How to assess trade secret damages

Calculating damages in trade secrets cases can be more difficult than in cases involving other IP rights. **Marc J Pensabene** and **Christopher E Loh** consider strategies for plaintiffs and defendants and, overleaf, provide a guide to how contracts can help you avoid liability

Assessing monetary damages in suits for trade secret misappropriation presents a unique set of challenges not found in patent, copyright and trade mark suits. Whereas patents, copyrights and trade marks cover discrete forms of intellectual property, trade secrets protect more nebulous categories of information, such as know-how, manufacturing processes and business practices, for which a dollar value might be harder to ascertain. Unlike patents, copyrights and trade marks, trade secrets may lose value once they are no longer secret, and damages for their misappropriation must account for this unique form of asset erosion. Lastly, while suits for patent, copyright and trade mark infringement are controlled by federal law, suits for trade secret misappropriation remain the province of state law, which – despite the widespread adoption of the Uniform Trade Secret Act – varies significantly from state to state.

Given the difficulties inherent in valuing trade secrets and the inconsistencies in the laws governing them, dealing with damages for trade secret misappropriation can sometimes feel like placing a bet at a roulette table. The determination of damages rests with jurors, not economists, and the amounts awarded often bear little resemblance to economic reality, reflecting as much the intent to punish the defendant as to compensate the plaintiff. This article presents some basic concepts to help litigants navigate the vagaries of trade secret damages. Though trade secrets may derive their value from their secrecy, the tactics for dealing with trade secret damages need not remain cryptic to be valuable.

Plaintiff's strategies

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. Depending on the circumstances, the plaintiff may also be able to recover punitive damages, prejudgment interest and attorneys' fees. Such damages may further be combined with injunctive relief, though once the trade secret has been publicly disclosed through the defendant's misappropriation, such relief may not be available.

The most important factors affecting the amount of plaintiff's recovery are the determination as to which state's substantive law will govern the claim for damages; the form of compensatory damages claimed; and the availability of punitive damages.

The burden of proving damages in most cases is relatively easy to meet. While the plaintiff must show by competent, non-speculative evidence that it has been damaged, it need not prove the precise amount of the damages with mathematical certainty, and all doubts as to the amount are resolved in the plaintiff's favour.

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. Most commonly, a plaintiff will seek damages in the form of either its lost profits or the defendant's unjust enrichment. Lost profits and unjust enrichment generally are regarded as mutually exclusive forms of relief, and the award of both in full as an impermissible double recovery. However, in certain instances, the portion of the defendant's profits that exceeds the plaintiff's lost profits may be recoverable.

Another way for the defendant to attack the plaintiff's damages claim is to demonstrate that the amounts claimed are not related to the alleged trade secret misappropriation

Lost profits are typically calculated as net profits – that is, gross profits minus overhead and expenses. The amounts recoverable in the form of lost profits can include not only lost sales that were diverted from the plaintiff to the defendant, but also losses attributable to price erosion or to increased costs caused by the defendant's misappropriation, such as the costs of an advertising campaign to recoup market share stolen by the defendant. Depending on the circumstances, the plaintiff may also be able to recover overhead costs, general and administrative expenses, lost profits on reorder or spare parts or other follow-on items, and even provable future profits. Creative accounting is frequently employed to measure the extent of the plaintiff's lost profits; for example, it is not uncommon for a court to calculate the plaintiff's lost profits by applying the defendant's profit margins to the plaintiff's lost sales.

If the defendant does not impair the value of the trade secret through its misappropriation and does not compete directly with the plaintiff, the plaintiff may find it difficult to demonstrate that it lost anything due to the misappropriation. As an alternative to lost profits, a plaintiff may claim as damages the defendant's unjust enrichment; for example, the portion of the defendant's profits that are attributable to its misappropriation. If the plaintiff elects this form of recovery, it should gather evidence of which of the defendant's acts constitute an improper use of its trade secret, and include the amount of profits flowing from those acts as part of its damages claim. Such acts can include those that seem, at first glance, to be only tangentially related to the trade secret. For example, if the defendant does not incorporate the trade secret into a product, but rather uses the trade secret to promote its existing products or to develop new and different products, a portion of the profits from those products may be recoverable as a form of unjust enrichment. The plaintiff should also bear in mind that, in certain circumstances, it can recover damages for the defendant's acts outside of the United States.

