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The Defend Trade Secrets Act: Will It Do More Harm Than Good?

by Stephen Berry, Chris McGrath, Blake Bertagna and Beau Stockstill, Paul Hastings LLP

Trade secrets are critical to success in today's global and information-based marketplace. Until a few months ago, trade secrets were protected solely by state law. On May 11, 2016, however, President Obama signed the Defend Trade Secrets Act ("DTSA"), amending the Economic Espionage Act of 1996, to create the first federal civil cause of action for trade secret misappropriation. Touted as a business friendly piece of legislation, it is far from clear that this is the case.

The Good:

Seizure Orders

In addition to damages, royalties, and injunctive relief, the DTSA creates a new remedy for trade secret owners. In "extraordinary circumstances," it allows them to seek an order, on an *ex parte* basis, for the seizure of property necessary to prevent the propagation or dissemination of a trade secret—without notice.

Seizure will be granted if the employer can satisfy strict requirements, including: (1) establishing that the injunctive relief otherwise available is insufficient; (2) describing with reasonable particularity the matter to be seized and, to the extent reasonable under the circumstances, identifying the location where the matter is to be seized; and (3) establishing that the seizure target would destroy, move, hide, or otherwise make such matter inaccessible to the court, if given notice.



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The Somewhat Good:

Injunctions

The DTSA provides for injunctions to prevent unauthorized disclosure and use of a company's trade secrets, but expressly bars orders that "prevent a person from entering into an employment relationship." Despite this prohibition, the DTSA contemplates that injunctions may be used to place conditions on employment, as long as they do not conflict with state laws prohibiting restraints on trade and as long as they are "based on evidence of threatened misappropriation and not merely on the information the person knows." This provision comes close to California law, which rejects the so-called inevitable disclosure doctrine, requiring proof of actual misappropriation of trade secrets.

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Companies Can Get Hammered for Willful Patent Infringement, Say Supremes

Three years ago, companies who knew their products infringed or might infringe a patent could roll the dice. That was a gamble worth taking. For example, in *Stryker Corp. v. Zimmer Inc.*, the patentee (the holder of the patent) had created a “pioneering” product. The patentee’s competitor had no answer to this new device – and its market shares fell dramatically. Any company in the competitor’s shoes faces a choice. The competitor “chose a high-risk/high reward strategy of competing immediately and aggressively...and opted to worry about the potential legal consequences later.” *Stryker Corp. v. Zimmer Inc.*, Case No. 1:10-CV-1223 (W.D. Mich. Aug. 7, 2013). The competitor did not rely on its own engineers to develop an alternative product. Instead, it essentially asked an independent contractor to make a copy of the patentee’s product. The result was predictable. The competitor immediately began capturing a market share with its competing product, which looked and functioned just like the patentee’s product.

The patentee sued the competitor. At trial, the jury found the competitor willfully infringed the patentee’s patents and awarded \$70 million in damages, which reflected the profits the patentee lost as a result of the competing product. The district court also awarded the patentee treble damages and attorneys’ fees, resulting in a total award of over \$228 million. On appeal, the Federal Circuit (the U.S. appellate court specializing in patent cases) vacated the treble damages award because defenses the competitor raised during litigation were not “objectively unreasonable.” In other words, no matter how egregious the competitor’s conduct when it copied the product, it could escape treble damages because it was able to develop a reasonable defense during litigation.

\$70 million is a lot of money. But that amount reflects only the patentee’s lost profits for the years it had to compete with a copycat product. The competitor could have made millions by copying the patentee’s product, and if it later lost at trial, as it did, all it had to give up were the profits the patentee would have earned if the competitor’s copycat product hadn’t come to market.

Last month, the United States Supreme Court changed the risk/reward analysis for business owners in a way that should grab the attention of all competitors.

The Patent Act and its Provisions for Attorneys’ Fees and Enhanced Damages

Section 285 of the Patent Act states, “The court in exceptional cases may award reasonable attorney fees to the prevailing party.” Similarly, section 284 states that after a finding of infringement, “the court may increase the damages up to three times the amount found or assessed.” The increased damages are often referred to as “enhanced damages.”

