a trade secret is misappropriated by accessing a computer “without authorization or exceeding authorized access.” See, e.g., *Am. Family Mut. Ins. Co. v. Rickman*, 554 F. Supp. 2d 766, 772 (N.D. Ohio 2008) (“Computer access alone does not make the conduct subject to the CFAA.”).

“At present, courts are split as to what circumstances give rise to access without authorization or access that exceeds authorization.” *Modis, Inc. v. Bardelli*, 531 F. Supp. 2d 314 (D. Conn. 2008). *Shurgard Storage Centers Inc. v. Safeguard*, 119 F. Supp. 2d 1121 (W.D. Wash., 2004). *International Airport Centers v. Citrin*, 440 F.3d 418 (7th Cir. 2006).

Recovery is limited to “reasonable cost to any victim, including the cost of responding to an offense, conducting a damage assessment, and restoring the data, program, system, or information to its condition prior to the offense, and any revenue lost, cost incurred, or other consequential damages incurred because of interruption of service.” However, revenue lost by reason of trade secret misappropriation may not be recovered under the statute. *Nexans Wires S.A. v. Sark-USA, Inc.*, 319 F. Supp. 2d 468, 478 (S.D.N.Y. 2004) (“revenue lost because the information was used by the defendant to unfairly compete after extraction from a computer does not appear to be the type of ‘loss’ contemplated by the statute”).

2. Economic Espionage Act of 1996, 18 U.S.C. § 1831, *et seq.*

Intended to address “technological and economic realities” by criminalizing conduct involving domestic industrial spying and international espionage.

Severe penalties (up to \$5 million and 15 years in jail) apply to theft of trade secrets, attempts to sell same, or bribes to so obtain.

No private right of action.

As of 2008, there have been less than 60 prosecutions.

Trade Secrets Defined:

“All forms and types of financial, business, scientific, technical, economic or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing.”

IV. Enforcement of Rights

1. TRO and Preliminary Injunction:

A. Elements of an injunction:

1. Irreparable harm in absence of the injunction

Irreparable harm is no longer automatically presumed for misappropriation of a trade secret in the Second Circuit. *Faiveley Transp. Malmö AB v. Wabtec Corp.*, 559 F.3d 110 (2d Cir. March 9, 2009); cf. *FMC Corp. v. Taiwan Tainan Giant Indus. Co.*, 730 F.2d 61, 63 (2d Cir. 1984). When a misappropriator seeks only to use the trade secrets in pursuit of profit without further dissemination, “no such presumption is warranted because an award of damages will often provide a complete remedy for such injury.” *Faiveley*, 559 F.3d at 118-19.

2. Likelihood of success on the merits

3. Balancing of the equities

4. No adequate remedy at law

B. Money damages:

1. Compensatory

Pencom Sys., Inc. v. Shapiro, 193 A.D.2d 561 (1st Dep’t 1993)

Special Prods. Mfg. v. Douglass, 169 A.D.2d 891 (3d Dep’t 1991)

2. Punitive:

Sysco Corp. v. Maines Paper & Food Service, 254 A.D.2d 611 (3d Dep't 1998).

Contempo Communications v. MJM Creative Services, Inc., 182 A.D.2d 351 (1st Dep't 1992).

3. Liquidated Damages:

The presence of a valid liquidated damages provision for violation of a noncompete covenant “d[oes] not [necessarily] foreclose the granting of injunctive relief.” *Zellner v. Stephen D. Conrad, M.D., P.C.*, 589 N.Y.S.2d 903 (2d Dep't 1992).

DAR & Assocs., Inc. v. Uniforce Servs., Inc., 37 F.Supp.2d 192, 200 (E.D.N.Y 1999).

Crown it Services, Inc. v. Koval-Olsen, 782 N.Y.S.2d 708, 712 (1st Dep't 2004).

Jacobs v. Citibank, 61 N.Y.2d 869 (1984) (finding liquidated damages clause unenforceable if it constitutes a penalty); *see also Fingerlakes Chiropractic v. Maggio*, (4th Dep't 2000).

The View From Inside – Strategic Considerations

Alexander C.B. Barnard
Director and Counsel, Credit Suisse

Aggressive Early Strategies for Protecting Your Intellectual Property

A. Learn of facts suggesting theft/misuse of trade secrets/ related concerns

1. Client departures
2. Departure of employees
3. Files missing/clean desks
4. New deals done/product launch that looks like ours
5. Business people have concern/ “hunch”

B. Initial Steps

1. Determine the “client”

2. Determine the business risk
3. Set expectations regarding outcomes/costs

C. Investigate Facts: “Is there a case?”

1. Interview all witnesses and ask for documents – determine who witnesses will be for court – let them know
2. Review e-mail accounts/other electronic information
3. Review computer, work space
4. Review any other materials
5. Insist on equipment return

D. Action Plan

1. Communicate immediate action plan to business
2. Get commitment to particular course of action (cease and desist letter, injunction action, damages), associated costs/burdens
3. Hire outside counsel as needed
4. Circulate an evidence preservation notice
5. If litigation ensues, consider a protective order with two levels of protection

E. Pursuing a Trade Secret Claim

1. Prepare the Client/Former Employer

- a. Lay out the costs and strategy/methods to the client early, so that the client will see the process through.
- b. The value of the violation will ordinarily exceed the costs, but the executives/stakeholders must see this.
- c. Consider the impact on future cases.
- d. Consider the strength of the evidence now, and separate evidence from speculation.

2. Act Swiftly

- a. Demonstrate “emergency”
- b. Determine the forum.
- c. Demand short response time to cease and desist letter.

3. Misappropriation Important

- a. Theft of data—e-mails, downloads, discs, copies, long, unusual data accesses

- b. The Disloyal Employee: benefiting the new employer and feathering the new nest while still employed
 - c. Lies about activities and new employer (in exit interview or otherwise)
 - d. Deleting information or damaging the computer
- 4. Seek a TRO
 - a. Show why notice should not be required—in the Verified Complaint and TRO papers—so that ex parte relief is fair.
 - b. Join the new employer (tortious interference)
 - c. Seek expedited discovery in the TRO papers.
- 5. Plaintiff Strategy
 - a. Insist on injunctive relief regarding:
 - 1. Employment
 - 2. Solicitation of customers and employees
 - 3. Non-use/return of data
 - 4. Preservation of evidence
(unless you really discover that your claim is unsound)
 - b. Specify the trade secrets with reasonable particularity without revealing them
 - c. Circumstantial evidence may be sufficient
 - d. Retain computer experts/chain of custody
 - e. Expedited discovery is likely to be crucial to support the P.I. motion.
 - f. Anticipate the Usual Defenses
 - 1. Matter not treated as secret.
 - 2. The information may be proprietary, but not a trade secret.
 - 3. Others have been given the “secrets,” and no prior suit on same grounds.
 - 4. The information is in the public domain.
 - 5. Constructive discharge/harassment/unfair termination.