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Trade Secrets And 3rd Parties: Litigation Traps To Avoid

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Many companies have developed trade secrets policies to protect their valuable information, but even forward-thinking companies may not have internal controls to avoid liability as third parties to alleged trade secret misappropriation. While recently hired employees are one obvious source of potential liability if they bring to the job information obtained from their prior employer, in recent years companies have also increasingly faced suits based on relationships with contractors and vendors. In any of these situations, a company can find itself charged both directly for misappropriation of trade secrets derived from others, and vicariously based on agency principles.

This article explores recent cases involving both theories of third-party liability for trade secret misappropriation, considers several hypothetical third-party liability scenarios, and concludes with some practical considerations for companies to mitigate potential liability in the first instance.

Direct Liability

While it may seem counterintuitive, a company could find itself held directly liable for misappropriation of another entity's trade secret even if it had no business contact or relationship with the entity whatsoever, fiduciary or otherwise. This is because the Uniform Trade Secrets Act defines "misappropriation" to include the acquisition, use or disclosure of a trade secret a party "knew or had reason to know" was obtained by improper means or derived from a person who used improper means or had a duty to maintain their secrecy. Specifically, the act defines "misappropriation" to mean:

(i) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or

(ii) disclosure or use of a trade secret of another without express or implied consent by a person who

(A) used improper means to acquire knowledge of the trade secret; or

(B) at the time of disclosure or use, knew or had reason to know that his [or her] knowledge of the trade secret was

(I) derived from or through a person who had utilized improper means to acquire it;

(II) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or

(III) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or

(C) before a material change of his [or her] position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

Unif. Trade Secrets Act § 1(2)(i)-(ii). As discussed below, several recent cases have confronted the state of mind required of a third party to be liable for trade secret misappropriation.

Silvaco Data Sys. v. Intel Corp., 184 Cal. App. 4th 210 (2010)

In this well-publicized case, Silvaco sued Intel on the theory that Intel misappropriated trade secrets embodied in source code when it used software acquired from another software company (CSI) with knowledge that Silvaco had accused the other company of misappropriating its source code to create the competing program. Id. at 215-16. Even though Intel only had executable code (not the source code), Silvaco alleged that Intel's use of the allegedly tainted program was akin to using "stolen property."

The Court of Appeal interpreted California's version of the Uniform Trade Secrets Act and concluded that "the statute specifies required mental states with respect to both the trade secret and the means by which it became available to the defendant." Id. at 228. The court held that Intel could not be liable for "using" Silvaco's alleged trade secrets, even though it used the accused product, because it never had knowledge of the trade secrets: "One does not, by executing machine-readable software, 'use' the underlying source code; nor does one acquire the requisite knowledge of any trade secrets embodied in that code." Id. at 216.

Softech Worldwide LLC v. Internet Tech. Broadcasting Corp., Case No. 1:10CV651, (E.D. Va. Nov. 8, 2010)

Softech followed on the heels of Silvaco and also involves the use of software, but the court's ruling turned on whether the defendant, Fedstore, had reason to know the software was allegedly obtained by improper means.

Fedstore was the primary contractor for the U.S. Department of Veterans Affairs and engaged ITBC as a subcontractor. Id. at *1. ITBC in turn contracted with Softech for software services, and allegedly obtained and used copies of source code from Softech after terminating the parties' relationship. Id. Softech then sued both Fedstore and ITBC for violation of Virginia's Uniform Trade Secrets Act as well as copyright infringement. Id.

After finding that Softech adequately pled the existence of trade secrets in its software components, the court concluded that it nevertheless failed to state a claim against Fedstore because it did not plead the requisite knowledge: "The Complaint states that ITBC represents to Fedstore that the allegedly infringed material is its own and takes active measures to reduce Softech's visibility — statements that cannot be squared with the notion of Fedstore using software it knows or should know belongs to Softech." Id. at *6. While the court did not consider whether Fedstore could be vicariously liable for trade secret misappropriation (which apparently was not pled by the plaintiff), it did find that Softech stated a claim for vicarious copyright infringement. Id. at *4.