Situations may arise in which the plaintiff is unable to demonstrate either that it lost profits, or that the defendant was enriched by the misappropriation. For example, the plaintiff may not make use of the trade secret, and the defendant may not earn any profit from its misappropriation of the trade secret. As a substitute for – or in addition to – lost profits or unjust enrichment, several alternate forms of compensatory damages are available. These include the costs incurred by the plaintiff to develop the trade secret; the time and costs saved by the defendant from not having to independently develop the trade secret (commonly referred to as head start damages); the diminution in the value of the plaintiff's business or stock; and a reasonable royalty, based either on the actual royalties that have been paid to the plaintiff, or a hypothetical royalty that the litigants would have been expected to negotiate at the time of the misappropriation. Additionally, if the defendant's misappropriation of the trade secret resulted in the breach of either an express or implied duty of confidentiality – as is often the case in trade secret actions – that breach may result in a separate and independent award of damages under contract law.

Most courts continue to favour the plaintiff's lost profits or the defendant's profits as the preferred measure of damages in trade secret cases. However, in certain circumstances, these alternate forms of compensatory damages may constitute a better gauge of economic reality. For example, if the defendant does not misappropriate the trade secret to compete directly against the plaintiff, it cannot be said that the defendant's enrichment came at the expense of the plaintiff's profits, and damages based on a reasonable royalty may measure more appropriately the harm done. Moreover, some states allow plaintiffs to recover at least some of these alternate damages in addition to lost profits or unjust enrichment. The plaintiff should therefore determine whether these additional damages can be recovered, or whether they are prohibited as a form of double recovery, under the governing law.

In addition to the aforementioned compensatory damages, punitive damages may be awarded if the plaintiff can show that the defendant's misappropriation is sufficiently wilful or deliberate; calculated to cause substantial harm to the plaintiff; and/or motivated by malice rather than competition. The plaintiff should review the evidence carefully to determine whether the necessary showing can be made, since it is not uncommon for courts to award punitive damages in trade secret misappropriation cases, and such amounts can easily dwarf the amount of compensatory damages. Some states limit punitive damages to a multiple (usually two or three times) of the amount of compensatory damages. Other

Contracting your way out of potential trade secret liability

Is it possible for the recipient of a trade secret to contract its way out of liability? Claims for trade secret misappropriation typically are based upon the breach of either an express or implied duty to maintain the confidentiality of the trade secret, and to refrain from using the trade secret for an improper purpose. However, if there is a written contract between the parties that permits the specific disclosure or use complained of, the existence of such a contract may be sufficient to preclude the claim for trade secret misappropriation.

This outcome is premised upon the familiar contract law principle that, where there is an express agreement setting forth the obligations which each party is to assume, the law should be reluctant to expand those obligations or to create others by inference. If, however, the subject matter of the parties' express agreement is not at least coextensive with the trade secret in question, the law properly may infer an implied duty of confidentiality as to the trade secret.

Accordingly, to effectively disclaim liability, the contract between the parties must be broad enough to cover the trade secret at issue, in terms of both subject matter and time. If the trade secret at issue is broader than the subject matter covered by the contract, or if it was disclosed to the recipient prior to the effective date of the contract, the contract may not serve to insulate the recipient from claims of misappropriation. The recipient therefore should ensure that the contract language is sufficiently broad to encompass any material that might foreseeably become a subject of future dispute, and should take care that no disclosure takes place beyond the effective period of the contract. However, if a disclosure does take place outside the effective period of the contract, the recipient may be able to contract retroactively for those disclosures.