For Almost a Decade, the Federal Circuit Has Required an Objective and Subjective Test for Attorneys’ Fees and Enhanced Damages

In 2005, the Federal Circuit stated its test for attorneys’ fees under section 285: a case was “exceptional,” and attorneys’ fees may be awarded, only if the trial court found material inappropriate conduct such as willful infringement, fraud, misconduct during litigation, or vexatious and unjustified litigation. See *Brooks Furniture Mfg., Inc. v. Dutailier Int’l, Inc.*, 393 F.3d 1378 (Fed. Cir. 2005). Absent such misconduct, the litigation must have been both “brought in subjective bad faith” and be “objectively baseless.” This test became known as the *Brooks Furniture* test.

Similarly, in 2007, the Federal Circuit stated a two-part test for enhanced damages under section 284, requiring both “objective recklessness” and “subjective knowledge.” In *re Seagate Technology, LLC*, 497 F.3d 1360 (Fed. Cir. 2007). Under the “objective recklessness” prong of that standard, “a patentee must show by clear and convincing evidence that the infringer acted despite an objectively high likelihood that its actions constituted infringement of a valid patent,” without regard to “[t]he state of mind of the accused infringer.” The categorical bar applies even if the accused infringer was unaware of the defense when it acted. This two-part test became known as the *Seagate* test.

Under these standards, the result in *Stryker* was unsurprising. No matter the evidence about the competitor’s subjective state of mind and actions (*i.e.*, asking an independent contractor to copy the patentee’s product), the competitor had raised a reasonable defense during litigation. According to the Federal Circuit, that made enhanced damages improper.

The Supreme Court’s Decisions and its Practical Impacts

In 2014, the Supreme Court first changed the *Brooks Furniture* test. In *Octane Fitness, LLC v. ICON Health & Fitness Inc.*, 572 U.S. ____ (2014), based on the plain language of the statute, the Court held that district (trial) courts should consider the totality of the circumstances, and determine whether a case is “exceptional” on a case-by-case basis. The district courts would no longer be handcuffed by the requirement that the litigation be “objectively baseless.”

And just last month, the Supreme Court abrogated the *Seagate* test. In *Halo Electronics, Inc. v. Pulse Electronics, Inc.*, 579 U.S. ____ (2016), the Court found the objective prong in the *Seagate* test ignored the plain language of section 284, and that “[s]uch a threshold requirement excludes from discretionary punishment many of the most culpable offenders, such as the ‘wanton and malicious pirate’ who intentionally infringes another’s patent—with no doubts about its validity or any notion of a defense—for no purpose other than to steal the patentee’s business.” Instead, district courts should measure culpability against the knowledge of the infringer at the time of the challenged conduct.

These new standards announced by the Court give more protection to patent holders, and should change the decision-making process of business owners when their product could infringe a patent. No longer can an accused infringer escape awards of attorneys’ fees or enhanced damages merely by presenting a defense during litigation that is not “objectively baseless.” Rather, in cases such as *Stryker*, where the competitor “all but instructed its design team to copy” the patentee’s products, the district courts will have discretion to award enhanced damages and attorneys’ fees.

Similarly, business owners should now re-evaluate whether to obtain a patent opinion from outside counsel *before* engaging in business activities which may potentially infringe on a patent. Although there is no affirmative duty to obtain opinion of counsel, acquiring one may help avoid a later finding of willful infringement. Such opinions may be expensive; the concurring opinion in *Halo* recognized that patent opinions could easily cost up to \$100,000 per patent. But it also states another less expensive possibility: “an owner of a small firm, or a scientist, engineer, or technician working there, might, without being ‘wanton’ or ‘reckless,’ reasonably determine that its product does not infringe a particular patent, or that that patent is probably valid.”