Nova Design Techs. Ltd. v. Walters, 875 F. Supp. 2d 458 (E.D. Pa. 2012)

Nova Design demonstrates the potential for trade secrets liability in purchases of intellectual property assets. The plaintiff, Nova Design, claimed that it invented a sandpaper-based trigger for heat packs and that it provided samples under a confidentiality agreement to Omni, a manufacturer of heat packs. Id. at 461. Omni sent Nova Design a purchase order in 2000, but cancelled the order because it was having difficulty manufacturing heat packs with the trigger. Id. at 463-64. In 2001, Omni and its principals filed patent applications relating to a sandpaper-based trigger, and ultimately received a patent in 2005. Id. at 461. In 2006, Omni sold its assets — including the patent — to a seller of heat warmers, CMV. Id. at 464. Omni warranted to CMV that title to the patent was marketable. Id. at 464. CMV was not aware of Nova Design prior to a lawsuit filed by Nova Design against CMV and the principals of Omni seeking correction of inventorship on the patent and other claims including trade secret misappropriation under the Pennsylvania Uniform Trade Secrets Act. Id. at 465.

The court granted summary judgment to CMV on the trade secrets claim because there was no evidence that it "knew or had reason to know" that it had acquired, used, or disclosed trade secrets acquired by improper means. Id. at 473-74 (noting that evidence showed Omni warranted good title to the patent and that CMV was not aware of any interactions with Nova Design prior to the lawsuit). CMV also obtained summary judgment on plaintiff's other tort-based claims, but the claim for correction of inventorship of the patent survived. Thus, while CMV avoided liability it still found itself faced with losing an asset. This case therefore highlights importance of due diligence in IP transactions.

Central Trust & Inv. Co. v. SignalPoint Asset Mgmt. LLC, 422 S.W.3d 312 (Mo. 2014) (en banc)

In Central Trust, the Missouri Supreme Court reached a conclusion similar to the court in Silvaco regarding the knowledge component of an action for direct misappropriation. The plaintiff, Central Trust, purchased a financial management company. Id. at 317. Following the acquisition, an employee named Troy Kennedy left the company to start a new investment management company (ITI), departing with a client list and later soliciting Central Trust's clients. Id. Several months later, SignalPoint entered an affiliation agreement with Kennedy making him an independent contractor. Id. at 318. This arrangement allowed him to solicit orders to buy and sell securities from clients, and gave SignalPoint a percentage of the associated fees. Id. After Central Trust sued SignalPoint (along with Kennedy and ITI) for trade secret misappropriation under the Missouri Uniform Trade Secrets Act, SignalPoint sought and obtained summary judgment because there was no evidence that it had ever had access to the secret client list or its contents.

The Missouri Supreme Court affirmed: "Although SignalPoint performs services for and bills people who were once Central Trust or STC clients and who eventually became clients of Kennedy and SignalPoint, there is no support in the record that SignalPoint had any way of knowing which of Kennedy's clients are new clients and which are former clients of STC or Central Trust." Id. In other words, there was no evidence that SignalPoint had acquired, used or disclosed any trade secret information. Id. ("SignalPoint can identify which of its clients are also Kennedy's clients, but this is not the compilation of names that Central Trust argues is a 'trade secret.'").

Central Trust also sought to hold SignalPoint vicariously liable for Kennedy's misappropriation, but that claim also failed. While Missouri generally recognizes that wrongful acts of an agent may be imputed to the principal where an agency relationship exists, Central Trust never pleaded the existence of any such relationship between Kennedy and SignalPoint. Id. at 323. Moreover, the agreement between the parties made Kennedy an independent contractor, so the Court refused to impute Kennedy's conduct to SignalPoint. Id.

Vicarious Liability

Courts in some states have recognized vicarious liability for trade secrets misappropriation based on agency principles. See, e.g., Newport News Indus. v. Dynamic Testing Inc., 130 F. Supp. 2d 745, 754 (E.D. Va. 2001).