Ideally, from the recipient's point of view, the contract between the parties should unambiguously disclaim any obligation of confidentiality on the part of the recipient. An effective disclaimer might state, for example, that any material submitted by the disclosing party is not to be submitted "in confidence" (despite representations or markings to the contrary); that any material received by the recipient is not to be received or held "in confidence" (despite any representations or markings to the contrary); that no confidential relationship exists between the parties; that no such relationship may be established or implied by the existence of the contract or any act by the parties; and that the disclosing party expressly waives any claim to any such relationship or any claim, relief or remedy based thereon. While inclusion of all of the above terms might be excessive, it is important that the agreement at least state affirmatively that all of the material submitted or received is not confidential. Merely disclaiming a confidential relationship may not be sufficient to ward off liability.

If the disclosing party will not agree to an outright disclaimer of any obligation of confidentiality, then the recipient should consider whether the disclosing party nevertheless is amenable to an express contract limiting the extent of states do not place any explicit limits on punitive damages.

Prior to asserting a claim for damages, the plaintiff should first determine which state's substantive law will govern its claim. Though almost all states have now adopted the Uniform Trade Secrets Act in some form, decisions dealing with trade secret damages continue to show significant state-to-state variation at every stage of the damages analysis, including the appropriate burdens of proof; the available forms of compensatory damages; the freedom of the plaintiff to choose or combine the available forms of compensatory damages; and the applicability and amount of punitive damages, interest or attorneys fees. Once the governing law is determined, all available forms of damages should be considered, along with the relevant elements of proof, to identify the theory or combination of theories that will yield the greatest potential recovery.

Defendant's strategies

Faced with a claim for trade secret damages, the defendant's basic objective, aside from proving an absence of liability, is to challenge or otherwise reduce the claimed damages amount. The defendant can do this in several ways. It can assert that the plaintiff has not borne its burden of showing that its damages were in fact caused by the defendant's misappropriation. It can demonstrate that the claimed amount, or portions thereof, are unrelated to the trade secret. It can attempt to offset the claimed amount by the expenses it incurred in connection with its alleged use of the trade secret. It can try to shorten the accounting period for the damages. Lastly, it can show that some portion of the claimed amount constitutes an impermissible double recovery.

While the plaintiff's burden of proof as to damages is relatively easy to meet, the plaintiff still must show a causative relationship between the fact of its damages (if not their precise amount) and the defendant's misappropriation. Any doubts as to this causative relationship may provide the defendant with an opportunity to challenge the claimed amount. For example, if the plaintiff itself never commercializes a product that incorporates the trade secret, there may be some question as to whether the defendant's misappropriation was in fact the cause of the plaintiff's losses, as opposed to the plaintiff's own deliberate non-use. Generally, if the facts indicate that that the plaintiff would have suffered the claimed losses regardless of the defendant's misappropriation, it may be argued that the plaintiff's claim for those losses is speculative and should not be allowed.

Another way for the defendant to attack the plaintiff's damages claim is to demonstrate that the amounts claimed are not related to the alleged trade secret misappropriation. For example, if the defendant sells a power saw that incorporates the misappropriated trade secret, the plaintiff might reasonably argue that the defendant's profits from the sale of replacement saw blades should also be included in its damages claim. The defendant, in turn, may defeat such a claim by demonstrating that the profits from its sale of the replacement blades are not related to the trade secret. However, if the defendant cannot demonstrate affirmatively which of its profits are related to the trade secret and which of its profits are not, it may be liable to the plaintiff for all of its profits.

One might well question the fairness of this outcome, since plaintiffs frequently claim amounts that bear no apparent relation to their trade secrets, and defendants just as frequently are unable to produce the proof necessary to exclude these profits. After all, seldom do businesses maintain financial records that allow them to demonstrate convincingly which revenues and expenses are *not* related to trade secrets. If the defendant foresees difficulty in procuring such proof, it should consider, as an initial matter, whether its discovery obligations and the plaintiff's discovery requests require it to surrender company-wide or other far-reaching financial data. Where possible, the defendant should limit discovery only to the financial data that bear a direct relationship to the trade secret. Limiting discovery to the relevant data at the outset will spare the defendant the potentially difficult task of later having to demonstrate which amounts are relevant and which are not.