The Supreme Court has now changed the risk/reward analysis for potential patent infringement. Business owners should take heed; the \$228 million award against the competitor in *Stryker*, vacated by the Federal Circuit, likely would be upheld post-*Halo*. From now on, deliberate patent infringement could be punished so severely as to be far beyond a mere cost of doing business.

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INTELLECTUAL PROPERTY

The Defend Trade Secrets Act of 2016: New Federal Protection for Trade Secrets

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On May 11, 2016, the President signed into law the Defend Trade Secrets Act (DTSA). The DTSA significantly expands protection of intellectual property rights by creating a body of trade secrets law that applies nationwide and by allowing businesses to enforce their trade secret rights in federal court. Previously, trade secrets were protected only by state laws (which varied from state to state), and trade secret claims ordinarily could be brought only in state court. The new federal law does not preempt the state laws; it provides an additional avenue for protection and enforcement.

What Qualifies

Along with patents, trademarks, and copyrights, trade secrets protect some of businesses' most valuable intellectual property. The categories of information that can constitute a trade secret are broad—all types of financial, business, scientific, technical, economic, and engineering information can qualify. Examples include customer lists, computer source code, manufacturing methods, and formulas. Claims are frequently brought against employees, contractors, and competitors.

How to Protect

Unlike patents, which require inventors to share details of inventions with the public, trade secrets must be kept secret. The trade secret's owner must take "reasonable measures" to maintain its secrecy, and the information must have value, at least in part, because it is not generally known. Also unlike patents, which expire after a fixed period of time, trade secret protection lasts as long as these conditions are met. (The recipe for Coca-Cola has been a trade secret for more than a century.) Businesses should take steps to protect their trade secrets, including requiring non-disclosure agreements, implementing confidentiality policies, having password protection for electronic files, and having physical access controls for locations where trade secret documents and information are stored.

Remedies for Misappropriation

The DTSA allows parties to bring lawsuits in federal court to obtain damages for actual loss, unjust enrichment, or a reasonable royalty, as well as an injunction. For willful and malicious misappropriation, a business may also receive an award of exemplary damages and attorneys' fees.

A court can award exemplary damages or attorneys' fees in a lawsuit against an employee only if the employer previously provided the employee with notice of "whistleblower immunity." Thus, employers should notify employees that they cannot be held criminally or civilly liable under the DTSA for disclosing a trade

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secret in confidence to law enforcement or an attorney for the purpose of reporting a violation of law.

The DTSA also allows parties to move aggressively at the beginning of litigation to preserve evidence of misappropriation. The DTSA gives courts the power to seize property from defendants accused of misappropriation using law enforcement officers—without first giving any notice to the defendants. This allows parties to prevent the destruction or disclosure of misappropriated trade secrets that could occur if a defendant knew it was the target of a lawsuit—while sending a strong message regarding the seriousness of the just-filed lawsuit.

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The Bad:

Immunity and a Whistleblower Privilege

The DTSA immunizes employees, defined to include independent contractors and consultants, from criminal or civil liability under any federal or state trade secret law for disclosing trade secrets in confidence to federal, state, or local governments solely for purposes of reporting or investigating a suspected violation of law or in complaints and filings in anti-retaliation lawsuits relating to such disclosures.

The Act also states that companies "shall" provide notice of the immunity—in one of two ways—to employees, contractors, and individual consultants.

► The employer may provide notice in any contract or agreement with an employee that governs the use of a trade secret or other confidential information.

OR

► The employer can satisfy the notice requirement by providing a cross-reference to a policy document given to the employee that sets forth the employer's reporting policy for a suspected violation of law.

If an employer does not comply with the notice requirement, it may not be awarded exemplary damages or attorneys' fees in an action against an employee to whom notice was not provided.

Conclusion

The passage of the DTSA underscores that every business must think about protecting its trade secrets and guarding against claims for misappropriation by competitors. Under direction of legal counsel, companies should immediately review their policies and agreements to insure compliance with the DTSA, and should implement measures to address employee access to confidential information, ensure the return of all confidential information upon employee separation, and remind employees of their legal obligations after employment ends.

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