Two recent decisions are discussed below: The first demonstrates the value of contracts recognizing the independence of contractors; the second highlights the risks of permitting new employees to bring to the job information obtained from their prior employer.

Ennis Transportation Co. Inc. v. Richter, Case No. 3:08-CV-2206, (N.D. Tex. Aug. 22, 2011)

In Ennis Transportation, several individuals who were agents for Ennis Transportation started a competing company, Overcomers. Id. at *1. Dynasty Transportation then entered into an agreement with Overcomers to provide moving services. Id. at 4. The agreement classified Overcomers as an independent contractor responsible for maintaining an office and personnel, and required Dynasty to pay Overcomers a commission by the job worked (rather than based on time spent). Id. at *4. Ennis Transportation sued Overcomers and its former employees for allegedly misappropriating confidential customer lists and other information when they left the company, and sought to hold Dynasty vicariously liable for their conduct. Id. Applying Texas agency law, the Court granted summary judgment of no vicarious liability to Dynasty, finding that the contract between the parties showed—and Ennis did not even dispute—that Overcomers was an independent contractor and that Dynasty had no right to control its work. Id.

Kassa Ins. Servs., Inc. v. Pugh, 180 Wash. App. 1051 (Wash. Ct. Appeal Apr. 29, 2014) (unpublished)

Kassa involved an insurance agent, Pugh, who developed a book of business while working at Kassa Insurance. Id. *1. Pugh maintained that he had an ownership interest in his clients (Kassa disagreed), and prepared a client list before leaving the company to join RJC. Id. Pugh began calling on former clients, and Kassa lost some of them. Id. at *2. Kassa also lost a client for insurance adjustment work (Continental) after another RJC employee suggested that Kassa had a conflict of interest and should not be performing that work. Id. At trial, Pugh was found liable for trade secret misappropriation. RJC was found liable for tortious interference with its business relationship with Continental, but not vicariously liable for Pugh's misappropriation. Id. at *1. After defendants appealed, Kassa cross-appealed the finding of no vicarious liability against RJC. Id. at *14.

The Washington Court of Appeal stated that under the doctrine of respondeat superior, "[a]n employer may be held vicariously liable for violations of the UTSA." Id. at *15. Nevertheless, the court affirmed the lower court, because RJC had no control over actions of Pugh when he took the client list, and Pugh always represented that he owned the list (RJC did not know he had misappropriated the list — so they never ratified his conduct in taking the list). Id. at *15.

This is a strange decision in several respects. The ruling focuses on Pugh's taking of the list, but Pugh's use of the list to solicit clients as an employee of RJC would also seem to support a finding of vicarious liability. It also appears that Kassa did not include a claim against RJC for direct misappropriation, which may have had some support in the record. Nevertheless, the case reinforces the risk presented if new employees bring to the job information obtained from their prior employer.

Liability Scenarios

Consider the following two scenarios involving a hypothetical company, Alpha.

Scenario No. 1

Alpha solicits bids from various vendors for a component for an upcoming product. Delta Manufacturing submits the strongest bid, which Delta says is based on its own proprietary manufacturing process for the component. One of Alpha's officers, Alice Anderson, tours Delta's manufacturing facility and is impressed. The companies enter into a contract for supply of the component. The contract specifies that Delta Manufacturing is an independent contractor with control over the manufacturing process for the component, but must meet certain quality requirements imposed by Alpha. Alpha completes its development process, and rolls out a product containing the component manufactured by Delta. Alpha later learns that Delta Manufacturing has been adjudged to have misappropriated a trade secret manufacturing process from Beta Company, which Delta Manufacturing used in manufacturing the component for Alpha's product.