If the plaintiff claims damages in the form of the defendant's profits, the defendant may be able to offset the damages by certain incremental expenses incurred by the defendant's use of the trade secret, including salaries, advertising and certain taxes. However, the defendant bears the burden of proving that these incremental costs in fact are directly attributable to the trade secret or its misappropriation, and are not merely ascribed to that part of the business for accounting purposes. If evidence of such costs is unavailable, the defendant cannot offset them.

In view of the potential difficulties the defendant may face in obtaining the proof required to reduce or offset the claimed damages amount, the defendant may instead find it a more fruitful strategy to argue for a limitation on the accounting period for damages. Logically, damages for trade secret misappropriation should be confined to the period during which the trade secret would have remained secret, absent any improper or unauthorized use. Courts accordingly have limited accounting periods for trade secret damages to the time it would have taken to independently develop the trade secret; the time it would have taken to reverse engineer the trade secret from products or services already on the

the recipient's obligations. Such an agreement should include terms that clearly define what material is to be kept in confidence and what material is not; that limit the period during which the recipient is obligated to keep the material confidential; that permit the recipient to use the confidential material freely or for certain purposes; and that provide that any inherent disclosure of the confidential material owing to the recipient's (permitted) use of it will not be considered a breach. The recipient may also wish to specify in the agreement what jurisdiction will govern the agreement and any disputes arising therefrom, and whether or not the parties are entitled to a jury trial in the event of a lawsuit.

As noted above, in some cases, disclosing parties have been permitted to maintain claims for trade secret misappropriation based on breach of a confidential relationship, even where there existed an express contract disclaiming any such relationship. Such outcomes were based in part on the existence of other agreements or conduct indicating some ambiguity as to whether the parties in fact agreed to disclaim a confidential relationship. To avoid a similar outcome, the recipient should refrain from engaging in any activity that might contradict or otherwise cast doubt on the disclaimer, such as offering to return or destroy the disclosed material if it is not used. The recipient should also review any other contracts it has with the disclosing party to determine whether these might affect the disclaimer, for example through merger and integration clauses.

market; the period during which the trade secret is protected by a confidentiality agreement; and the time prior to the trade secret's authorized disclosure, for example, in the form of an issued patent. However, the defendant should bear in mind that the permissible limitations on accounting periods vary considerably from state to state. Some states expressly reject limiting accounting periods to the time required for independent development or reverse engineering. Others extend the accounting period past the trade secret's legitimate loss of secrecy to be co-extensive with the life of the product incorporating the trade secret.

In addition to the above considerations, the defendant should be alert to any attempt by the plaintiff to obtain an impermissible double recovery. Obviously, an attempt by the plaintiff to claim both its lost profits and the defendant's unjust enrichment in full usually would not be allowed. Additionally, a claim for a reasonable royalty in addition to a claim for lost profits or unjust enrichment would probably also constitute a double recovery, insofar as the reasonable royalty should already reflect the profitability of the trade secret to the plaintiff as well as its worth to the defendant.

Like the plaintiff, the defendant should undertake a thorough analysis of the substantive state law that will govern the trade secret claim. States differ considerably, for example, in terms of what combination of damages they will regard as an impermissible double recovery, and what types of expenses they will permit the defendant to offset.

Stop the roulette wheel

Trade secret damages are far from uniform, and any generalizations about them remain subject to exceptions. While the above discussion provides some basic strategies for dealing with trade secret damages, the litigants must tailor these strategies to the applicable laws and the specific facts of their case. In the end, only a careful consideration of the legal and economic particulars will support a reasoned calculation of damages, and stop the roulette wheel from turning.


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