What is Alpha's legal exposure in this scenario? In order to establish a claim for direct liability for trade secret misappropriation against Alpha, Beta Company would have to establish that Alpha acquired, used, or disclosed Beta's trade secret information. Unless Beta Company can allege facts suggesting that Alpha had knowledge of the secret information, Alpha would succeed on a motion to dismiss a claim for direct liability—like Intel in the Silvaco case. But Alpha should investigate what Ms. Anderson learned during her facility tour: if Delta Manufacturing shared details of its manufacturing process, Alpha may have (unwittingly) acquired Beta trade secret information. But even if that were the case, Alpha would avoid liability unless Beta could should Alpha "knew or had reason to know" that the information had been improperly obtained by Delta Manufacturing. Since Delta Manufacturing represented that it had invented the manufacturing process itself, Alpha will likely be able to avoid direct liability. Moreover, because Delta Manufacturing was operating as an independent contractor, Alpha is also likely to avoid vicarious liability.

Scenario No. 2

Alpha is hiring for a position within its product development team. One of Alpha's officers and hiring directors, Allen Armstrong, went to college with Nan Newsome. Armstrong knows that Nan is currently working in a similar role at Beta Company, one of Alpha's top competitors. He believes that Nan would be well-suited for the job, and invites her to interview. At the interview, Newsome generally discusses her product development experience at Beta Company, and says that she has learned a lot from her work experience there. Newsome sends Armstrong a thank-you email, and notes that she believes that the knowledge she's gained working at Beta Company makes her a strong candidate and would be extremely helpful if she were hired by Alpha. Armstrong thinks Newsome is a great fit for the product development position at Alpha and offers her the position. Newsome accepts and begins working in that role at Alpha.

Several months later, Alpha learns that Beta Company has sued both Alpha and Newsome for trade secret misappropriation. The complaint alleges that just before Newsome left her position at Beta Company — and after she gave notice that she was leaving to join Alpha — she forwarded 20 emails containing proprietary Beta Company product development information to her personal email address. The complaint alleges, on information and belief, that Newsome has been using the information in her new role at Alpha. Alpha conducts an internal investigation, and learns that Newsome forwarded the same 20 emails to her new Alpha email address on the day she joined the company, and downloaded several PowerPoint presentations from those emails onto the desktop of her Alpha computer.

What is Alpha's legal exposure in this scenario? Beta Company likely states a claim for direct misappropriation against Alpha. Assuming that the material Newsome brought with her to Alpha in fact contains trade secrets, Alpha could be liable for direct misappropriation if Beta Company can show the company "knew or had reason to know" Newsome was using Beta confidential information at her new job. Among other things, Beta Company will be able to point to the email from Newsome touting the value of the knowledge she gained at Beta Company in obtaining the job. Moreover, depending on the state, Alpha could also face vicarious liability for Newsome's conduct.

While Alpha can argue that it never had reason to believe Newsome was bringing to the job anything more than the general skills she acquired at Beta Company, Alpha faces significant uncertainty as a fact-finder could conclude otherwise. Alpha's chances of success would be improved if Armstrong had made it clear to Newsome that Alpha was not interested in Beta Company's confidential information, or if Alpha had obtained a representation from Newsome when she joined the company that she was not bring Beta confidential information with her to the job. To minimize its ongoing legal risks, Alpha should implement an immediate quarantine related to Newsome so that others within the organization are not exposed to the allegedly misappropriated information.

Takeaways for Companies

In many of the cases discussed above, the third-party company accused of trade secret misappropriation was able to avoid liability — eventually. But companies could save considerable expense and mitigate their legal risks if they developed policies to minimize the risk of liability in the first instance. A risk management policy could include the following steps:

- From the outset of discussions with potential hires, establish that the company does not wish to learn confidential information of their current employer;

- Seek confirmation in writing from each new hire that he or she has not brought to the job proprietary information from his or her previous employer;

- Establish contractual relationships with independent contractors that give them control over their work and make their independence clear;

- Investigate cases of potential misappropriation, inadvertent or otherwise (willful blindness is not a defense);

- Perform diligence in acquisitions and IP asset purchases, and obtain warranties from the seller.

Companies that adopt a straightforward set of policies like these will be more likely to identify and avoid — at minimal expense — third-party liability in trade secret misappropriation actions.

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